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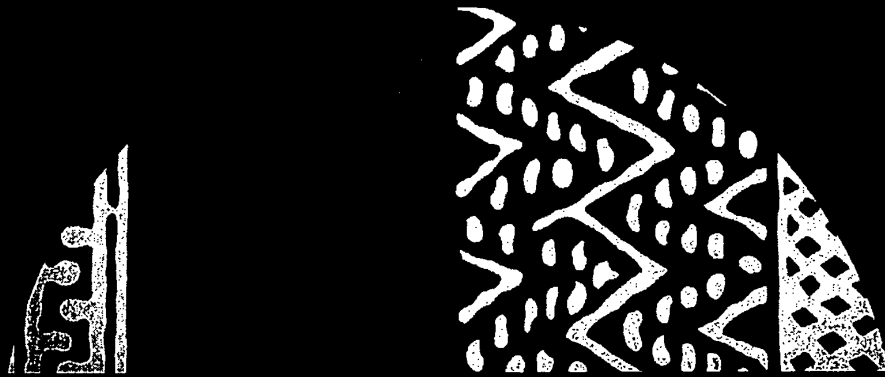
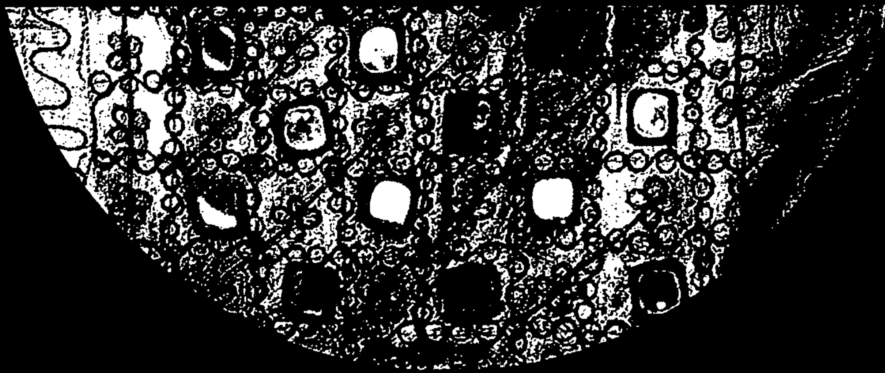


Africa's Silk Road

CHINA AND INDIA'S NEW ECONOMIC FRONTIER



THE WORLD BANK

HARRY G. BROADMAN

Acronyms and Abbreviations

ACP	Africa, the Caribbean, and the Pacific
AGOA	African Growth and Opportunity Act
ATI	Africa Trade Insurance Agency
AVE	*ad valorem* equivalent
BCSs	Business Case Studies
BIT	bilateral investment treaty
CBU	complete-build-up
CEMAC	Economic and Monetary Community of Central Africa
CII	Confederation of Indian Industry
CIS	Commonwealth of Independent States
CKD	complete-knock-down
COMESA	Common Market for Eastern and Southern Africa
DFID	United Kingdom Department for International Development
DFIZ	Dakar Free Industrial Zone
DOT	Direction of Trade Statistics
DTC	Diamond Trading Company
DTIS	Diagnostic Trade Integration Study
DTT	double taxation treaty
EAC	East African Community
EBA	Everything But Arms
EBID	ECOWAS Bank for Investment and Development

EBP	Enterprise Benchmarking Program
ECCAS	Economic Community of Central African States
ECOWAS	Economic Community of West African States
EFE	Free Export Enterprises
EOU	Export Oriented Units
EPA	Economic Partnership Agreement
EPA	export promotion agency
EPCG	Export Promotion Capital Goods
EPZ	export processing zone
EU	European Union
ExIm	Export-Import
FDI	foreign direct investment
FFE	Foreign Funded Enterprise
FIAS	Foreign Investor Advisory Service
FTA	free trade agreement
G-8	Group of Eight
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDI	gross domestic income
GDP	gross domestic product
GIPA	Global Investment Prospects Assessment
GSP	Generalized System of Preferences
HACCP	Hazard and Critical Control Point
ICA	Investment Climate Assessment
ICF	Investment Climate Facility
ICT	information and communications technologies
IF	Integrated Framework for Trade-Related Technical Assistance to Least Developed Countries
ILO	International Labor Organization
IMF	International Monetary Fund
IPA	investment promotion agency
ISO	International Organization for Standardization
IT	information technology
LAC	Latin America and the Caribbean
LDB	Live Database
LDC	least developed country
LOC	line of credit
MENA	Middle East and North Africa

MFA	Multifibre Arrangement
MFN	most favored nation
MIDP	Motor Industry Development Program
MIGA	Multilateral Investment Guarantee Agency
MNC	multinational corporation
NEPAD	New Economic Partnership for Africa's Development
NTB	nontariff barrier
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OEM	original equipment manufacturer
OFDI	outward foreign direct investment
OLS	ordinary least squares
R&D	research and development
RIA	regional integration agreement
RTA	regional trade agreement
SACU	Southern Africa Customs Union
SADC	Southern African Development Community
SEZ	Special Economic Zone
SITC	Standard International Trade Classification
SME	small and medium enterprise
SOE	state-owned enterprise
sqkm	square kilometer
SSA	Sub-Saharan Africa
TA	technical assistance
TACT	Air Cargo Tariff
TCMCS	Coding System of Trade Control Measures
TEST	Textile Support Team
TRAINS	Trade Analysis and Information System
TRI	Trade Restrictiveness Index
TRIMs	trade-related investment measures
UEPB	Uganda Export Promotion Board
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
US	United States
VAT	value added tax
WAEMU	West African Economic and Monetary Union
WBAATI	World Bank Africa-Asia Trade and Investment

WDI	World Development Indicators
WEO	World Economic Outlook
WTO	World Trade Organization

Note: All dollar amounts are U.S. dollars ($) unless otherwise indicated.

Overview

Connecting Two Continents

China and India's newfound interest in trade and investment with Africa—home to 300 million of the globe's poorest people and the world's most formidable development challenge—presents a significant opportunity for growth and integration of the Sub-Saharan continent into the global economy. These two emerging economic "giants" of Asia are at the center of the explosion of African-Asian trade and investment, a striking hallmark of the new trend in South-South commercial relations. Both nations have centuries-long histories of international commerce, dating back to at least the days of the Silk Road, where merchants plied goods traversing continents, reaching the most challenging and relatively untouched markets of the day. In contemporary times, Chinese trade and investment with Africa actually dates back several decades, with most of the early investments made in infrastructure sectors, such as railways, at the start of Africa's post-colonial era. India, too, has a long history of trade and investment with modern-day Africa, particularly in East Africa, where there are significant expatriate Indian communities. Today's scale and pace of China and India's trade and investment flows with Africa, however, are wholly unprecedented.

The acceleration of South-South trade and investment is one of the most significant features of recent developments in the global economy.

For decades, world trade has been dominated by commerce both among developed countries—the North—and between the North and the developing countries of the South.[1] Since 2000 there has been a massive increase in trade and investment flows between Africa[2] and Asia. Today, Asia receives about 27 percent of Africa's exports, in contrast to only about 14 percent in 2000. This volume of trade is now almost on par with Africa's exports to the United States and the European Union (EU)—Africa's traditional trading partners; in fact, the EU's share of African exports has halved over the period 2000–05.[3] Asia's exports to Africa also are growing very rapidly—about 18 percent per year—which is higher than to any other region.[4] At the same time, although the volume of foreign direct investment (FDI) between Africa and Asia is more modest than that of trade—and Sub-Saharan Africa accounts for only 1.8 percent of global FDI inflows[5]—African-Asian FDI is growing at a tremendous rate. This is especially true of Asian FDI in Africa.[6]

China and India each have rapidly modernizing industries and burgeoning middle classes with rising incomes and purchasing power. The result is growing demand not only for natural resource–extractive commodities, agricultural goods such as cotton, and other traditional African exports, but also more diversified, nontraditional exports such as processed commodities, light manufactured products, household consumer goods, food, and tourism. By virtue of its labor-intensive capacity, Africa has the potential to export these nontraditional goods and services competitively to the average Chinese and Indian consumer and firm.

With regard to investment, much of the accumulated stock of Chinese and Indian FDI in Africa is concentrated in extractive sectors, such as oil and mining. While this has been grabbing most of the media headlines, greater diversification of these countries' FDI flows to Africa has in fact been occurring more recently. Significant Chinese and Indian investments on the African continent have been made in apparel, food processing, retail ventures, fisheries and seafood farming, commercial real estate and transport construction, tourism, power plants, and telecommunications, among other sectors. Moreover, some of these investments are propelling African trade into cutting-edge multinational corporate networks, which are increasingly altering the "international division of labor." China and India are pursuing commercial strategies with Africa that are about far more than resources.

Despite the immense growth in trade and investment between the two regions, there are significant asymmetries. While Asia accounts for one-

quarter of Africa's global exports, this trade represents only about 1.6 percent of the exports shipped to Asia from all sources worldwide. By the same token, FDI in Asia by African firms is extremely small, both in absolute and relative terms. At the same time, the rise of internationally competitive Chinese and Indian businesses has displaced domestic sales as well as exports by African producers, such as textile and apparel firms, whether through investments by Chinese and Indian entrepreneurs on the Sub-Saharan continent or through exports from their home markets. This competition spurs African firms to become more efficient, but it also creates unemployment and other social costs during the transition. Not surprisingly, some African governments are responding with policies that protect domestic businesses.

As the global marketplace continues to be increasingly integrated, with rapidly changing notions of comparative advantage, much is at stake for the economic welfare of hundreds of millions of people in Sub-Saharan Africa. With this newest phase in the evolution of world trade and investment flows taking root—the increasing emergence of South-South international commerce, with China and India poised to take the lead—Africans cannot afford to be left behind, especially if growth-enhancing opportunities for trade and investment with the North continue to be as limited as they have been. Nor can the rest of the world, including Africa's international development partners, afford to allow Africans to be unable to genuinely participate in—and most important, benefit from—the new patterns of international commerce.

Objectives of the Study

Against this backdrop, there is intense interest by policy makers and businesses in both Africa and Asia, as well as by international development partners, to better understand the evolution and the developmental, commercial, and policy implications of African-Asian trade and investment relations. This interest is reflected, perhaps most notably, in the South-South discussions held during the African-Asian summit in Jakarta in April 2005 celebrating the fiftieth anniversary of the Bandung Declaration, where the dramatic rise in international commerce between the two regions figured prominently, as well as at the July 2005 G-8 summit in Gleneagles, where the leaders of the North underscored the growing importance of South-South trade and investment flows, especially as they

pertain to the prospects for fostering growth and poverty reduction in Africa.

Yet despite the sizeable—and rapidly escalating—attention devoted to this topic, especially by some of the world's most senior officials, there is, surprisingly, a paucity of systematic data available on these issues to carry out rigorous analysis, and from which inferences of a similar caliber could be drawn to meet the interest and provide the desired understanding. The vast majority of accessible information is based on anecdotes or piecemeal datasets, which make a well-informed assessment difficult to generate.

This study utilizes new firm-level data from a large World Bank quantitative survey and from originally developed business case studies, both carried out by the World Bank in the field in mid-2006 in four countries—Ghana, Senegal, South Africa, and Tanzania. The survey and business case studies focused on the African operations of Chinese and Indian businesses, as well as the operations of domestic (African-owned) and other internationally owned firms located in Africa.[7] Based on these data, official government statistics, and existing data compiled by the World Bank and other donors, the study seeks to answer:

- *What* has been the recent evolution of the pattern and performance of trade and investment flows between Africa and Asia, especially China and India, and *which* factors are likely to significantly condition these flows in the future?

- *What* have been the most important impacts on Africa of its trade and investment relations with China and India, and *what* actions can be taken to help shape these impacts to enhance Africa's economic development prospects?

In focusing on these questions the study examines four key factors that are significantly affecting trade and investment between Africa and Asia:

- *"At-the-border" trade and investment policies,* including policies affecting market access (tariffs and nontariff barriers (NTBs)); FDI policy regimes; and bilateral, regional, and multilateral trade agreements;

- *"Behind-the-border" (domestic) market conditions,* including the nature of the business environment; competitiveness of market structures; quality of market institutions; and supply constraints, such as poor infrastructure and underdeveloped human capital and skills;

- *"Between-the-border" factors,* including the development of cross-border trade-facilitating logistical and transport regimes; quantity and quality of information about overseas market opportunities, including through expatriates and the ethnic diasporas; impacts of technical standards; and the role of migration;
- *Complementarities between investment and trade,* including the extent to which investment and trade flows leverage one another; the effects of such complementarities on scale of production and ability of firms to integrate across markets; participation in global production networks and value chains; and spillover effects of transfers of technology.

The first set of factors is typically presumed by most observers to be dominant in affecting trade and investment relations between Africa and Asia. This study finds, however, that the effects of formal trade and investment policies are likely to be of equal, if not secondary, importance compared to the latter three sets of factors. The analysis finds that behind-the-border and between-the-border conditions, as well as the interactions between investment and trade flows, are the major elements that influence the extent, nature, and effects of Africa's international commerce with China and India, and therefore these are the areas on which the priority for policy reforms likely should be placed.

The assessment undertaken in this study is largely economic in nature. In this regard, the analysis focuses on political economy, governance, and institutional issues insofar as they directly have economic implications. Important as these issues are, however, the intention here is not to focus on them per se; they are topics deserving of separate, dedicated study.

Moreover, the study's prism is largely on the impacts on Africa of China and India's trade and investment flows to that continent, rather than the reverse. To be sure, the analysis does cover lessons that can be drawn from Asia's economic success stories that might be applicable for Africa. But a focus on the implications of African-Asian trade for China and India is beyond the scope of the study.

Finally, Sub-Saharan Africa is not a country: it is a very heterogeneous continent comprising 47 nations with great variations in physical, economic, political, and social dimensions. The bulk of the analysis focuses on those African countries for which new data have been collected specifically for this study, or for which there are systematic data from which economically meaningful analysis, including cross-country comparisons, can be

made. The countries that are the subject of the analysis were chosen to be somewhat representative of the continent, but there is no pretense that the study's findings are necessarily applicable to all African countries.

The following sections summarize the study's main findings.

Africa in the Global Economy

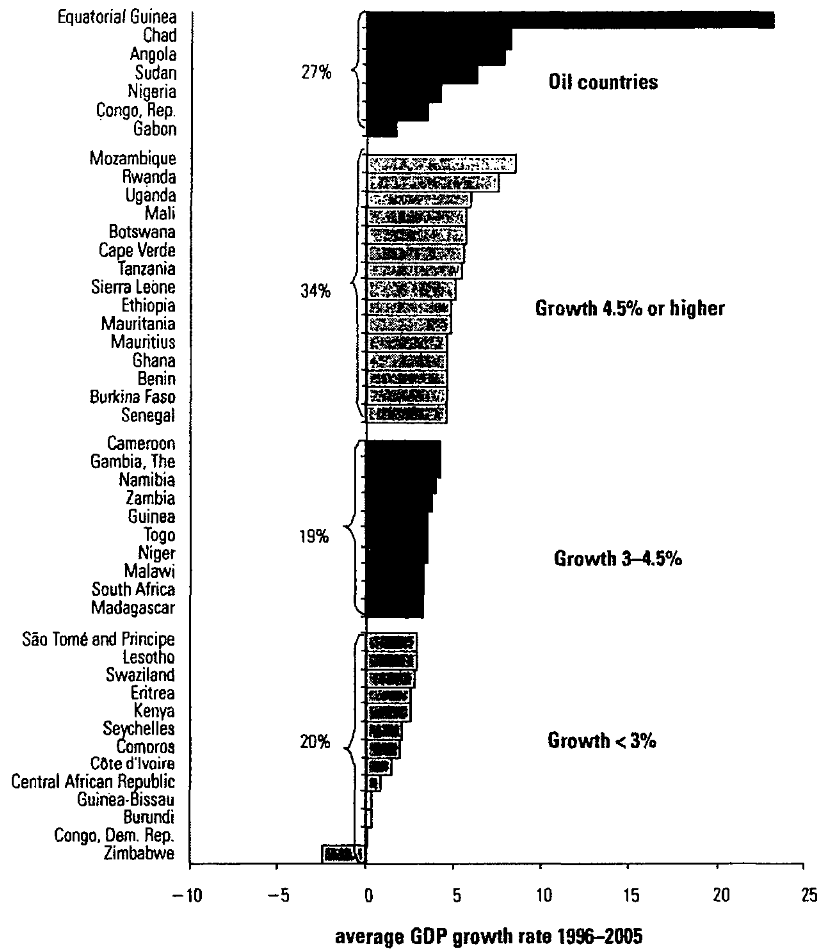
Economic development patterns in Africa have become increasingly diverse over the last decade, with more and more success stories; see figure 1. Since the mid-1990s, 19 Sub-Saharan countries have had annual GDP growth of 4.5 percent or higher. The rise in the world price of oil is certainly a major factor at play for some of these countries. One-third of the world's resource-dependent economies are in Africa. Yet even excluding the oil-rich countries, the fastest growing group of African countries (total 15 countries) has had an average growth rate of at least 4.5 percent. These countries host 34 percent of the region's people. By contrast, the 13 slowest-growing economies in Africa have seen less than 3 percent growth on average, with some having near zero or negative growth. These countries, many either engaged in conflict or having recently emerged from conflict, account for 20 percent of the region's people.

Africa is quite diverse in other aspects. Geography has played a major role in shaping its economic fortunes. The continent has the largest number of countries per square area in comparison with other developing regions, with each on average sharing borders with four neighbors. Africa is also highly geographically segmented. A large proportion of its population lives in countries with an unfavorable geographic and economic basis for development. Forty percent of Africans live in landlocked countries, compared with 23 percent of the population in East and Central Asia. Moreover, Africa's low population density is accentuated by high internal transport costs, estimated at nearly twice the levels of other developing regions. The result is that, except for South Africa and Nigeria—the two dominant economies in Africa—the continent is comprised of countries that have small and shallow markets.

All told, these conditions—compounded by underdeveloped market institutions, constraints on business competition, and weak governance—make international trade and investment in Africa costly. World trade and investment flows have dramatically expanded in the last 15 years, but the African continent's overall trade performance in the global marketplace

FIGURE 1

Africa's Development Pattern is Increasingly Diverse, with More and More Success Stories



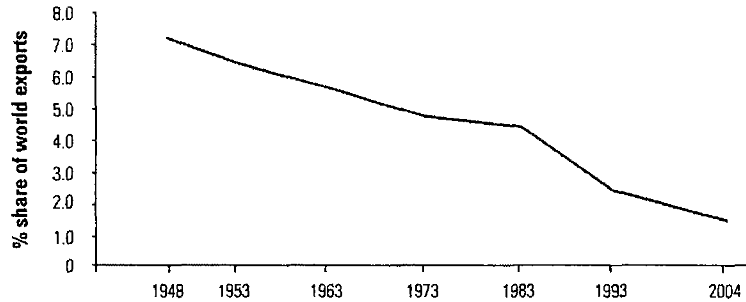
Source: World Bank World Development Indicators.

has been very disappointing. In fact, Africa's overall export market share has continuously fallen over the last six decades; see figure 2. Unless reversed, this pattern does not bode well for sustained growth on the continent. In spite of Africa's recent rapid growth of FDI inflows, the continent accounts for 1.8 percent of global net FDI flows; see figure 3.

Africa's merchandise exports are dominated by oil. In fact, Sub-Saharan Africa is the only region of the world that has not exhibited an increasing

FIGURE 2

Africa's Share of World Exports Has Been Declining



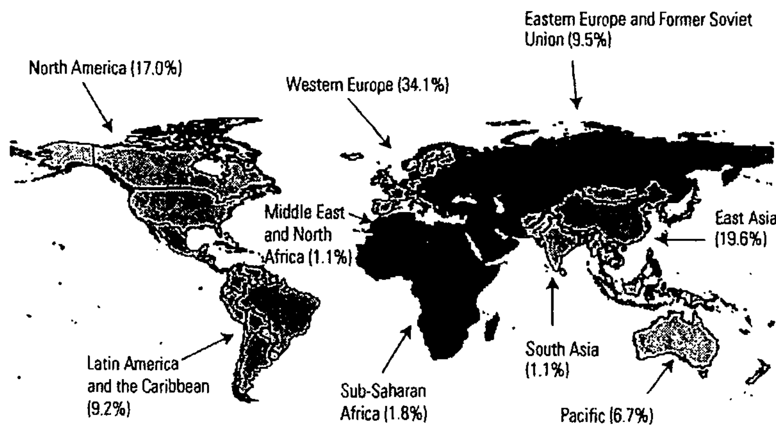
Source: IMF Direction of Trade Statistics.

share of non-oil exports over the last two decades; see figure 4. This disappointing performance means that Africa has not taken full advantage of international trade to leverage growth.

The countries in Africa experiencing strong growth outside the oil-producing nations have been buoyed, in part, by global price increases in other primary export commodities. As illustrated in figure 5, with the exception of raw materials, whose prices have been relatively stagnant, other commodities, including metals and non-oil minerals, have experienced noticeable increases in their price levels. This worldwide rise of com-

FIGURE 3

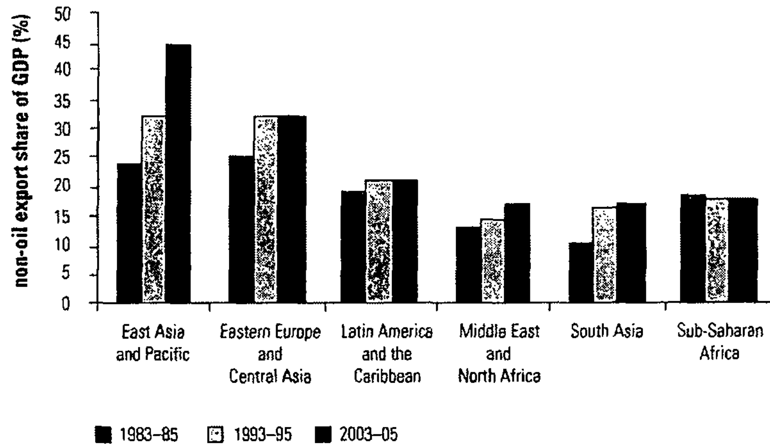
Africa Accounts for 1.8 Percent of Global FDI Flows



Source: World Bank World Development Indicators.

FIGURE 4

Africa Is Virtually the Only Region that Has Not Increased its Share of Non-Oil Exports

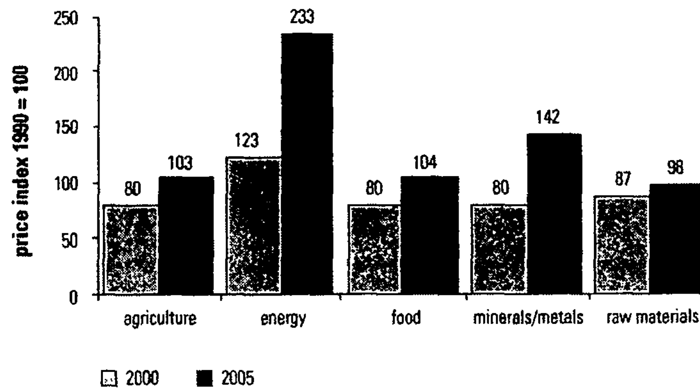


Source: IMF Direction of Trade Statistics.

modity prices has been engendered in large part by the rapid growth of Asian developing countries, especially China and India. They contributed close to 40 percent of global import growth for precious stones, 30 percent for crude oil, and 20 percent for metallic ores; see figure 6. Their demand for these commodities is likely to grow, or at least not change from current levels, in the foreseeable future.

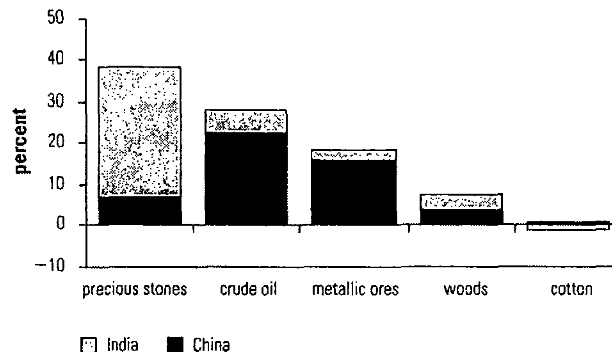
FIGURE 5

Prices Have Risen for Many of Africa's Major Export Commodities, Not Just Oil



Source: World Bank staff estimates.

FIGURE 6
China and India's Contribution to Global Commodity Demand, 2000–04



Source: Goldstein et al. 2006.

Still, a number of countries in Africa are diversifying their exports, no longer relying solely on the export of a few raw commodities. Exports are increasingly composed of light manufactured goods, processed foods, horticulture, and services such as tourism. Some countries—such as Nigeria and South Africa—have been increasing their shares of exports in technology-based products. In fact, they are moving up the technology ladder and exporting low- to medium-technology products in sectors where Asian countries are increasingly putting less emphasis.

Country-Level Patterns and Performance of African-Asian Trade and Investment Flows

There has been a dramatic increase in trade flows between Africa and Asia, and this trend is a major bright spot in Africa's trade performance. These trade flows are largely driven by economic complementarities between the two regions. Africa has growing demand for Asia's manufactured goods and machinery, and demand in Asia's developing economies is growing for Africa's natural resources, and increasingly for labor-intensive goods. Factor endowments and other economic resources will likely continue to yield these strong country-level African-Asian complementarities, indicating the likely sustainability of the current African-Asian trade boom.

The volume of African exports to Asia is growing at an accelerated rate: while exports from Africa to Asia grew annually by 15 percent between

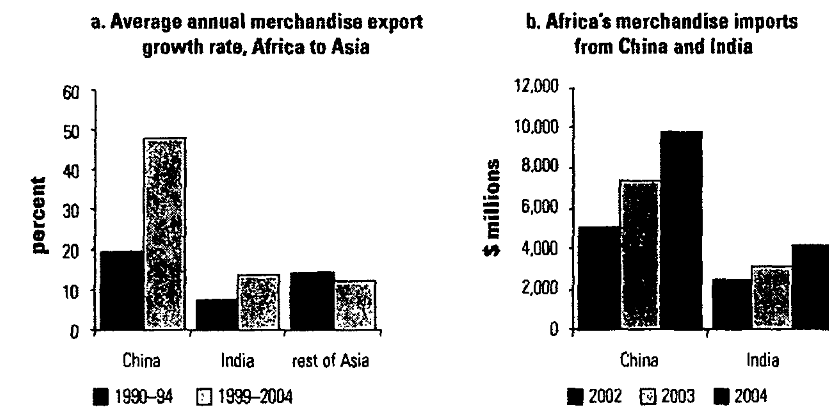
1990 and 1995, they have grown by 20 percent during the last five years (2000–05). Asia is now a major trading partner of African countries. Asia accounts for 27 percent of Africa's exports, an amount that is almost equivalent to the EU and US share of Africa's exports, 32 percent and 29 percent, respectively. Despite this growth, Africa's exports still remain relatively small from the Asian perspective: Africa's exports to Asia account for only 1.6 percent of Asian global imports.

The recent growth of African exports to Asia largely reflects a sharp upturn in its exports to China and India. African exports to these two countries have been rising dramatically; see figures 7a and 7b. Though China and India still account for only 13 percent of all of Africa's exports, Africa's exports to China and India have grown 1.7 times the growth rate of the continent's total exports worldwide. Between India and China, it is China that is the more dynamic destination market for Africa's exports. Exports to China grew by 48 percent annually between 1999 and 2004, compared to 14 percent for India. Ten percent of Sub-Saharan exports are now to China and some 3 percent are to India. China has overtaken Japan as the leading importer of African products in Asia.

The growth in African exports to China and India in the last few years is largely driven by large unmet domestic demand for natural resources in those countries, reflecting growing industries as well as increasing consumption by households. Petroleum is the leading commodity, followed by

FIGURE 7

A Steady, Dramatic Rise of China and India as Destinations for African Exports



Source: IMF Direction of Trade Statistics.

ores and metals. That oil dominates Africa's exports to China and India is part of the larger profile of Africa's global export pattern.

Africa's rapidly growing exports to China and India are not limited to fuels and other mineral and metal products. Labor-intensive raw or semi-processed agricultural commodities that are used for further processing either for industrial use (timber, cotton) or for consumer use (food products) are also increasingly imported by China and India. Still, taken together, petroleum, metals, and agricultural raw materials account for 85 percent of Africa's exports to China and India.

The current geographic distribution of Africa's origin markets for the continent's exports to China and India is concentrated. Five oil- and mineral-exporting countries account for 85 percent of Africa's exports to China. South Africa alone accounts for 68 percent of Sub-Saharan exports to India.

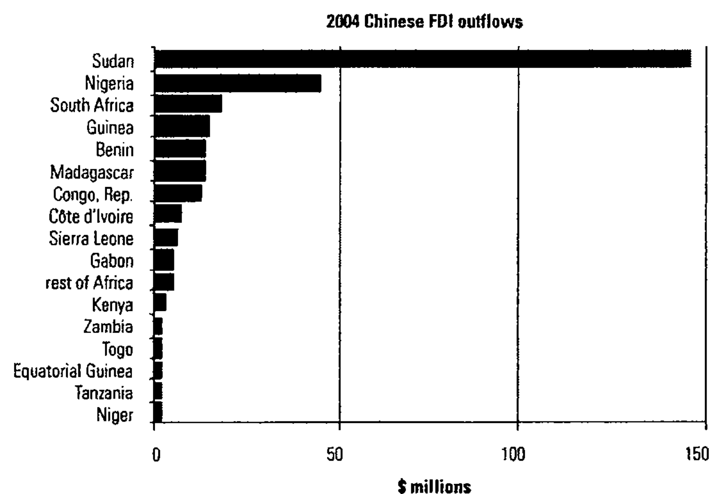
Asian exports to Africa are also increasing. Over the last five years, they have grown at an 18 percent annual rate, higher than that of any other region, including the EU. These exports are largely manufactured goods, which have surged into African markets. Some of them are intermediate inputs for products assembled in Africa and shipped out to third markets, such as the EU and United States, or capital goods (machinery and equipment) for African manufacturing sectors themselves. At the same time, there is also a sizable amount of African imports of consumer nondurables from Asia, which compete against Africa's domestically produced products.

African-Asian FDI flows are also growing rapidly, but the volume of such flows is more modest than that of trade. While there is some African FDI in China and India, this investment is dominated by the flows of Chinese and Indian FDI in Africa. As of mid-2006, the stock of China's FDI to Africa is estimated to be $1.18 billion.

The vast majority of Chinese and Indian FDI inflows to Africa over the past decade have been largely concentrated in the extractive industries. Because such investments are typically capital intensive, they have engendered limited domestic employment creation. However, in the last few years, Chinese and Indian FDI in Africa has begun to diversify into many other sectors, including apparel, agroprocessing, power generation, road construction, tourism, and telecommunications, among others. Chinese and Indian FDI in Africa has also become more diversified geographically; figure 8 shows the current country distribution of Chinese FDI flows to Africa.

FIGURE 8

Current Chinese FDI Outflows to Africa are Largely, But Not Exclusively, Resource-Oriented



Source: Chinese FDI Statistics Bulletin.

Examining the Determinants of the Patterns of African-Asian Trade Flows

What are the principal factors that account for the differences observed in the patterns of African-Asian trade flows? At-the-border formal trade policies are often at the forefront of negotiations and discussions on international commerce. Obviously, tariff and nontariff barriers (NTBs) are the primary targets of trade liberalization. It is thus important to investigate the impact of such factors on the patterns of Africa's trade flows with Asia. More liberal import policies (for example, low tariff rates) taken by individual countries should facilitate more trade flows among such countries. Preferential market access measures or free trade agreements also should stimulate more trade flows.

However, changes in formal trade policies are only a necessary and not a sufficient condition for engendering cross-border trade. For trade to take place, tradable, internationally competitive goods and services need to be produced. Most African nations, like other developing countries, possess a rather thin base of internationally competitive private sector enterprises and the related institutions and infrastructure needed for them to be able to engage in sustainable and commercially attractive international transac-

tions. Under these conditions, arguably there would be limited or perhaps no supply response to any beneficial reforms in trade and investment policies that might materialize. Simply put, without such reforms, new trade and investment opportunities will likely go unexploited by Africa. At the same time, for the goods and services produced to be traded efficiently, sufficient capacity is needed for trade-facilitating infrastructure, institutions, and services to lower "between-the-border" trade-related transactions costs.

A large number of *qualitative* studies have been conducted to analyze how "at-the-border," "behind-the-border," and "between-the-border" factors influence the trade performance of developing countries. Prominent among them are the Diagnostic Trade Integration Studies (DTISs) carried out under the Integrated Framework for Trade-Related Technical Assistance to Least Developed Countries (IF) program. DTISs have been developed for 26 countries in Africa to identify country-specific bottlenecks for promoting trade in those countries. These studies find that these three factors are indeed major parameters affecting African trade performance. But due to their country-specific, qualitative nature, these instruments have little capacity to systematically gauge how these various factors impact African countries across the board. Nor do they give a sense of the relative importance of such impacts. To do so requires a *quantitative* cross-country approach.

"Gravity models" of bilateral trade flows provide useful information as to how significant are the various policy factors in influencing the pattern of overall trade flows between Africa and Asia on a cross-county basis. An estimated multivariate gravity model is applied to bilateral trade flows of African countries to and from various countries in the world, including Asian countries as well as African countries themselves. In addition to standard economic and geographic factors such as GDP, GDP per capita, physical distance, and common language, among others, the model incorporates variables depicting the stance of formal trade policies (at-the-border factors), intensity of domestic business constraints (behind-the-border factors), and extent of development of institutions and infrastructure that facilitate trade and lower transactions costs (between-the-border factors). (The model also incorporates variables that permit an assessment of the extent to which African-Asian investment and trade flows complement (or leverage) rather than substitute for one another; see below.)

Table 1 summarizes the direction of statistically significant impacts from various factors based on the signs of coefficients estimated by Ordinary Least Squares (OLS) regressions. (Although not reported in the table, most of the economic, geographical, historical, and cultural factors have the predicted signs and their coefficients are statistically significant.) All of the statistically significant coefficients display the expected sign. Moreover, the results from the estimation procedures show that the same factors are equally important when examining Africa's trade performance on a global basis or its trade performance vis-a-vis Asia in particular. This indicates the robustness of the estimated model.

The empirical analysis shows that, on a cross-country basis, in addition to trade policy variables, both behind-the-border and between-the-border factors significantly influence the trade performance of African countries. In fact, the analysis suggests that the impacts of behind-the-border and between-the-border factors on the export propensity and orientation of international commerce between African and Asian countries are at least

TABLE 1

What Determines Bilateral African-Asian Trade Flows? Relative Roles of "At-the-Border," "Behind-the-Border," and "Between-the-Border" Factors

Indicator	All merchandise trade		Manufactured trade	
	Exports from Africa	Imports to Africa	Exports from Africa	Imports to Africa
At-the-border factors				
Importer trade testrictiveness	n.s.	n.s.	–	n.s.
Regional trade agreement	+	+	+	n.s.
Preferential market access	n.s.	n.s.	+	n.s.
Between-the-border factors				
Customs procedure—exporter	–	n.s.	–	n.s.
Customs procedure—importer	+	n.s.	n.s.	n.s.
Internet access—exporter	+	+	+	+
Internet access—importer	n.s.	n.s.	n.s.	n.s.
Port quality—exporter	–	+	–	+
Port quality—importer	+	+	+	+
Behind-the-border factors				
Domestic business procedure—exporter	–	n.s.	–	n.s.
Power infrastructure quality—exporter	n.s.	n.s.	+	n.s.

Source: Authors' calculations based on 2002–04 average figures. See chapter 2 for details.

Note: Only the signs of significant coefficients are shown (level of significance above 10 percent). "n.s." represents a coefficient not statistically significant.

equal to or even greater than those of formal at-the-border policies. For example, it is estimated that a 10 percent reduction in domestic barriers to new business start-ups or a 10 percent improvement in domestic electric power service would increase Africa's manufactured exports by about 28 percent or 15 percent respectively.

We now turn to examine in detail the overall impacts of these various factors on African-Asian trade and investment.

Role of At-the-Border Policies

Tariff structures of African countries as well as China and India still have some unfavorable elements that constrain mutual trade. Because China, India, and most African countries are members of the World Trade Organization (WTO), as a rule, their tariffs are generally set on a nondiscriminatory, Most-Favored-Nation (MFN) basis. One of the objectives of the WTO Doha Round, which at present is suspended, is to seek a global agreement to lower countries' various MFN tariffs.

With some important exceptions, the import tariff rates African exporters face in Asia are higher than those they face in the United States and the EU. Among Asian countries, the tariff levels of China and India on African products remain high. Tariff rates on agricultural products are high in both countries. The prevalence of high tariff rates in India is broadly based. China is a relatively liberalized market. It has zero tariffs for its most highly demanded raw materials, including crude petroleum and ores, but has moderate-to-high tariffs on other imports, especially on inedible crude materials from the South. China has announced plans to further lower its tariffs and bring about lower dispersion in the structure of tariffs by the end of 2007.

Particularly problematic is the fact that in certain cases, tariff escalation in Asian markets has been discouraging the export of higher value-added processed products from Africa. This is especially true for some of Africa's leading exports to China and India, including coffee, cocoa beans, and cashews, to pick but three examples; see table 2.

Like Asian countries, Africa also has many tariff peaks against Asian imports. Textiles, yarn, apparel, footwear, and light manufactured goods are among Africa's largest imports from Asia; they also carry some of the highest tariffs in Africa. However, other significant imports from China and India, including electronics, machinery, and transportation equip-

TABLE 2
Africa's Leading Exports Face Escalating Tariffs in China and India

SITC	Product	African imports			
		China	India	Japan	Asia average
211	Raw hides	6.5	0.1	0	0.8
611	Leather	8.8	14.7	0.7	4.6
612	Manufactures leather	14.6	15.0	1.9	7.9
222	Oil seeds	5.0	30.0	0.4	2.0
423	Vegetable oils	10.0	45.0	—	27.7
07111	Coffee, not roasted	8.0	100.0	0	2.3
07112	Coffee, roasted	15.0	30.0	9.1	9.1
0721	Cocoa beans, raw	8.0	30.0	0	2.8
0722	Cocoa powder	15.0	—	—	0.2
333	Petroleum oils, crude	0	—	—	0.2
334	Petroleum products, refined	7.4	15.0	2.1	0.3
66722	Diamonds, sorted	3.0	—	0	2.2
66729	Diamonds, cut	8.0	15.0	0	6.0
6673	Other precious/semi-precious stones	7.3	15.0	0	9.0
897	Jewelry	26.8	15.0	0.9	15.7
263	Cotton	27.0	10.0	0	14.8
6513	Cotton yarn	5.0	15.0	—	5.0
652	Cotton fabrics, woven	10.0	15.0	1.0	5.6
84512	Jerseys, etc. of cotton	14.0	—	5.7	6.8
8462	Under garments, knitted	14.1	15.0	6.9	5.2

Source: UNCTAD TRAINS.

Note: Darker shades represent higher levels of processing; — = data not available.

ment, generally have relatively low tariffs. Although African tariff barriers have been lowered significantly, some high tariffs on intermediate inputs into African countries constrain African manufacturing exports. This bias against exports is an obvious target for reform by African policy makers.

Non-tariff barriers (NTBs), such as technical standards, pose special challenges to African exports to Asia (as well as elsewhere). Most countries in Africa lack the institutional capacity and resources to fully implement or effectively enforce these standards. This diminishes the ability of domestic producers to penetrate certain export markets in Asia, including China and India.

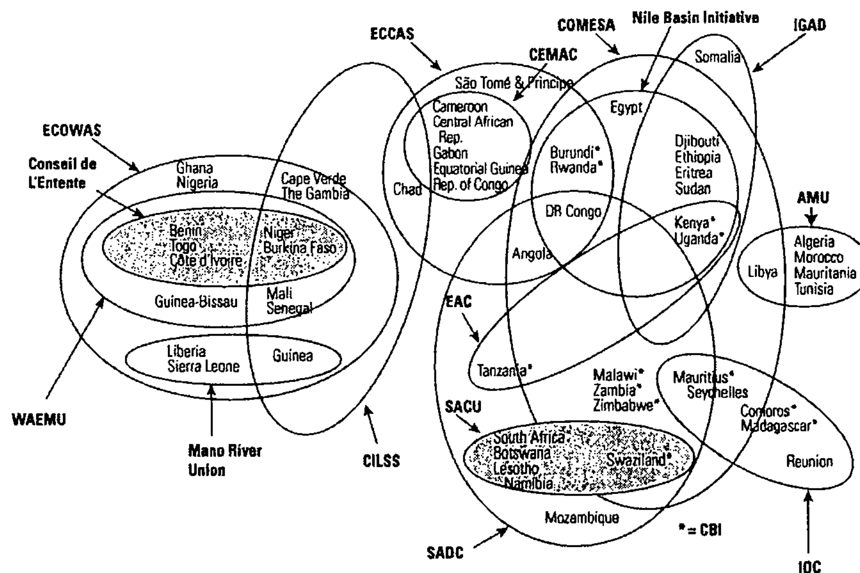
As in other areas of the world, there has been a proliferation of regional and bilateral trade and investment agreements on the African continent in recent years, including reciprocal agreements among other countries in the South, including China and India. No bilateral free trade agreements

(FTAs) are currently in effect between Asian and African countries, but several are either under negotiation or have been proposed; these include a China–South Africa FTA, an India-Mauritius economic cooperation and partnership agreement, and an India-SACU (Southern Africa Customs Union) FTA.

The fashioning of the emerging "spaghetti bowl" of regional trade agreements among African countries, while perhaps being done with good intentions, in practice is not having demonstrable salutary effects; see figure 9. Many Chinese and Indian investors—not to mention African and other foreign investors—find them at best, ineffective, or at worst, confusing, and not conducive to attracting international commerce.

FIGURE 9

The Spaghetti Bowl of African Regional Trade Agreements is Not Investor Friendly



Source: World Bank.

Note: AMU: Arab Maghreb Union; CBI: Cross Border Initiative; CEMAC: Economic and Monetary Community of Central Africa; CILSS: Permanent Interstate Committee on Drought Control in the Sahel; COMESA: Common Market for Eastern and Southern Africa; EAC: East African Cooperation; ECOWAS: Economic Community of Western African States; IGAD: Inter-Governmental Authority on Development; IOC: Indian Ocean Commission; SACU: Southern African Customs Union; SADC: Southern African Development Community; WAEMU: West African Economic and Monetary Union.

There are also a few African-Asian preferential arrangements. Of significance in this regard is the unilateral liberalization by China in early 2006 of certain African imports: tariffs were eliminated on 190 commodities from 25 African countries. There are also preferential arrangements provided by developed countries in the North, such as the U.S. African Growth and Opportunity Act (AGOA) and the EU Everything But Arms (EBA) programs, which also facilitate market access for exports from Africa produced by Chinese and Indian firms operating in Africa. Among other effects, these have encouraged Asian investment in manufacturing sectors such as the apparel industry in Lesotho and automobile assembling in South Africa. The size of the benefits derived from preferential arrangements diminishes significantly when market barriers for other competitors are lowered, challenging the sustainability of such regimes.

In addition to formal international agreements, African-Asian trade and investment are also influenced—in varying degrees—by other instruments. Investment promotion agencies (IPAs) and public-private investors' councils in African and Asian countries have been playing an increasing and critical role in facilitating international commerce between the two regions. China and India have also established various other mechanisms in the hopes of stimulating trade and investment with Africa. A recent—and perhaps most notable—initiative is the January 2006 release in Beijing of "China's Africa Policy."[8] The white paper identifies a large set of economic issues over which China proposes to cooperate with Africa, including trade, investment, debt relief, economic assistance, finance, agriculture, and infrastructure.

While some export and investment incentives, such as export processing zones (EPZ), have been successful in China and India, in Africa, with only a few exceptions, their potential to stimulate exports has not effectively materialized. Export incentives in African countries have also had mixed results in creating backward production linkages and enhancing value-added in processed exports. The general ineffectiveness of such incentives on the African continent is due, in part, to significant implementation and enforcement challenges in the face of generally weak institutional capacities. Without strong governance discipline and incentives in place, opportunities for discretionary behavior and corruption have arisen. The ineffectiveness of export and investment incentives is also due to the lack of the requisite infrastructure and labor skills.

"Behind-the-Border" Factors

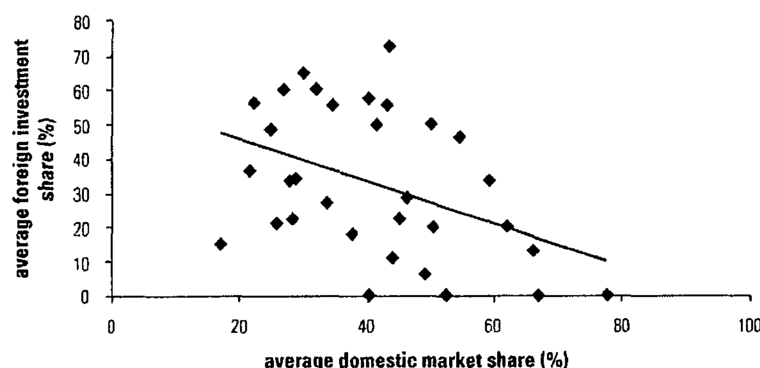
Competition is a potent force in affecting Africa's integration with Asia, particularly with businesses from China and India, and the influence occurs through a variety of channels. Domestic competition matters significantly in explaining the performance of firms operating in Africa—regardless of nationality—both in terms of productivity and international integration through exports. Intense competition on the sales side enhances both productivity and export performance. Tougher import competition, lower barriers to entry and exit, and less reliance on sales to government through public procurement, for example, tend to result in a higher propensity to export, again, across firms of all nationalities. The more competitive are African input markets, the more competitive are product markets, and both productivity and export performance are enhanced.

Scale strongly influences the performance of firms operating in Africa. This is true regardless of the nationality of the business. Larger firms outperform surveyed smaller firms both in terms of productivity and exports. Smaller firms in Africa face tougher competition overall than do larger firms, resulting in higher firm turnover among smaller businesses. However, in the case of competition from imports, larger firms are more affected, in part because they have a higher propensity to import and a greater tendency to populate import-sensitive sectors than do their smaller counterparts.

The sectors in Africa that exhibit more competition are not only able to attract more FDI, but also are more effective in penetrating foreign markets through exports. In this way, domestic competition and international integration are mutually reinforcing. The lesson for African firms is clear: "success at home breeds success abroad," a finding consistent with recent experience in other regions of the world, including firms in the "transition" countries in the former Soviet Union.[9]

There is a clear role played by the entry of Chinese and Indian investors in fostering domestic competition in African markets; see figure 10. In fact, a mutually reinforcing effect is found: African firms that face more competitive markets at home have greater involvement with Chinese and Indian capital, while the African markets where Chinese and Indian investors are most prevalent tend to be the most competitive. The analysis also shows that the major source of the competition engendered in the African markets by the presence of Chinese and Indian investors is competition from imports—indeed imports from China and India themselves.

FIGURE 10
Chinese and Indian Foreign Investors Foster Competition in African Markets



Source: World Bank staff.

As is the case throughout much of the African continent, Chinese and Indian businesses face high transactions costs behind-the-border in the locales in which they operate. The result is diminished attraction of trade and investment by investors from China and India (as well as from other countries) than otherwise would be the case. Four elements of the high cost of doing business in Africa by Chinese and Indian firms stand out:

- poor quality of infrastructure services (power supply, telephone services, Internet access),
- inefficient factor markets (lack of skilled labor, rigidities in the domestic labor market, and limited access to local finance),
- unfavorable regulatory regimes, and
- weak governance disciplines.

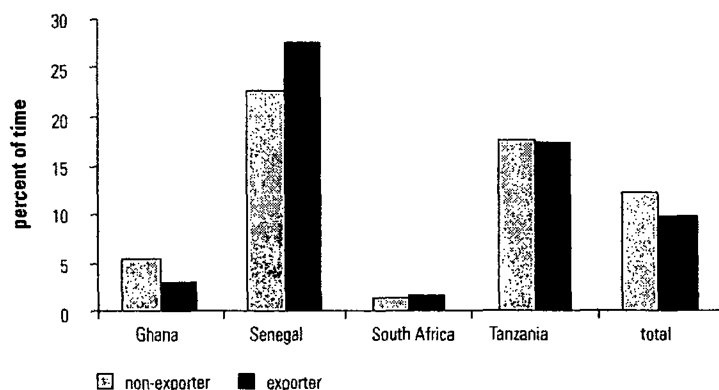
Figure 11 illustrates the burden that exporters face from the interruption of electric service from the public grid.

"Between-the-Border" Factors

Africa's trade and investment flows with Asia are affected by the amount of economic or institutional "friction" between-the-borders, as is the case for trade and investment between other regions of the world. As a result, building new trade and investment relations is associated with incurring

FIGURE 11

Exporters in Africa Face Significant Interruption in Electricity Service from the Public Grid, Lowering Their International Competitiveness



Source: World Bank 2005d, 2005e, and 2004a for Senegal, South Africa, and Tanzania. Teal et al. (2006) for Ghana.

certain—and often, large—costs. Such costs arise from, among other things, assessing new market opportunities, searching for new trading or investment partners, establishing financing and marketing channels, transferring personnel and technology, conforming with customs regulations and technical standards, and determining how best to utilize logistical, transport, and communications systems, especially for landlocked countries, which are prominent on the Sub-Saharan continent.

These costs can be lowered through a variety of means. Search costs, for example, can be reduced through use of either formal channels—whether on a businesses-to-business or a government-to-government basis—or informal "soft" networks, such as ethnic networks and the diasporas.

TABLE 3

Remedying Information Market Imperfections

(percent)

	Ethnic origin of owner			
Nationality of owner	African	Chinese	Indian	European
African	100	4	48	51
Chinese	0	93	0	1
Indian	0	0	45	0
European	0	0	4	41
Other	0	4	3	7

Source: World Bank staff.

Reducing costs arising from logistical bottlenecks can come about through improvement in (or development of) trade facilitation infrastructure and related institutions. The availability of trade finance and risk insurance can help address commercial considerations. In some respects, Africa and Asia are two regions that are still widely apart: there are large gaps of knowledge about each other's markets, and there are only limited direct interregional transport services (air, maritime shipping services, and passenger routes). The limited provision of such services could be binding constraints to trade and investment flows between the two regions.

For African, Chinese, and Indian investors, there are significant imperfections and asymmetries in the quality of market information regarding potential cross-border commercial opportunities for the two regions. Ethnic networks are increasingly relied on to facilitate the flow of such information and to compensate for these imperfections and asymmetries. There is a striking difference in the reliance on ethnic networks between Indian and Chinese firms operating on the continent; see table 3. About one-half of the owners of surveyed firms in Africa that are of Indian ethnic origin are in fact African by nationality. (A similar proportion exists for European owners of the surveyed African firms.) These figures suggest that Indian (and European) migrants are substantially integrated into the business community in Africa.

On the other hand, there is near identity in the proportion of owners of surveyed Chinese firms operating in Africa who are Chinese both by nationality and by ethnicity. This underscores the fact that Chinese investors in Africa are relative newcomers and have not, at this juncture, integrated into the African business community to any significant degree; this notion is explored more deeply in chapter 6. Instead, recent Chinese investments in Africa, as evidenced in virtually all of the business case studies carried out for this analysis, have been largely accompanied by temporary assignments of executives to the African continent. As Chinese investment in Africa has grown, it is estimated that some 80,000 migrant workers from China have moved to Africa, creating a new Chinese diaspora.[10]

At the same time, given that impediments to cross-border information flows are inherent in international trade and investment—particularly in the most underdeveloped countries in the world—public information services run by governments or by private firms are proving to be very important. In addition, there has been a growing role for institutional providers

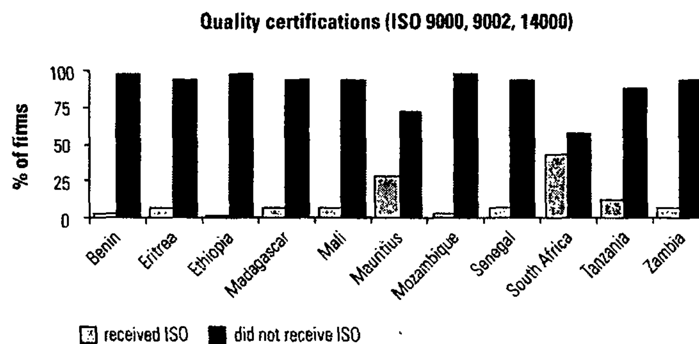
of export market information, such as export promotion agencies, and the similar providers of foreign investment information, such as investment promotion agencies.

The adherence by African firms to internationally recognized technical standards and accreditation schemes, such as those governed by the International Organization for Standardization (ISO), is extremely low; see figure 12. Indeed, only 34 countries in Sub-Saharan Africa belong to the ISO. This limits the ability of potential importers in Chinese and Indian markets to readily assess the quality of an African export in comparison to other internationally transacted products.

The flows of technology and labor—line workers as well as professionals—between Africa and Asia are facilitating the formation of business links between the two regions, which then lead to trade and FDI flows. In fact, there is a mutually reinforcing effect between trade and investment on the one hand, and skills and technology transfers on the other. For example, among surveyed Chinese and Indian firms operating in Africa, on average, those that export more from the continent have a higher proportion of workers from their corporate headquarters at home than those who export less.

But Africans and the Chinese and Indian investors operating on the continent face significant challenges in effectively exploiting such synergies. Local technological transfers or skills transfers are compromised when foreign skilled workers, brought in with foreign capital, are not given the

FIGURE 12
Imperfections in the Market for Information: High Transactions Costs



Source: World Bank.

resources, let alone the incentives, to engage in effective skill transfers to local workers. At the same time, because of inadequate education or training, Africans are often ill-equipped to adopt the new skills even when such transfers are being attempted.

Of importance, Chinese and Indian governments are providing or investing in resources for greater technical cooperation with African countries so as to facilitate such technological transfers, among other objectives. Greater participation by African firms in international network production increasingly being carried out by Chinese and Indian investors on the continent is another way for Africans to effectively capture opportunities for the acquisition of advances in technology and modern skills (this will be described in greater detail below).

Chinese and Indian firms (as well as other foreign investors) operating in Africa—not to mention African firms themselves—are being hampered by the inadequate and costly transport and logistics services currently found in Africa; see table 4. Enhancing trade-facilitation infrastructure systems and related institutions could offer tremendous opportunities for reducing the direct and indirect transactions costs of African-Asian trade and investment. Evidence from the business case studies illustrates the point. A Chinese firm in South Africa finds that sending products from Angola to South Africa is as expensive as shipping them to China. An Indian firm in Ghana reports that shipping costs and tariffs *within* the Economic Community of West African States (ECOWAS) are very expensive. It costs $1,000 to send a container from Accra to Lagos. For that reason, the firm decided to do a cross-border investment rather than export. For firms operating in Africa to be able effectively to compete in today's global marketplace will require dramatic improvements in the complex chain of trade-supporting services that include customs and border procedures, management and control of freight movements, transaction documentation, and banking instruments. Indeed, the weaknesses in the continent's trade support services undermine the international competitiveness of African products, and constrain the ability of otherwise internationally competitive African firms to take advantage of new global market opportunities, including those in China and India.

Both domestic and foreign-invested firms in Africa face major problems in accessing local trade financing, which is particularly serious among small and medium enterprises. At the same time, investment by Chinese and Indian firms in Africa is being significantly aided by public

TABLE 4
Trade Facilitation Infrastructure and Institutions: High Transactions Costs

	Export			Import		
	Documents for export (number)	Signatures for export (number)	Time for export (days)	Documents for import (number)	Signatures for import (number)	Time for import (days)
Sub-Saharan Africa average	9	19	49	13	30	61
Ghana	6	11	47	13	13	55
Senegal	6	8	23	10	12	26
South Africa	5	7	31	9	9	34
Tanzania	7	10	30	13	16	51
East Asia and Pacific average	7	7	26	10	9	29
China	6	7	20	11	8	24
South Asia average	8	12	34	13	24	47
India	10	22	36	15	27	43

Source: World Bank 2005.

trade finance programs offered by the export-import banks of the two countries.

FDI-Trade Complementarities and Network Production-Sharing Opportunities

Firms in Africa—both domestic and foreign-owned—have combined international investments and trading relationships for decades. In recent years, however, the globalized marketplace has witnessed the fragmentation of the production process and the formation of new global production and distribution networks that are tightly integrated. The rise of trade in intermediate goods and parts and components constitutes a fundamental shift in the structure of the world trading system. These transformations pose a major challenge to the businesses already operating in Africa, including Chinese- and Indian-owned, as well as those that are contemplating doing so. They also pose a challenge—and opportunity—to African policy makers in their understanding of how their countries fit into today's "international division of labor."

Under traditional notions of international trade, the direction of trade (that is, which countries produce what goods for export) was determined by the principle of "comparative advantage," and a country specialized in the production and export of the good (or goods) for which its relative productivity advantage exceeded that of foreign countries. It is clear, however,

that a radically different notion of comparative advantage has now emerged due to the cross-leveraging of investment and trade flows and the significant role that intermediate goods play in overall international trade.

Technological advances in information, logistics, and production have enabled corporations to divide value chains into functions performed by foreign subsidiaries or suppliers and to become more footloose. The availability of real-time supply-chain data has allowed for the shipping for large distances not only of durable goods, but also components for just-in-time manufacturing and—important for developing countries such as those in Africa—perishable goods. The result has been the rapid growth of intra-industry trade—"network trade"—relative to the more traditional interindustry trade of final goods and services. In this environment, it is hard to imagine that the future of Africa's economic development can be isolated from these networks.

"Buyer-driven networks" are usually built without direct ownership and tend to exist in industries in which large retailers, branded marketers, and branded manufacturers play the central role in the organization of the value chain. Buyer-driven commodity chains are characterized by highly competitive, locally owned, and globally dispersed production systems. The products are typically labor-intensive consumer goods such as apparel, footwear, food, and furniture, among others. "Producer-driven networks" are often coordinated by large multinationals. They are vertical, multilayered arrangements, usually with a direct ownership structure including parents, subsidiaries, and subcontractors. They tend to be found in more capital- and technology-intensive sectors, often dominated by global oligopolies, such as automobiles, machinery, and electronics. The manufacturers control "upstream" relations with suppliers of intermediate components and "downstream" or forward links with distribution and retailing services.

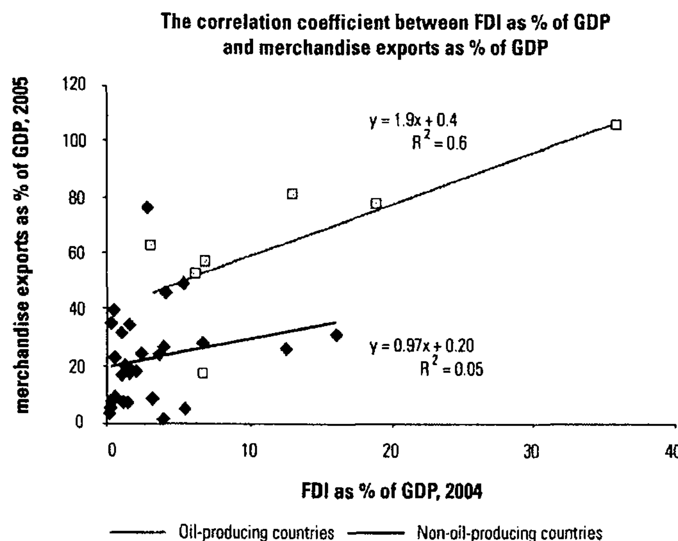
New statistical analysis at the country level indicates that in both Africa and Asia there are strong complementary relationships between FDI and trade; in particular, a greater inward stock of FDI is associated with higher exports. For the African countries taken together as a group, these country-level complementarities are more muted than they are for the Asian countries. However, among non-oil-exporting African countries, the complementary effects are actually larger than they are for the Asian countries. Similar results are obtained from a comparison of FDI per GDP and exports per GDP among African countries; see figure 13.

Chinese and Indian firms operating in Africa have been playing a significant role in facilitating these linkages between FDI and trade on the African continent. Indeed, firm-level evidence on these businesses' operations from new survey data and original business case studies developed in the field shows that their trade and FDI flows are complementary activities, rather than substitutes. What gives rise to this behavior?

For one thing, Chinese and Indian businesses in Africa tend to achieve larger-sized operations than do their African counterparts within the same sectors, and this appears to allow them to realize economies of scale. Thus, it is not surprising that the evidence shows that, all other things being equal, Chinese and Indian firms have significantly greater export intensity than do African firms. Moreover, the exports from Africa produced by Chinese and Indian businesses are considerably more diversified and higher up the value chain than exports sold by domestic firms.

The corporate structures of Chinese and Indian firms also differ from those of African businesses. First, the former have more extensive participation in international group enterprises or holding companies (with headquarters in their home countries); see table 5.

FIGURE 13
African FDI and Exports are Complements



Source: IMF World Economic Outlook; oil countries include Angola, Chad, Republic of Congo, Equatorial Guinea, Nigeria, and Sudan.

TABLE 5

Extent of Scale and Geographic Spread: Number of Separate Firms Belonging to Holding Companies or Group Enterprises

	African	Chinese	Indian	European
Domestic	8	1	2	3
Other Africa	2	4	1	8
Outside Africa	2	16	5	58

Source: World Bank staff.

Note: Data pertain to median values.

At the same time, Chinese and Indian firms engage more extensively in regional integration on the African continent relative to African firms themselves. They also exhibit more extensive integration into a more geographically diverse set of third country markets outside of Africa than do African businesses; see table 6. These are important findings, suggesting that Chinese and Indian firms are effecting greater integration of the African economy—whether on the continent itself or into the global marketplace—than heretofore has been the case by Africa's own businesses.

There is also strong evidence that Chinese and Indian firms are vehicles for the transmission of advances in technology and skills, as well as new equipment, to the African continent. This is the classic case of spillovers in the host market that often accompany flows of FDI; see table 7.

To be sure, there are significant differences between Chinese and Indian firms operating in Africa. Chinese businesses in Africa tend to have a dif-

TABLE 6

Distribution of Output Sales by Destination Market and Firm Nationality
(percent)

Destination market	African	Chinese	Indian	European
Domestic	85	81	89	76
Other Africa	8	14	10	11
Europe	4	0	0	7
North America	1	0	0	1
India	0	0	0	0
Other South Asia	0	1	0	0
China	0	3	0	0
Other East Asia	0	0	0	2
Other	1	1	0	2

Source: World Bank staff.

Note: Data pertain to 2005 median annual sales.

TABLE 7
Purchases of New Machinery by Import Origin and Firm Nationality
(percent)

Import origin	African	Chinese	Indian	European
Domestic	55	32	15	28
Other Africa	3	1	7	12
China	6	60	13	1
India	5	0	22	2
Other	31	8	44	56

Source: World Bank staff.

Note: Data pertain to 2005 median values.

ferent risk-aversion profile than do Indian firms, as reflected in their foreign investment decisions regarding mode of entry, their degree of vertical integration, the origin of source markets for their inputs, and the strength of affiliation with state (as opposed to private) entities in conducting transactions, among other attributes. Chinese businesses in Africa pursue business strategies that yield them greater control up and down the production chain, resulting in enclave types of corporate profiles, with more limited spillover effects. Indian firms, conversely, pursue African investment strategies that result in greater integration into domestic markets and operate extensively through informal channels, indeed even into facets of the local political economy, surely a result of the fact that there is a longer tradition of Indian ethnic ties to Africa[11] (see tables 8 and 9).

Global value chains offer real opportunities for African countries to use Chinese and Indian investment and trade activities to increase the volume, diversity, and value-added of exports from the continent; see table 10. Indeed, as has happened elsewhere in the world to developing countries and economies making the transition from central planning to capitalism, even landlocked countries in Africa—with the right mix of policies—may well engage in network trade.[12]

Detailed value chain analysis of industry cases in Africa shows that certain factors are likely to be especially critical for African businesses wanting to successfully engage in network trade. These include implementing pricing schemes that fully take into account market conditions; taking steps to enhance product quality, for example, through ISO certification; organizing lines of business to be as flexible and as responsive as possible to changes in demand and supply; developing the capacity to

TABLE 8

Distribution of Material Input Purchases by Origin Market and Firm Nationality

(percent)

Origin market	African	Chinese	Indian	European
Domestic	60	31	27	40
Other Africa	7	4	9	9
Europe	13	1	13	34
North America	3	5	1	6
India	5	2	26	3
Other South Asia	3	1	4	1
China	4	55	7	3
Other East Asia	2	1	3	3
Other	2	0	11	1

Source: World Bank staff.

Note: Data pertain to 2005 median annual purchases.

TABLE 9

Extent of Vertical Integration by Firm Nationality

(percent)

Indicator	African	Chinese	Indian	European
Output sales to parent firm or affiliate	9	19	0	14
Input purchases from parent firm or affiliate	3	23	9	15

Source: World Bank staff.

Note: Data pertain to 2005 median values.

TABLE 10

Extent of Value-Added in Output Sales and Exports, by Destination Market and Firm Nationality

(percent)

Destination market	Product	Firm nationality			
		African	Chinese	Indian	European
Domestic sales	Finished assembled	88	90	90	89
	Partially finished	5	9	4	4
	Raw material	6	0	5	6
Sales to other African countries	Finished assembled	83	89	100	78
	Partially finished	8	11	0	15
	Raw material	9	0	0	7
Export sales outside of Africa	Finished assembled	77	75	100	90
	Partially finished	10	25	0	10
	Raw material	13	0	0	0

Source: World Bank staff.

Note: Pertains to sales to private firms. Data pertain to 2005 median values.

maximize speed to market; and working to enhance labor productivity through fostering skills and technology transfers as well as requiring training.

There are several industries in Africa that have either already engaged in or have strong prospects for engaging in buyer-driven network trade, including food, fresh-cut flowers, apparel, and fisheries, among others. These are all products where African exports face far tougher competition in international markets than do the continent's traditional raw commodities, and they must meet world-class standards. The prospects for African industries engaging in producer-driven network trade in the short to medium run are far more limited—without implementing concrete and economywide reforms that will attract substantial FDI by international firms plugged into such networks. There are some exceptions, however, such as South Africa's automotive assembly and parts and components industry, a sector in which Chinese and Indian multinational firms are rapidly participating.

There is evidence of significant opportunities for greater African participation in network trade in services exports. And these can engender significant supply chain spillover effects domestically, as well. One possible area is outsourcing and back-office services, such as those already being implemented in Ghana, Senegal, and Tanzania, among others. This is especially relevant to India in light of the commonality of language.

A second concrete opportunity for growth in services network exports is tourism. With rising middle classes in China and India looking to spend a significant part of their increased disposable incomes on holidays, there is clear potential for Africa to reap the benefits. Through positioning itself as a relatively close and attractive holiday destination, the gain for Sub-Saharan Africa would not just be direct (in tourism services, hotels, restaurants, and the like) but also indirect: the fact that more and more flights arrived in African airports would make transport cheaper and Asian markets more readily accessible for African goods and services.

In the main, opportunities are offered by trade in global supply chains, although few African countries have been able to make the leap and exploit these opportunities. To take but one example, India's large exports of diamonds are in part based on the polishing and cutting of unfinished diamonds imported from Africa. Yet the higher value-added process of diamond finishing could well be retained in Africa, possibly by inviting Indian investment.

Investment and trade by China and India could facilitate the African continent's ability to avail itself of such opportunities. Indeed, Africa's rapid export growth to China and India could contribute even more to Africa's export diversification, in terms of products and trading partners, than has already been the case. The strong and intensifying complementarities between the two regions provide African countries with increased opportunities to use FDI and trade flows from China and India to help boost domestic growth by increasing participation in global network trade in nontraditional exports; by developing value-added, local industries through deepening forward and backward linkages to resource-based products; and by enhancing regional economic integration.

If the African continent is to effectively take advantage of the opportunities afforded by China and India's already sizable and growing commercial interests in Africa, it will have to successfully leverage this newfound interest and be a more proactive player in global network trade. Elsewhere in the world, countries' differential performance in terms of network trade can be attributed to the large variation in the amount of FDI received.

FDI inflows are largely determined not only by traditional macropolitical and macroeconomic factors, but also by the quality of the *underlying* domestic business climate and related institutional conditions, both within individual countries and on a regional basis. Thus, the focus of reforms to enhance participation in network trade should be on a set of factors that shape a country's microeconomic fabric at a *deeper* level beyond that touched by the reform of so-called administrative barriers—such as speeding up the pace of business registration or of obtaining a business license—which has become in the conventional wisdom the way in which improvement in the investment climate comes about.

To be sure, there have been visible efforts taken by several African governments in reforming their domestic business environments. However, African countries overall still lag behind other regions with whom they are competing, both in terms of attracting investment and in exporting to foreign markets.

Conclusions and Policy Implications

Market opportunities for trade and investment in the world economy will no doubt continue to grow for the countries of Sub-Saharan Africa. How-

ever, as the international economy continues to globalize, market competition from other regions—especially those in the South—will only become stronger. This poses a challenge to African policy makers to make better use of international trade and investment as levers for growth.

China and India's rapidly growing commerce with the African continent presents to its people a major opportunity. In particular, the intense interest by these two Asian economic giants to pursue commercial relations with Africa could lead to greater diversification of Africa's exports away from excessive reliance on a few commodities and toward increased production of labor-intensive light manufactured goods and services. It could also enable Africa to build on the strength of its endowment of natural resources and develop backward and forward linkages to extract more value from processing, and in some cases participate in modern global production-sharing networks. This intense interest could also lead to enhanced efficiency of African businesses through their being more exposed to foreign competition, advances in technology, and modern labor skills; and to greater international integration, not only with other regions of the world, but perhaps most important *within* Africa itself, where most domestic markets are too shallow and small to allow for the scale needed to produce exports that are internationally competitive.

To be sure, there are major imbalances in the current commercial relationships that Africa has with China and India. For example, whereas China and India are emerging as increasingly important destination markets for African exports, from the perspective of these Asian countries, imports from Africa represent only a very small fraction of their global imports. At the same time, FDI inflows to Africa from China and India, although still small in an absolute sense, are growing rapidly. But both the level and growth rate of African FDI going to China and India remains extremely limited.

Absent certain policy reforms, the opportunities presented by China and India's interest in Africa may not be fully realized, while the existing imbalances could continue for the foreseeable future. All other things equal, taken together, these could reduce the likelihood of a boost in Africa's prospects for economic growth and prosperity.

The reform experience in Africa, as well as in other regions of the world, shows that reform success in such an environment requires a *combination* of actions. In particular, the lessons from these experiences are that it is not only important to implement sound, market-based, at-the-border trade

and investment policies, but also to take actions that deal with the impediments to trade and investment that exist behind the border as well as between the borders. Indeed, these experiences suggest that, if anything, behind-the-border and between-the-border reforms actually provide for trade to have greater leverage on growth than do at-the-border formal trade and investment policies. Moreover, the evidence suggests that these reforms should be designed in such a way as to exploit the growth-enhancing complementarities between trade and investment.

The study of which this *Overview* is a part discusses such policy implications based on the empirical findings presented. Below, the principal policy implications that deserve priority attention are summarized. A "division of labor" for the responsibilities of the various stakeholders with policy-making roles in furthering Africa-Asian trade and investment is also suggested.

It is important to emphasize that, because of the significant heterogeneity among the 47 countries of Sub-Saharan Africa, the enunciated policy reforms should *not* be interpreted as being "one-size-fits-all" actions. Indeed, in practice, the reforms must be designed to take into account country-specific circumstances. These circumstances will affect not only the actual contours of actions to be taken, but also the speed and sequencing of their implementation.

Summary of Policy Implications

In view of the fact that reforms of formal trade and investment policies have long been the starting point of negotiations on international commercial relations, the discussion here focuses on them first. However, following this convention should not be interpreted as assigning greater importance to these reforms relative to those pertaining to behind-the-border and between-the-border factors and to capitalizing on FDI-trade linkages. As noted, the contrary is more likely to be the case.

At-the-Border Formal Policy Reforms

Various elements of the policy regimes governing trade and investment between Africa and Asia are driven by traditional protectionist motives. If Africa is to take full advantage of trade and investment opportunities with Asia, especially those arising with China and India, a number of reforms to these policies will be important.

- For all countries: Lowering the level of tariffs overall. Ideally, this should be done on an MFN basis in the context of WTO negotiations. Should the currently suspended Doha Round terminate, consideration might be given to a pan-Asian-pan-African FTA, but doing so only in a WTO-consistent manner and ensuring that opportunities for "trade diversion" are minimized.

- For China and India: Eliminating the numerous escalating tariffs that limit Africa's leading exports from entering their markets at competitive prices.

- For most African countries: Mitigating elements of the trade policy regime, such as tariffs on imports of certain material inputs, which serve to impart a bias toward exports. Reforms are also needed to reduce the bias in investment decisions across sectors and reduce disincentives for greater product diversification.

- For most African countries, as well as China and India: Eliminating nontariff barriers (NTBs), including not only quotas, but use of technical standards and similar instruments as protectionist measures.

- Primarily for African countries: Rationalizing and harmonizing existing bilateral and regional agreements. The current "spaghetti bowl" of intra-African regional trade agreements provides little, if any, incentive for new trade and investment; in some cases they appear to be more "trade-diverting" than "trade-creating."

- For African countries: Strengthening the role of IPAs and public-private investors' councils to proactively promote FDI opportunities and eliminate bottlenecks for foreign investors interested in African-Asian investment opportunities.

- Primarily for African countries: Based on the experiences of the "East Asian Miracle" countries over the last several decades, there is a legitimate role for using export and investment incentives. But as the evidence shows, use of these incentives must be tailored to country-specific circumstances and even then they entail risks, especially where the requisite institutional and governance capacities do not exist. Such incentives also must be implemented in concert with existing WTO rules.

Beyond Formal Trade and Investment Policy Reforms

Reforms of formal trade and investment policies in both Africa and Asia are certainly necessary to further facilitate the flows of African-Asian

commerce and to enlarge the benefits that such commerce brings—and can bring—to both regions. However, they are not sufficient. While high Asian tariffs, for example, clearly curb and shape the contours of African exports to Asia, inefficiencies, distortions, weak market institutions, and lack of competitive productive capacity in Africa appear to be equally if not more critical in limiting the export penetration in Asian markets by African businesses. Thus, even if China and India were to immediately provide open and full market access to African producers, the intended outcomes probably would only materialize if certain reform actions were taken by African policy makers. Indeed, reforms that ameliorate both behind-the-border and between-the-border impediments to African-Asian commerce and that foster the exploitation of complementarities between investment and trade flows so that they leverage one another, would be needed.

Behind-the-Border Reforms

- Primarily for all African countries: Governments should work toward enhancing domestic interenterprise competition by eliminating fundamental economic and policy barriers to new business entry.
- Primarily for all African countries: Barriers to exit of commercially nonviable firms also need to be eliminated to enhance domestic competition, through reducing subsidies and eliminating the practice of tolerating arrears (with the government, banks, and among firms).
- Primarily for all African countries: Sound governance will also require mechanisms to ensure greater transparency and accountability of public officials' conduct. Improving governance will also require efficient institutions that facilitate effective resolution of commercial disputes. Policies for the simplification and cost reduction of formal legal procedures as well as bolstering out-of-court mechanisms will strengthen contract sanctity and property rights and improve the level of investor confidence.
- All African countries: To reduce poverty impacts from changes in prices and outputs engendered by trade flows, measures should be implemented to promote labor mobility (for example, enhancing wage differentiation and adaptability and improving the effectiveness of social safety nets).

BETWEEN-THE-BORDER REFORMS

- Primarily for all African countries: Further development of trade facilitation infrastructure, including improvement and modernization of ports, road, and rail transport, and telecommunications and information technology (IT) capacity. These will foster not only Africa's further integration into the global marketplace, but also regional integration *within* Africa itself. Meeting this challenge will require continued privatization or private-public partnerships to entice new investments.
- Primarily for all African countries: In customs, the priority reforms are to improve coordination among border-related agencies, both in countries and across countries; simplify customs procedures; make customs codes and associated regulations rules-based, transparent, and commercially oriented, with proper incentives for employees; and introduce the use of IT into customs systems.
- Most African countries: Addressing imperfections in the "information market for trade and investment opportunities." Among other measures, this would include adopting international production technical standards, such as those certified by the ISO.
- Primarily for all African countries: Reviewing measures that restrict the movement of professionals (Mode IV reforms) so as to foster transfers of modern skills and technology.

REFORMS FOR ENHANCING FDI-TRADE COMPLEMENTARITIES AND PARTICIPATION BY AFRICAN FIRMS IN NETWORK TRADE

- Most African countries: Bringing the regime governing FDI in line with international best practices so as to attract modern multinational corporate investment and global production- network trade. Typically this would include (i) adhering to "national treatment" for foreign investors; (ii) prohibiting the imposition of new, and the phasing out of existing, trade-related investment measures (TRIMs), for example, local content measures; and (iii) providing for binding international arbitration for investor-state disputes. However, the practical design of these reforms should be tailored to country-specific circumstances. Moreover, it may be desirable to phase in some measures over a longer time than others.

- All African countries: Deregulating services should be the rule rather than the exception, and should include the implementation of market-reinforcing reforms of regulatory procedures and rules, including rate levels and structures. Of course, certain African countries, such as South Africa, are more advanced on this score than are others.
- All African countries: Enhancing flexibility in capital markets so that resources can respond more efficiently to changes in market forces.
- All African countries: Strengthening training and secondary and post-secondary educational programs for workers and managers.

Division of Labor among Policy Makers

International Community (Donors and International Organizations)

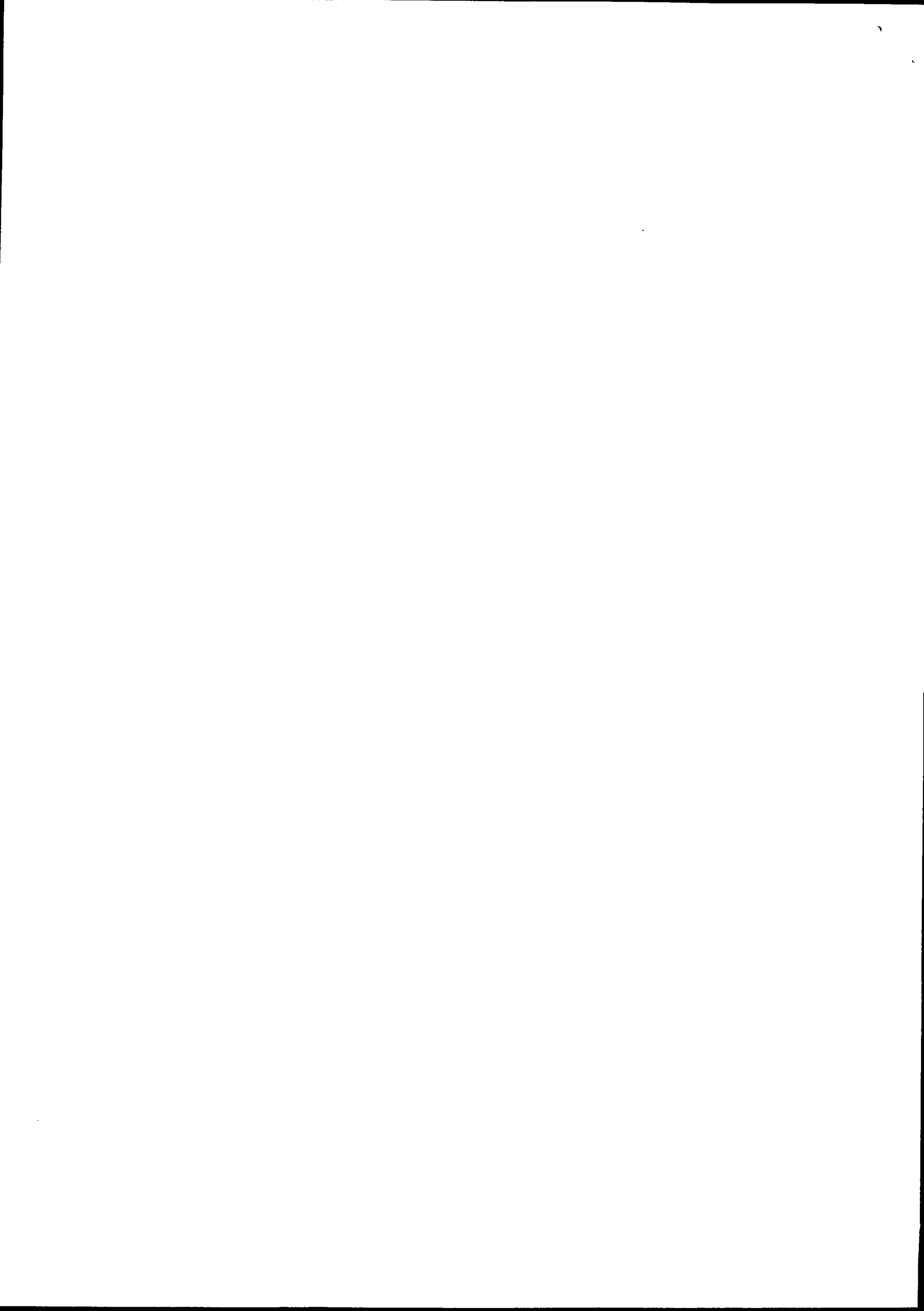
- Most, if not all, countries in Sub-Saharan Africa are in need of technical assistance (TA) and capacity building to strengthen trade-related institutions and policy implementation and management. Priority areas of focus for such TA would be in "aid-for-trade" issues, such as trade facilitation, technical standards, and improving customs regimes; harmonization of regional trade agreements; WTO accession (for current nonmembers); and governance reform.

African, Chinese, and Indian Governments

- Much of the reform agenda will largely depend on the implementation efforts of the countries themselves.
- Arguably, the most challenging of such tasks will be the vigorous implementation of economywide behind-the-border and between-the-border reforms, as well as reforms to leverage the complementarities between trade and FDI. These would involve actions to enhance competition in domestic markets and foster greater flexibility in labor markets; improve trade facilitation mechanisms; liberalize the services sectors and reform of associated regulation; and improve the climate to attract FDI.
- In the area of trade policy, actions would include tariff reductions; elimination of escalated tariffs; termination of NTBs; removal of disincentives to exporting; pursuit of WTO accession; and rationalization, harmonization, and modernization of existing regional trade agreements.

Endnotes

1. UNCTAD has estimated that South-South trade accounts for about 11 percent of global trade and that 43 percent of the South's trade is with other developing countries. It also has estimated that South-South trade is growing about 10 percent per year. "A Silent Revolution in South-South Trade," WTO (2004) http://www.wto.org/english/tratop_e/dda_e/symp04_paper7_e.doc.
2. Throughout this study, "Africa" refers to the countries of Sub-Saharan Africa.
3. Between 2000 and 2005, the share of Africa's exports destined for the EU was reduced by almost one-half-from 50 percent to 27percent. Data for 2000 are from World Bank (2004). Data for 2005 are from IMF Direction of Trade Statistics ("IMF DOT"); for details see chapter 2.
4. IMF DOT.
5. UNCTAD 2006.
6. UNCTAD 2005b.
7. The new survey is referred to as WBAATI (World Bank African-Asian Trade and Investment) survey.
8. http://www.fmprc.gov.cn/eng/zxxx/t230615.htm
9. See Broadman (2005).
10. Eisenman and Kurlantzick 2006.
11. This finding of greater integration into African host markets by Indian firms is consistent with the evidence presented earlier regarding the ethnicity and nationality of managers.
12. See Broadman (2005).



DEVELOPMENT COMMITTEE
(Joint Ministerial Committee
of the
Boards of Governors of the Bank and the Fund
On the
Transfer of Real Resources to Developing Countries)

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**GLOBAL MONITORING REPORT 2007:
CONFRONTING THE CHALLENGES OF
GENDER AND FRAGILE STATES**

Final Text

Attached for the April 15, 2007, Development Committee Meeting is a paper entitled "Global Monitoring Report 2007: Confronting the Challenges of Gender and Fragile States", which includes the Executive Summary and the Overview Chapter of the full report, prepared by the staff of the World Bank and the International Monetary Fund. The full report will be available as a background document. This item will be considered under Item 1 of the Provisional Agenda.

* * *

Report Overview

Introduction

Broad-based global economic growth in 2006, and more generally since 2000, provides grounds for optimism about progress in advancing the Millennium Development Goals (MDGs). For low-income countries, real per capita income growth in Sub-Saharan Africa and South Asia has been stronger in the period since 2000 than at any time since the 1960s, and stronger than at any time since transition in Europe and Central Asian countries. Based on this strong growth performance, the estimated number of extremely poor people (living on $1 per day) fell by 135 million between 1999 and 2004.

Although still uneven, progress with poverty reduction is evident across all regions. Sub-Saharan Africa reduced the share of people living in extreme poverty by 4.7 percentage points over five years to 41 percent, although high population growth left the same absolute number of poor, at nearly 300 million. South Asia, Latin America, and East Asia all appear to be roughly on track to halve extreme poverty by 2015 from 1990 levels. Europe, Central Asia, and the Middle East and North Africa have largely eliminated extreme poverty. There are also hopeful signs that international development efforts may be gaining momentum, and new innovations in resource mobilization for development are taking shape.

Yet in spite of this optimistic outlook, the international community faces a much more demanding agenda in advancing the MDGs as 2015 draws nearer. Despite progress, nearly 1 billion people remain in extreme poverty. All regions are off track to meet the target for reducing child mortality; nutrition is a major challenge, with one-third of all children in developing countries underweight or stunted; half the people in developing countries lack access to improved sanitation.

Action to scale up development efforts needs to accelerate, but steps forward still appear tentative. Nearly seven years after the Millennium Summit and five years after the Monterrey summit, there has yet to be a country case where aid is being significantly scaled up to support a medium-term program to reach the MDGs. While there has been modest progress in Paris or Brussels or London to address the well-recognized problems in designing and delivering international aid—proliferation of aid channels, weak coordination, lack of resource predictability, misalignment with country strategies, and so on—viewed from the capitals of Ethiopia, Madagascar, or Bolivia, this progress appears to be slow.

This *Global Monitoring Report* (GMR) highlights two areas that require greater international attention if higher global growth

trends are to translate into sustainable development outcomes and if the gains are to be shared more evenly:

- *Gender equality.* The first of these arises from gender inequality and lost opportunities for *all* people to help generate and participate in the gains from economic growth. The choice to focus the 2007 report on the third MDG—the promotion of gender equality and empowerment of women—reflects a recognition by the international community that more is needed to support equality for the half of humanity disadvantaged through less access than men to *rights* (equality under the law), to *resources* (equality of opportunity), and to *voice* (political equality).
- *Fragile states.* The second risk arises from the especially difficult development challenges and greater needs facing *fragile states.* Fragile states—countries with particularly weak governance, institutions, and capacity—comprise 9 percent of the developing world's population but over one-fourth of the extreme poor. They represent an enormous challenge: how can the international community provide resources to support efficient service delivery, postconflict recovery, and reform? Without addressing these development challenges the fragile states pose risks that can cross borders—through civil conflicts, risks to public health, and humanitarian crises.

Two additional risks pertain to environmental sustainability and securing the gains from trade liberalization. Natural resource depletion and environmental degradation pose risks to both the quality of growth, and the potential for sustaining future growth. Growth based on the depletion of natural wealth, rather than through increasing wealth for current and future generations, is unsustainable. The "adjusted net savings rate" measures national savings after accounting for resource depletion and damage to the environment, raising broad policy questions about environmental policies that are beyond the scope of this report but may be tackled in future GMRs.

Risks from failure to advance multilateral trade liberalization and expand market access are also highlighted in this year's report. The Doha Round of trade negotiations was effectively suspended in July 2006, but early in 2007 there was an informal agreement to resume talks. Failure to make progress means depriving many countries of vital opportunities for accelerating their growth through trade.

To address these risks and advance the MDG agenda there is a pressing need for better aid coordination to strengthen aid quality and scale-up assistance. This requires efforts by all parties—donors, international financial institutions (IFIs), and developing countries. Agreement needs to be forged at the global level on practical mechanisms and instruments to scale up aid and on measures to reduce the costs of aid fragmentation. Progress with scaling-up will require more and better aid resources (donors); sound, sequenced development strategies (developing partners); better technical support for strong strategies (the IFIs); and a more coherent "aid architecture" to reduce the costs of fragmentation.

Progress toward the MDGs

Growth and Poverty Reduction

The world economy is growing at a pace last seen at the beginning of the 1970s. This is welcome news for developing countries in view of its implications for trade, aid, private financial flows, and remittances. Both low- and middle-income countries have benefited from the trend. Performance varies widely across regions, but there is a favorable trend evident in East Asia, South Asia, Eastern Europe, and Central Asia, and particularly Sub-Saharan Africa, where the sustained and rising growth performance since the late 1990s is in sharp contrast to the weak performance evident over the last three decades. Average per capita income growth in Sub-

BOX 1 Global Monitoring Report 2007: Five key messages

Growth is reducing poverty, but not everywhere or always sustainably. Continued strong growth is generating significant progress in poverty reduction globally. But many countries are failing to benefit, especially fragile states, and for some others the sources and quality of growth (unsustainable resource extraction; accumulating pollutants) undermine environmental sustainability and future growth potential.

Investing in gender equality and empowerment of women is smart economics. Greater gender equality helps to create a fair society, raises economic productivity, and helps advance other development goals. Major gains have been achieved, particularly in education, while in other areas progress is lagging. Better monitoring and mainstreaming of women's empowerment and equality into policy formulation and programs of international assistance are therefore vital to the development agenda.

Fragile states are failing to keep up—speed and staffing by development agencies are critical. The largest "MDG deficit" is in states with weak institutions and governance, and often in conflict—the "fragile states." With 9 percent of the developing world's population, they account for over one-fourth of the extreme poor and nearly one-third of child deaths and 12-year olds who do not complete primary school. Efforts to support their transition from fragility must be deepened through improving response time to crises and opportunities, increasing field presence, better interagency collaboration, and building on lessons from successful state-building transitions.

Quality lags quantity—children enroll in school but don't always learn. Advancement in primary school completion has been rapid and encouraging in many countries. Yet cross-country evaluations suggest improvement in cognitive skills has often not kept pace. Quantity and quality in education and health need to proceed in tandem. More effort is needed to monitor outcomes (especially student learning). This provides an essential platform for tracking over time whether policies and incentives are truly producing more effective service delivery.

Scaling up "quality" aid requires greater coherence among donors, developing countries, and international agencies. Donor commitments to scaling up aid have so far been unrealized as real aid flows have faltered and a more complex aid architecture—proliferation of donor channels, fragmentation of aid, ear-marking of funds—undermines aid quality and effectiveness. Scaling-up aid to meet the MDGs requires more and better aid resources (donors); sound, sequenced development strategies (developing partners); better technical support for strong strategies (the IFIs); and a more coherent "aid architecture" to reduce the costs of fragmentation.

Saharan Africa has recently been at about 3 percent and is forecast to continue at this level in 2007. By contrast, growth among low- and middle-income countries in Latin America, and the Middle East and North Africa, continues to be more modest.

Evidence suggests that better growth is translating into declining poverty levels. The most recent data show that all regions except for Sub-Saharan Africa are on track to reach the MDG1 poverty target. In Sub-Saharan Africa the share of people living in extreme poverty has declined little from its 1980 level, but this masks the protracted deterioration during the 1980s and first half of the 1990s, along with marked improvements since the late 1990s. The share of people in poverty fell by nearly 7 percentage points between 1996 and 2004, although the absolute number of poor has stagnated.

Preliminary estimates suggest that, on average, growth (in GDP) during the late 1990s through 2003/04 resulted in lower poverty incidence: for a sample of 19 low-income countries, 1 percent of GDP growth was associated with a 1.3 percent fall in the rate of extreme poverty and a 0.9 percent fall in the $2-a-day poverty rate. For middle-income countries the impact of GDP per capita growth on poverty was much less,

and average poverty has not declined with recent growth. Moreover, changes in income distribution have not, on average, reduced the impact of income growth on poverty reduction in low-income countries, whereas income inequality widened on average in middle-income countries.

One factor behind this favorable performance has been the continuing strength of macroeconomic policies, as evident through continued moderate inflation rates and average fiscal balances that shifted from deficit into balance in low-income countries during 2006. The quality of macroeconomic policies, particularly fiscal policy, in low-income countries shows considerable improvement over recent years.

The stronger growth performance in low-income countries is encouraging, particularly in Sub-Saharan Africa where the higher growth may mark a potential turnaround from the region's protracted stagnation. However, this has to be interpreted with caution. Concerns persist over the potential for a growth slowdown resulting from a disorderly unwinding of global imbalances, protectionism, the future behavior of world oil prices, or a possible global pandemic triggered by avian influenza.

Optimism over the prospects for improved growth and poverty reduction, however, does not apply to the many fragile states. Extreme poverty is increasingly concentrated in these states: by 2015 it is estimated that given projected growth performance, extreme poverty levels in nonfragile states will decline to 17 percent, more than achieving the MDG1 target, while levels of extreme poverty in fragile states will remain at over 50 percent, *higher* than the level in 1990.

Progress with the Human Development MDGs

Broad MDG trends do not change appreciably year to year, and remain much as described last year: all regions are off track on the child mortality goal, and some regions are off track on at least some of the other MDGs. The two regions that lag the most are South Asia and Sub-Saharan Africa. As *regions* they remain off track on all the goals; however, there is considerable variation within regions. MDG trends in fragile states are also examined; while there is variance within the group, fragile states have lower absolute performance and slower improvement than nonfragile ones.

It must also be recognized that there have been some significant successes. Since 2000, over 34 million additional children in developing countries have gained the opportunity to attend and complete primary school—one of the most massive expansions of schooling access in history. Over 550 million children have been vaccinated against measles, reducing death from measles in Sub-Saharan Africa by 75 percent. By mid-2006 the number of AIDS (acquired immunodeficiency syndrome) patients with access to antiretroviral treatment had increased nearly sevenfold to over 1.6 million from 2001 levels. There is little question that the MDG targets have helped stimulate more rapid expansion of basic health and education services.

Nutrition (MDG1). Nearly one-third of all children in developing countries are estimated to be underweight or stunted, and an estimated 30 percent of the total population in the developing world suffers from micronutrient deficiencies. Undernutrition is not only a threat to progress with poverty reduction; it is the underlying cause of over 55 percent of all child deaths, linking nutrition directly to reduction of child mortality (MDG4). In striking contrast to the region's strong growth performance, the highest rates of malnutrition are found in South Asia: underweight prevalence is estimated between 38 and 51 percent in the large countries, none of which appears on track to meet the nutrition goal. Sub-Saharan Africa is estimated to have a 26 percent prevalence of child malnutrition, and in some countries— Burkina Faso, Cameroon, Zambia—trends are worsening. East Asia, Latin America, and Eastern Europe show better performance although all have some countries that are off track.

Universal primary completion (MDG2). Globally the primary school completion rate rose between 2000 and 2005 from 78 to 83 percent and the pace of progress in many countries has accelerated. Gains are especially strong in North Africa, Sub-Saharan Africa, and South Asia. But 38 percent of developing countries are unlikely to reach 100 percent primary completion by 2015 and another 22 percent of countries, which lack adequate data to track progress, are also likely to be off track. The most intractable groups to reach with primary education are those that are "doubly disadvantaged": girls from ethnic, religious, or caste minorities. About 75 percent of the 55 million girls who remain out of school are in this group. But recent data also reveal countries that have made remarkable progress in recent years; six of the seven top countries in expanding primary completion rates (all by over 10 percent per year between 2000 and 2005) were in Sub-Saharan Africa (Benin, Guinea, Madagascar, Mozambique, Niger, and Rwanda). The weakest performers were also primarily in Africa, however, showing the sharp contrasts across countries in the region. And in Asia, Cambodia has made exceptional progress.

Child mortality (MDG4). Progress on child mortality lags other MDGs, despite the availability of simple, low-cost interventions that could prevent millions of deaths each year. Oral rehydration therapy, insecticide-treated bednets, breastfeeding, and common antibiotics for respiratory diseases could prevent an estimated 63 percent of child deaths. Yet in 2005 only 32 of 147 countries were on track to achieve the child mortality MDG. Moreover, 23 countries reveal stagnant or worsening mortality rates. Problems in fragile states are particularly severe: nearly one-third (31 percent) of all child deaths in developing countries are in fragile states, and only two of the 35 states currently considered fragile are on track to meet MDG4. The experience of countries that have achieved rapid gains is also noteworthy, including in Eritrea which, despite per capita income of only $190, cut child mortality in half between 1990 and 2005. This success appears in large measure attributable to implementation of the integrated management of childhood illness and points to the serious need to strengthen policy coherence and improve donor coordination in the health sector.

Maternal health (MDG5). Ninety-nine percent of maternal deaths, about 500,000 annually, occur in developing countries. Lack of direct data on maternal mortality requires the use of "skilled attendance at delivery" as a proxy measure. Survey evidence shows progress in 27 of 32 countries but also suggests that this is highly concentrated among richer households—*equity gaps* in access to skilled attendance are larger than for any other health or education service. Evidence on the main constraints to reducing maternal mortality in three low-income countries reaffirms the importance of early recognition of the need for emergency medical attention, access to adequate medical facilities, and receiving appropriate treatment. But it also underscores the essential need for skilled attendance at birth.

AIDS, malaria, and tuberculosis (MDG6). By end-2006 an estimated 39.5 million people were living with the human immunodeficiency virus (HIV), up 2.6 million since 2004. An estimated 3 million people died from AIDS in 2006. While the spread of this disease has slowed in Sub-Saharan Africa, it is a rapidly growing epidemic in Eastern Europe and Central Asia. Recent experience in combating the spread of AIDS has demonstrated some important messages: reversing its spread *is possible*, treatment *is effective* in the developing world, but prevention efforts need to be intensified.

Annually there are an estimated 300 to 500 million cases of *malaria*, and 1.2 million deaths, mainly among children and mostly in Sub-Saharan Africa. Several new initiatives hold promise for making inroads against malaria: with support from the Dutch and the "Roll Back Malaria" initiative, the World Bank is leading efforts to implement a global subsidy for artemisinin-based combination therapy, the most promising new treatment available because resistance to traditional

drugs has grown. The Malaria Booster Program, which supports country-led efforts to deliver concrete and measurable results, such as delivery of insecticide-treated bed nets and malaria treatment for young children and pregnant women, is currently operating in 10 countries and aims to expand to 20 over the next five years.

Tuberculosis (TB) is estimated to have led to 2 million deaths in 2004, and 9 million new cases. While incidence of TB is falling in five of six regions, global growth of 0.6 percent annually is attributed to rapid increases in infections in Sub-Saharan Africa, linked to the greater likelihood of TB appearing from latent infections in HIV carriers. The Directly Observed Treatment, Short-course (DOTS) is the main strategy to combat TB, and has expanded rapidly, with high-burden countries showing large decreases in TB incidence due to DOTS (for instance, Cambodia and Indonesia). In 2006 a new strain of TB—extensively drug-resistant TB—was discovered in South Africa. International efforts to stop its spread are being led by the World Health Organization (WHO) and the Stop TB Partnership.

Water supply and sanitation (MDG7). There has been significant progress on water supply; globally access has increased from 73 percent in 1990 to 80 percent in 2004, but only Latin America and South Asia are considered on track to meet this part of the goal (although more than one-quarter of developing countries lack data). However, within Africa there are some promising trends: 5 of the 10 countries making fastest progress are in Africa, and 17 of the 36 countries for which data are available are on or almost on track. By contrast, global progress on sanitation has lagged, increasing only from 35 percent in 1990 to 50 percent in 2004 and only three regions (East Asia and the Pacific, Latin America, and the Middle East and Northern Africa) are on track. Only 2 of the 32 African countries for which data are available are on track. Despite its importance for achievement of multiple MDGs, official development assistance (ODA) for water supply and sanitation (WSS) declined significantly from the mid-1990s through 2002. Although it rebounded somewhat after 2003, it still has not returned to the 2000 level. Recent efforts to ramp up financing for WSS, especially for Africa, through such initiatives as the Africa Infrastructure Consortium and the Rural Water Supply and Sanitation Initiative—even if successful—will take some time to have clear impact on the WSS target, given the long lead time for investments.

A continuing concern for all these aggregate data is whether poor households participate in the progress made. Demographic and Health Survey data allow comparison across income quintiles on relative progress. While gaps in access between rich and poor households remain significant, they are narrowing; the poor have had equal or faster rates of progress in child mortality reduction, immunization coverage, and primary completion in most countries.

Financing Trends and Alignment in Health and Education MDGs

External financing for health and education has nearly doubled in real terms since the MDGs were adopted. Aid for health continued to rise from 2004 to 2005, whereas education ODA commitments showed their first decline, reflecting lower commitments to China and India. Aid commitments for education are expected to have increased again in 2006 and beyond, owing in part to a major initiative announced by the United Kingdom.

Funding for health has grown even more strongly, from private sources such as the Gates Foundation; from global partnerships such as the Global Fund for AIDS, TB, and Malaria; and from bilateral donors: France, Norway, Spain, and the United States have increased health funding between two- and fourfold since 2000. Innovative financing mechanisms targeting the health sector are also getting off the ground: the international finance facility for immunization ($1 billion in 2006), advance market commitments for vaccines ($1.5 billion expected in 2007), and the airline ticket tax implemented by 21 countries ($300 million expected in 2007) are

all mobilizing new funds for health interventions. Despite this influx of funds for health, there remains a large shortfall relative to financing needs to reach the health MDGs, conservatively estimated at between $25 billion and $50 billion annually.

While increased external funding is crucial for progress on the health MDGs, there are growing concerns about policy coherence, aid alignment, and transactions costs in the sector, given the number of players and the absence of effective coordination mechanisms—a topic taken up below.

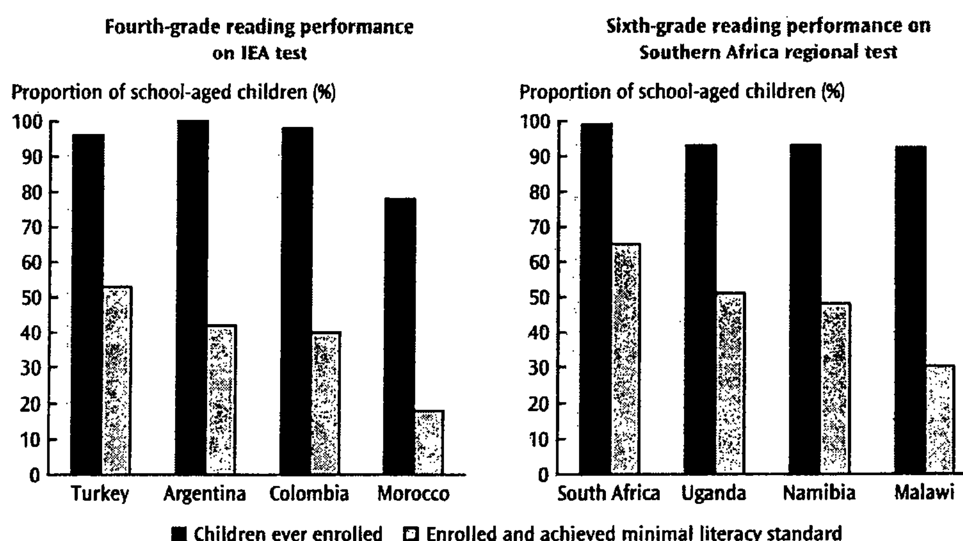
The Role of Quality in MDG Progress

Evidence is emerging that in many countries rapid progress in improving schooling enrollment and completion is not translating into better cognitive skills. New research suggests that this may have a high cost for countries: returns to investment in education appear to accrue to the skills of the population and not to the quantity of schooling attained.

Figure 1 illustrates weak learning outcomes and the gap across countries between education level and cognitive skills. By age nine reading skills in developing countries can significantly lag those in developed countries. While over 96 percent of children in Sweden, Latvia, and the Netherlands can read above the lowest—threshold—level of literacy on OECD-benchmarked tests by age nine, less than half the children in Argentina, Colombia, and Morocco can read at this level. Results from a regionally benchmarked assessment for Southern African countries are similarly distressing: in several countries, less than 50 percent of children are able to read by age 12.

It does not follow from this that there exists an inherent trade-off between quantity and quality in education. In fact, cross-country data show a strong positive correlation between schooling coverage and cognitive skills, at least over the long term. There are also numerous countries that have increased learning outcomes at the same time as they

FIGURE 1 Learning levels of primary school–aged children



Source: Fourth-grade test: International Association for the Evaluation of Educational Achievement (IEA), Progress in International Reading Literacy (PIRLS) 2001, Sixth-grade test: Southern African Consortium for Monitoring Educational Quality (SACMEQ). Enrollment data: Demographic and Health Surveys.

have expanded access. While this is not easy to do, and there are many cases where quality has been strained as countries rapidly scale up access, it is important to focus on the strategies for managing expansion better. Many poor countries are far from achieving universal primary completion and must accelerate service delivery to reach the MDG by 2015. Slowing expansion would harm the poorest and most marginalized groups most. The challenge must be to expand access while enhancing learning outcomes.

Progress on this challenge requires stronger efforts to monitor student learning in the developing world; most countries today lack national assessment systems and extremely few have engaged in any internationally benchmarked tests. Regular tracking of student learning is essential for accountability in education—for equipping teachers to manage their class time better, for empowering parents to hold schools accountable, and for allowing administrators to evaluate the effectiveness of education spending.

There is a strong case for donor support in developing benchmarked standards of competency linked to critical thinking skills expected by the end of primary school—in other words, basic learning goals for primary education to complement the quantitative goal of universal primary completion. An internationally benchmarked test to measure end-of-primary learning levels could be expensive and technically difficult to produce, but there is a clear public goods argument for such an investment. Precisely at a time when the global community is scaling up aid for the education MDG, a globally benchmarked assessment covering large numbers of developing countries would provide the strongest platform yet for generating knowledge on "what works" to promote learning in different country contexts.

Moving a proposal for basic learning goals for primary education forward will involve costs and face political and technical obstacles. But an internationally supported effort in this area could help countries build national capacity to track learning outcomes and create incentives to accelerate progress, *alongside efforts to expand school completion rates.*

The same concerns over quality arise in *health care*—and data are even harder to collect. Creative efforts have been made to measure the quality of health care providers across countries and measure the overall quality of care. The extent of misdiagnosed ailments, failure to complete basic checklists for major diseases, and mal-adherence to recommended protocols is alarming. The implication is that there are gaps between what health providers know is right and what they do. It suggests that greater attention to work incentives and institutional settings is needed rather than reliance on input-based approaches, such as raising training requirements or expanding medical schools. Performance contracting is one promising approach for effectively improving health coverage and quality. Greater attention is also needed to bring greater coherence and donor coordination to health sector strategies, as discussed below.

Governance Indicators: An Update

Recently released *aggregated* governance indicators (Kaufman-Kraay) suggest patterns of performance that reinforce key messages from the 2006 GMR. Governance is multidimensional, and there is no unique path from poor to good governance. Actionable indicators to track performance are being developed in several areas, including contributions from independent civil society organizations: Global Integrity released 43 new country reports, the Afrobarometer network released the results for 18 African countries of its third round of surveys, and a new index that monitors transparency in public budgets—the Open Budget Index—was released after four years of development. The World Bank Group also released publicly for the first time its Country Policy and Institutional Assessment (CPIA) scores—an important step in strengthening transparency and disclosure of these scores, which play an impor-

tant role in allocating concessional financing. By contrast, Public Expenditure and Financial Accountability (PEFA) assessments made less encouraging progress. While the use of PEFA indicators has greatly expanded and many new country assessments are planned, so far only 4 of 33 country reports have been made public, limiting the potential benefits from this valuable tool for analysis.

Promoting and Monitoring Gender Equality and Empowerment of Women

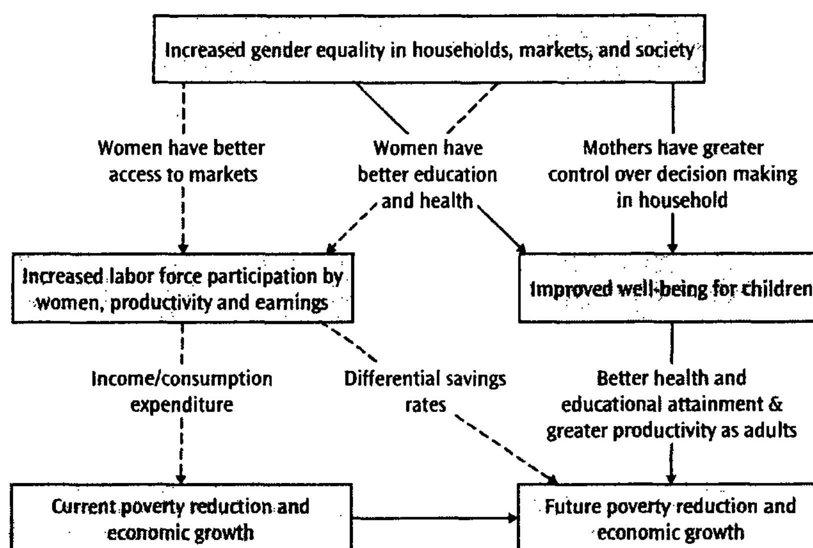
The Importance of Promoting Gender Equality

The 2006 *World Development Report* on equity and development refers to gender inequality as the "archetypal inequality trap," pointing to the sharp differences between men and women in access to assets and opportunities in many countries, and the negative consequences for the well-being of women, families, and society. The disadvantage of women in *rights* (equality under the law), *resources* (equality of opportunity), and *voice* (political equality) restricts basic freedom to choose and is unfair. This inequality is reflected in the poorer performance by women and girls across many of the MDGs.

"Improving gender equality and empowering women" (MDG3) thus stands on its own merits as a development objective. In addition to this intrinsic importance, gender equality and women's empowerment are also important channels to attain other MDGs. Gender equality and women's empowerment promote universal primary education (MDG2), reduce under-five mortality (MDG4), improve maternal health (MDG5), and reduce the likelihood of contracting HIV/AIDS (MDG6).

Improving gender equality also influences poverty reduction and growth directly through women's greater labor force participation, productivity, and earnings as well as indirectly through the beneficial effects of

FIGURE 2 Pathways from increased gender equality to poverty reduction and growth



Source: World Bank staff.

women's empowerment on child well-being. Figure 2 identifies the main pathways leading from gender equality to both current and future growth and poverty reduction. One path is through increasing the productive opportunities and higher incomes that women have, raising consumption and savings that help to raise investment rates. Another is through improving women's control over decision making in the household. Several studies have shown that the greater the mothers' control over resources, the more resources households allocate to children's health, nutrition, and education. Better maternal education also benefits children through improved hygiene practices, better nutrition, lower fertility rates, and hence higher per child expenditures. Taken together, these contribute to future growth and poverty reduction.

Progress toward Meeting MDG3

The four official MDG3 indicators—measuring gender equality in enrollments, literacy, and the share of women in nonagricultural employment and national parliaments—provide an important, albeit incomplete, snapshot of progress toward gender equality.

Thanks to efforts to achieve universal primary education (MDG2), girls' enrollments in all levels of schooling have risen significantly (figure 3). Most low-income countries made substantial progress between 1990 and 2005. By 2005, 83 developing countries (of 106 with data) had met the intermediate MDG3 target of parity in primary and secondary enrollment rates. Most of these countries are in regions where enrollment has historically been high—East Asia and the Pacific, Eastern Europe and Central Asia, and Latin America and the Caribbean. In the Middle East and North Africa, most countries met the target by 2005, but some still have a significant female disadvantage in enrollments. In Sub-Saharan Africa performance has been varied; less than one-quarter of countries met the enrollment targets for 2005, but some have attained parity (for example, Botswana, Rwanda, and South Africa). Of the 14 fragile states for which data are available, 9 are not expected to achieve the primary and secondary enrollment targets.

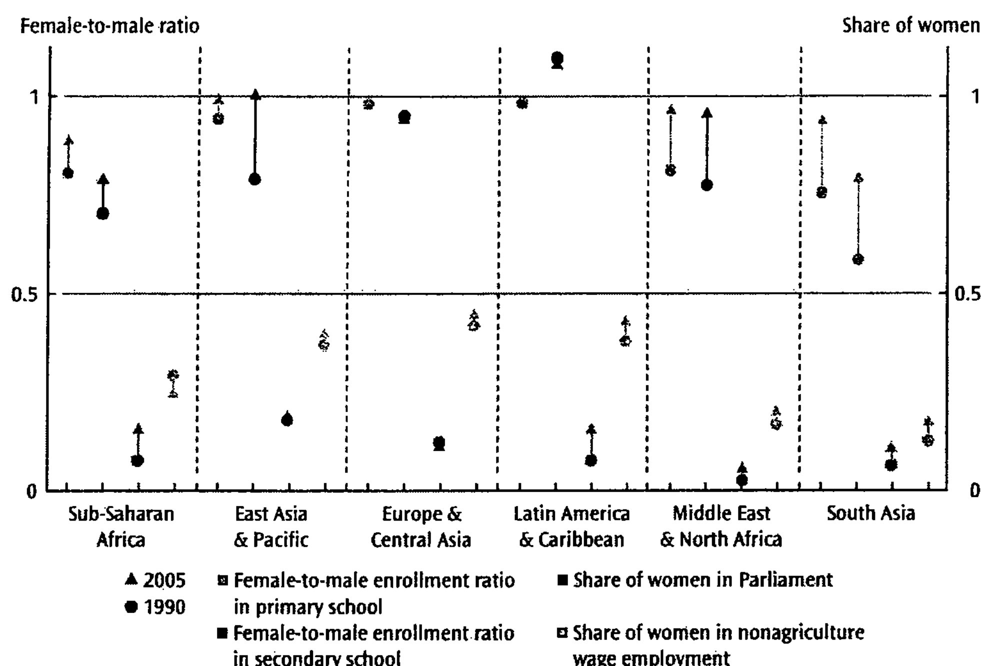
The female *tertiary* enrollment rate lagged behind the male rate in 63 countries (of 130 countries with data) and *exceeded* the male rate in 65 countries. The female disadvantage was evident mainly in Sub-Saharan Africa, South Asia, and in fragile states.

Progress in basic literacy skills and school enrollments over the years has resulted in higher literacy rates among youth (age 15–24), but gender gaps remain: the United Nations Educational, Scientific and Cultural Organization (UNESCO) estimates that of the nearly 137 million illiterate youths in the world, 63 percent are female. The female-to-male literacy ratio is lowest in Sub-Saharan Africa, Middle East and North Africa, and South Asia—regions that also have female disadvantages in primary and secondary enrollment.

Progress is also evident in women's share of nonagricultural wage employment, which increased modestly in all regions during 1990–2005, and with significant variation across regions and countries (figure 3). In 2005 the share of women in nonagricultural employment was highest in Europe and Central Asia (47 percent), lowest in the Middle East and North Africa (20 percent), and in-between in Latin America and the Caribbean and East Asia and the Pacific (over 40 percent). Trends and patterns in this indicator are difficult to interpret without accounting for country circumstances, such as the share of nonagricultural employment as a percentage of total employment. A favorable score on this indicator might on the surface seem to indicate equitable conditions for women in labor markets, but it may capture conditions for only a very small proportion of the total labor force.

The fourth official MDG3 indicator is the proportion of seats held by women in national parliaments (with no set target). Between 1990 and 2005, all regions except Europe and Central Asia increased women's

FIGURE 3 Progress in official indicators of gender equality and women's empowerment, by region, 1990–2005



Source: World Bank Indicators. The regional averages are calculated using the earliest value between 1990 and 1995 and the latest value between 2000 and 2005. The averages are weighted by the country population size in 2005.

proportion of the seats in national parliament, but starting from a very low level (figure 3). However, in no region did the average proportion exceed 25 percent, at either the beginning of the period or the end.

Strengthening Official Indicators

The shortcomings of the official indicators for monitoring progress in attaining MDG3 are widely recognized (see, for example, the report of the UN Millennium Project Task Force on Education and Gender Equality, UN Millennium Project 2005). Five supplemental indicators to better measure gender equality are proposed to address this (table 1). These indicators, complementary to the official MDG3 indicators, meet three criteria: data availability (wide country coverage), strong link to poverty reduction and growth, and amenability to policy intervention. Indicators that met all the three criteria but were highly correlated with other indicators were dropped from the list.

This proposed list draws on the recommendations of the UN Millennium Project Task Force, but is more parsimonious. It takes into account data availability, additionality (does it add new information), and the high costs associated with imposing additional monitoring burdens on already taxed national statistical offices. It also draws on a proposal to refine the existing MDG indicators that was put before the UN Secretary General's office for consideration in March 2007.

Four of the five indicators monitor gender equality in the household; the remaining indicator monitors gender equality in the economy. No additional indicators are recommended to monitor gender equality in

TABLE 1 Recommended additional indicators for MDG3

Household		Economy and markets
Modifications of official MDG indicators	**Additional indicators**	**Additional indicators**
Primary completion rate of girls and boys (MDG2)[a]	Percentage of 15- to 19-year-old girls who are mothers or pregnant with their first child[b]	Labor force participation rates among women and men aged 20–24 and 25–49[b]
Under five mortality rate for girls and boys (MDG4)		
Percentage of reproductive-age women, and their sexual partners, using *modern* contraceptives (MDG6)		

Source: World Bank staff.
a. Recommended by the UN Millennium Project Task Force on Education and Gender Equality.
b. Under consideration by the Inter-Agency and Expert Group for MDGs.

the domain of society, because none of the indicators considered for inclusion met the criteria of data availability. Three of the recommended indicators are modifications of official indicators already being monitored as part of the MDGs, while two are indicators not currently part of the official set.

Strengthening International Support for Gender Equality

The success in increasing girls' enrollments in schooling shows that progress in gender equality is possible. This progress, however, requires political will (high-level leadership) and concerted effort from countries and international development agencies. Donors and the multilateral development banks (MDBs) need to significantly improve the support and coordination for gender equality issues to accelerate progress toward MDG3; these issues should become central in their dialogue with partner countries. Since the 1995 Beijing Women's conference, which marked a milestone in international commitment to gender equality issues, donor support improved somewhat, and more resources are devoted to gender equality targets, particularly in the social sectors. Overall, a quarter of bilateral aid by sector—around $5 billion annually—is now focused on gender equality.

However, in spite of strong donor policy commitments to gender equality objectives, implementation has been disappointing. Self-evaluations of nine donor agencies' performance reflect a gap between words and deeds. One of the reasons for this gap is the diffusion of responsibility that resulted from the shared responsibility gender mainstreaming called for: all staff were responsible for promoting it, yet no one group in particular was held accountable for results.

These self-assessments have helped reenergize donors' commitments. Donors are revamping their approaches and setting more realistic targets to both strengthen mainstreaming and introduce specific actions to advance gender equality. There is wide agreement that high-level leadership, technical expertise, and financial resources remain key to implementing donor agencies' gender policies.

The MDBs have made similar progress in advancing their support for gender equality and women's empowerment. Systems to monitor progress with mainstreaming gender equality policies have been introduced, and suggest there has been modest but steady progress. Most MDBs have recently adopted Gender Action Plans to make their gender mainstreaming policies more strategic and operationally effective.

Nonetheless, significant gaps remain. Progress has been greater in the social sectors (especially health and education) than in productive sectors (agriculture, infrastructure, private sector development, and the like). There is also evidence that attention to gender issues is greater in project design than in implementation, and there has been little effort to monitor or evaluate outcomes. Institutions have generally been slow to develop and adopt measurable indicators of progress in gender equality, and the rating systems primarily measure good intentions rather than results. Nor can the resources spent on gender mainstreaming be measured. Clearly much more is needed to strategically realize the comparative advantage that the MDBs have in knowledge generation and analysis, in their convening and coordinating roles, in leading high-level dialogue, and in helping formulate development policy strategies. The MDBs should utilize their comparative advantage and take up a visible leadership role in investing dedicated resources to include gender equality and women's empowerment in the results agenda, in leading international efforts to strengthen MDG3 monitoring, and in better assisting client countries in scaling up MDG3 interventions. The business case for MDBs' investments in MDG3 is strong—it is nothing more than smart economics.

Addressing the Special Challenge of Fragile States

Fragile states are generally characterized by weak institutional capacities and governance, and by political instability. These countries are the least likely to achieve the MDGs and they contribute significantly to the MDG deficit. They account for 9 percent of the population of developing countries, but 27 percent of the extreme poor (living on US$1 per day, see table 2), nearly one-third of all child deaths, and 29 percent of 12-year olds who did not complete primary school in 2005. Of all low-income countries that are unlikely to achieve gender parity in primary and secondary enroll-

TABLE 2 Fragile states face the largest deficit in most MDGs

Indicator	Total in developing countries (millions)	Total in fragile states (in millions and % share)
Total population (2004)	**5,427 million**	**485 million (9%)**
MDG1—Poverty (2004)		
Extreme poverty	985	261 (27%)
Malnourished children	143	22.7 (16%)
MDG2—Universal Education		
Children of relevant age that did not complete primary school in 2005	13.8	4 (29%)
MDG4—Under-Five Mortality		
Children born in 2005 not expected to survive to age five	10.5	3.3 (31%)
MDG5—Maternal Health		
Unattended births	48.7	8.9 (18%)
MDG6—Diseases		
TB deaths	1.7	0.34 (20%)
HIV+	29.8	7.2 (24%)
MDG7—Environmental Sustainability		
Lack of access to improved water	1,083	209 (19%)
Lack of access to improved sanitation	2,626	286 (11%)

Source: World Bank staff estimates; for notes see table 2.9.

ments, half are fragile states. Their weak performance is clearly linked to chronically weak institutional capacity and governance and to internal conflict, all of which undermine the capacity of the state to deliver basic social and infrastructure services and offer security to citizens.

Conflicts are a major reason why countries slide into fragility; they extract high costs in terms of lives and physical damage, they reduce growth and increase poverty. While there are fewer conflicts in low-income countries than before, conflicts have become shorter and more intense, with an enormous negative impact on GDP growth averaging about 12 percent decline per year of conflict.

Despite the enormous challenges of poverty in fragile states, progress against the MDGs is possible. A number of countries (Mozambique, Uganda) have made a successful transition from weak institutions and/or the legacy of conflict to sustained gains in growth and poverty reduction. In countries that remain fragile, successful progress against the MDGs has been achieved: Timor-Leste, Eritrea, and the Comoros, for example, decreased child mortality by 7.1 percent, 4.2 percent, and 3.5 percent, respectively, between 2000 and 2005.

Aid is particularly important in fragile states because it constitutes the main source of development finance. However, IFIs account for only about 8 percent of total Development Assistance Committee (DAC) ODA flows to fragile states, with the rest coming from bilateral sources. The IFIs, nevertheless, have an important role to play in financing postconflict reconstruction, in aid coordination, and in policy dialogue and technical assistance. The MDBs have recently started to converge around four areas of specialized response to the development challenge in fragile states: (1) strategy, policy, and procedural frameworks; (2) exceptional financial instruments; (3) customized organizational and staffing approaches; and (4) partnership work.

Accelerating progress toward the MDGs in fragile states requires attention to several issues and lessons of recent experience. First, since many fragile states are emerging from conflict, the sequencing and coherence of support for security, electoral efforts, and aid-financing to boost growth and employment are critical for minimizing the risk of reversion to conflict. Donors need to consider whether current instruments provide adequate continuity of support to minimize risks of renewed conflict.

Second, engaging in fragile states requires the IFIs and other donors to review their business practices and procedures, to ensure that these are adapted to low-capacity and sometimes volatile environments. Taking advantage of new peace-building or governance reform opportunities, or adjusting programs in the event of a crisis, requires a rapid response from all international partners engaged in these countries. Supporting reforms in low capacity states also requires increased field presence.

Third, fragile states are especially vulnerable to donor fragmentation and its potential burden on government capacity. This makes implementation of the Principles for Good International Engagement in Fragile States and advancing principles of the Paris Declaration on Aid Effectiveness particularly important. The IFIs need to work both between themselves and with other international partners to develop common approaches and operating principles in fragile states, in particular through efforts to improve coordination and division of labor with organizations leading peace-building efforts, such as the United Nations and regional institutions.

Making Aid, Trade, and Debt Relief Responsive to Country Needs

The expansion in global aid has stalled, and two years after the Gleneagles summit the trends in real aid flows suggest that DAC donors' promises of higher aid to Sub-Saharan Africa appear increasingly unlikely to materialize. Seven years after the Millennium Summit at which the MDGs were adopted, there is yet to be a single country case where aid is being scaled up to support achieving the MDG agenda. Most "low hanging fruit"

identified in the Millennium Report of 2005 have yet to be harvested. Progress with multilateral debt relief was rapid after the Gleneagles meetings in 2005, demonstrating how quickly initiatives can advance when there is a strong international commitment. The lack of progress with multilateral trade reforms in the Doha Round similarly demonstrates just how weak international commitment and consensus stymies change. Forging an international consensus beyond rhetoric is needed to accelerate progress.

Aid Volumes Trends: Bringing Actions in Line with Commitments

Although aid was on an upward trend through 2005 as DAC members, non-DAC donors, and nontraditional donors expanded assistance to developing countries, in 2006 the level of real aid from DAC members fell. After reaching a record level in 2005, total DAC member aid fell by about 5 percent to about just below $104 billion in 2006. These trends suggest that real aid delivery is falling well short of donor commitments. Doubling of aid to Africa by 2010 looks increasingly unlikely.

There has also been a continuing concentration of aid in a small number of countries, leaving the majority of countries with little or no real increase. Between 2001 and 2005, real aid volumes grew by more than 50 percent, but nearly 60 percent of International Development Association (IDA) countries saw a decline or little change in aid over this period. Such heavy concentration is not consistent with efforts to broadly accelerate progress toward the MDGs. Even as assistance from DAC donors has declined in 2006, aid from nontraditional donors is on an upward trend: Non-DAC OECD donors are expected to double their assistance to over $2 billion by 2010; Saudi Arabia and other Middle East countries provided nearly $2.5 billion in assistance in 2005; and other emerging donors, China in particular, are also rapidly expanding aid and becoming significant foreign creditors. Much of this aid targets infrastructure and productive sectors that DAC donors have moved out of.

Progress with scaling up aid to Africa has been disappointing. Five years after the Monterrey Conference and two years since the G-8 pledges at Gleneagles, country examples of programs to scale-up aid to support the MDG agenda are lacking. Beyond debt relief (important to improving future growth opportunities), most countries in Sub-Saharan Africa are seeing stagnant or declining aid inflows. Excluding Nigeria (a recipient of exceptional debt relief) real bilateral ODA from DAC members to the region fell in 2005 and was unchanged in 2006.

There is evidence that aid allocation is becoming increasingly selective on the basis of need (poverty) and the quality of policies (governance). Selectivity varies across different aid instruments. Flexible ODA—aid that can be used toward regular project and program support as opposed to special-purpose grants such as technical or emergency assistance—has been the most responsive to country improvements in governance and greater need. Technical assistance (much of which is for consultants and never leaves donor countries) is the least responsive.

Attention by donors to the needs of fragile states is beginning to translate into increased assistance. Overall aid to fragile states rose by more than two-thirds in 2005 to nearly $20 billion (in 2004 dollars), of which about half was in debt relief and humanitarian assistance. Fragile states are seeing an improving trend in aid received per capita, although they receive somewhat less aid (excluding humanitarian assistance and debt relief) than other low-income countries. Aggregate trends mask the wide variation across different types of fragile states: those emerging from violent conflict typically receive much more aid than other fragile states, and more than other low-income countries.

Progress with Harmonization and Aid Effectiveness

A critical agenda for improving aid effectiveness is progress with harmonization and

alignment of aid with country strategies, both by donors and the international aid agencies. There is evidence of some progress in these efforts. Two-thirds of donors place strategic priority on implementation of the Paris Declaration on aid effectiveness, and efforts to monitor its implementation are gaining traction. However, translating this good intent to outcomes on the ground remains extremely challenging: the greatest need for better aid harmonization is often in countries least capable of leading donor coordination themselves.

A baseline survey for monitoring the Paris Declaration was undertaken in mid-2006, yielding benchmarking data on the constraints facing donors and partner countries. On ownership by partnership countries it finds the story is mixed: while comprehensive national strategies are being developed, they lack well-specified prioritization and sequencing of objectives and actions, leaving them operationally weak. Less than one-fifth of countries had developed operational strategies at the time of data collection. The survey also finds that overall public financial management systems are weak in over one-third of countries, and moderately strong or better in less than a third.

Regarding donor actions, it finds that about 40 percent of aid is disbursed using a partner's public financial and procurement systems; about two-thirds of aid is disbursed on time; nearly half of technical cooperation is already coordinated—which is the 2010 target, although different interpretations of "coordination" require caution. The survey finds that donors *are trying* to harmonize. Forty-two percent of aid is provided through program-based approaches such as direct budget support or sectorwide approaches. One-third of missions and one-fifth of country analytic work is joint. However, strategic partnership "satisfaction" surveys in Africa suggest increased dissatisfaction over donor reporting requirements and coordination of donor support.

Pledges of harmonization remain abstract unless tested in the field. A recent review of aid for the health sector in Rwanda illustrates some key problems on the ground. First, the government's ability to achieve *policy coherence* is undermined by donors channeling the majority (86 percent) of total reported aid for health outside the Ministry of Health through direct transfers to local NGOs, local governments, and other providers. Second, most on-budget donor funding is earmarked for HIV/AIDS and malaria (85 percent in 2005), to the relative neglect of capacity building, human resource development, and other sectorwide needs. Only 1 percent was allocated to child health. Third, aid is volatile as much is committed for only 1 to 2 years, constraining ability to scale up health services which require mainly stable recurrent expenditures for salaries and facility maintenance. Finally, there is a sharp disparity between donor funding for health, which has increased sharply, and infrastructure and agriculture, which have been neglected. These factors point to the need for coordination among donors, agencies, global programs, and developing countries, to develop an adequate coordinating mechanism and more coherent approach.

Harmonization in the health sector is particularly difficult: the number of donors is large and includes numerous vertical programs; there is usually no critical mass of health financiers "on the ground" who can meet regularly to coordinate and harmonize. There is also an inherent tension between the goals of harmonized aid through country systems and the explicit mandates of vertical funds—whose successful advocacy for specific global health issues depends critically on their ability to show direct results. A viable harmonization strategy may be to move toward a country-led arrangement whereby (1) all donor support is "on plan" and aligned with government priorities and initiatives; (2) funding is primarily through the government budget, and where this is not possible a share is specified for support to system capacity building; and (3) reporting to donors is less frequent and done through multipurpose reports that meet multiple donor needs.

The Rwanda health sector example points more broadly to challenges posed by the evolving and more complex aid architecture. The proliferation of new aid sources—donors, private foundations, global funds—increases total resources, but also the difficulty of coordination and coherence, and the costs posed by fragmentation and resource earmarking. The average number of official donors has tripled since the 1960s, and since 1990 the number of countries with over 40 active bilateral and multilateral donors increased from zero to over 30. Emerging donors are also expanding their presence rapidly, along with global funds, although these are difficult to track due to insufficient data. The problem of a large number of aid channels is compounded by the trend towards small size of funded activities, which declined on average from $1.5 million to $1 million between 1997 and 2004, while their number surged from 20,000 to 60,000.

This places particular stress on countries with weak capacity. Countries with lower institutional capacity are found to have higher aid fragmentation, with negative implications for aid quality through higher transaction costs and a smaller donor stake in country outcomes. Clearly excessive fragmentation is a serious problem and measures to address it, possibly through donors limiting their focus countries, providing larger funds, or adopting more efficient vehicles (including through multilateral channels), and donors committing to delegate authority to lead donors, could help reduce transactions costs and improve aid effectiveness.

Developments in Debt Relief

The past year saw important progress in deepening debt relief to the poorest countries. The African Development Fund (AfDF), IDA, and the International Monetary Fund (IMF) all implemented the Multilateral Debt Relief Initiative (MDRI), described in the 2006 GMR. This initiative provides 100 percent debt relief on eligible claims to countries that have reached, or will eventually reach, the completion point under the Heavily Indebted Poor Countries (HIPC) Initiative. Twenty-two postcompletion-point HIPCs (and two non-HIPCs) have benefited from the MDRI to date, providing $38 billion, in nominal terms, in debt relief. The ongoing HIPC initiative also saw substantial progress, and 30 HIPCs had reached the decision point and were receiving debt relief as of end-2006.

Developments in Global Trade

World trade in 2006 continued the strong growth trends of recent years. Merchandise exports expanded by 16 percent in value, well above the average of 8 percent experienced during 1995–2004. Developing-country export growth continued to outpace the global average, growing by 22 percent. In addition to cyclical factors, trade performance reflects continuing unilateral trade reforms. Average tariffs in developing countries have fallen from 16 percent in 1997 to around 11 percent in 2006. As the pace of global integration accelerates, harnessing the new opportunities and managing the risks places a premium on a strategy of greater openness, coupled with behind-the-border reforms.

Owing to the steady reduction of tariffs, overall trade restrictiveness has declined in recent years. With the exception of a number of African countries, most economies are now less trade restrictive than they were in 2000. Much of this observed liberalization pertains to manufacturing. Much less has been done in agriculture. For a number of countries (such as India) the agricultural sector is now more restrictive than six years ago; in the European Union there has been no change, while Canada and the United States have registered a small decline since 2000.

Progress with the Doha Round. Despite intensive efforts to conclude the Doha negotiations in 2006, they were effectively suspended in July amid disagreement on the level of ambition in agricultural market access and over reductions in domestic support. However,

in early 2007 there was an informal agreement by World Trade Organization members to restart talks, providing a narrow window of opportunity to reach agreement in the first half of 2007 on the key elements of a deal.

Failure to conclude the Doha Round would send a strong negative signal to the world economy about the ability of countries to pursue multilateral solutions. It could weaken the multilateral trading system, which provides developing countries with guaranteed nondiscriminatory market access; the rules-based settlement of disputes; and the transparency of trade regimes. But the biggest risk of failure is to countries' own economic growth, as trade reform is fundamentally about self-interest.

Aid for trade. Progress was made on aid for trade in 2006. Donors indicated that they are prepared to offer large increases in aid for trade to help developing countries address the supply-side constraints to their increased participation in global markets and any transitional adjustment costs from liberalization. How much of this would be additional to existing aid remains unclear. Also, more remains to be done to operationalize this agenda.

Monitoring IFI Performance

Enhancing IFIs' effectiveness in advancing the MDG agenda requires adapting their strategies and developing capacity to be responsive to (1) changing demands, including those related to globalization and global public goods; (2) growing differentiation among clients; (3) the availability of alternative financial resources; and (4) the growing number of actors on the development landscape. Several commissioned reports and events in 2006 reflect on the evolving responsibilities of the IFIs and the need to strengthen performance and collaboration. More coherent efforts may be needed to strengthen the results management capacity of the IFIs, both to support capacity building in partner countries and to reflect on their own performance.

Evolving Roles

A number of commissioned reports or initiatives were completed in the last 12 months with implications for the changing demands on IFI resources and responsibilities. Discussions have highlighted five key challenges: support to the poorest countries; strengthened engagement in middle-income countries; responding on critical global public goods; promoting coherence and collaboration; and strengthening the voice and representation of developing countries. Reports released in September 2006 included the IMF's Medium-Term Strategy and the Report of the International Task Force on Global Public Goods; in the same month the Middle Income Country Strategy Report was reviewed by the World Bank's Board. The Review Committee on IMF–World Bank Collaboration released its report in early 2007. In addition, initial measures were taken to address the need for changing voice and participation in the IMF and the World Bank.

These reports conclude that there is significant progress in assisting poor countries toward achieving the MDGs and in working to promote country-led efforts in partnership with other donors. Connecting results and resources remains a major challenge, however. There is broad recognition of the importance of continuing to engage with middle-income countries, which are home to some 70 percent of the world's poor, but also of the need to improve the responsiveness of the IFIs and tailor support to specific country conditions. Critical public goods include international financial stability, a strong international trading system, preventing the emergence of infectious diseases, generating knowledge, and tackling climate change.

Cooperation among MDBs is underpinned by Memoranda of Understanding between them, and in 2006 the managing director of the IMF and the president of the World Bank commissioned an external review of collaboration between the two institutions. The report noted many examples of good collaboration, but also identified scope for improve-

ment, including clarifying the role of the IMF in low-income countries. Concerning voice and representation, a program of revisiting quotas and governance reforms in the IMF was launched in 2006 to be completed by the 2008. The first step was to revise quotas for a group of the most underrepresented countries: China, the Republic of Korea, Mexico, and Turkey. The changes approved in 2006 increased these countries' total IMF quotas by 1.8 percent, raising their share to 7 percent of total voting shares. Further steps are under way to develop a new formula for a second-round quota adjustment, and preparation of a proposal to increase basic votes in order to enhance the voice of low-income countries. Consultations on voice and representation are also under way in the World Bank.

Assessing Effectiveness: Financial Flows, Results, Harmonization, and Alignment

Assessing the effectiveness of the IFIs poses difficult challenges. Development results often lag policies and programs, and are hard to measure, but the bigger problem is that of attribution of results. Each IFI has an independent evaluation agency that plays an important evaluative role, but it remains difficult to address the results and attribution problems. Three aspects of international financial institutions' performance—financial support, results-based management, and progress toward harmonizing and aligning aid through the Paris Declaration—are highlighted.

Financial flows. Despite the rapid growth in private capital flows to developing countries, the financing role of the IFIs remains an important one. In 2006, the five MDBs disbursed $43 billion, up 20 percent over 2005 levels. It is premature to assess whether this increase is a temporary trend. Nonconcessional gross disbursements increased by 29 percent to $32 billion. After strong growth in concessional gross disbursements since 2000, peaking at just over $11 billion in 2004, flows slightly declined in 2005 and 2006.

These trends suggest that while demand for MDB lending from middle-income countries has increased, the supply of concessional funds to low-income countries is now stagnant. This has implications for the role of MDBs in the future, particularly their ability to respond to demands for scaling up multilateral assistance. Viewed from the perspective of overall ODA flows, the share of MDB financing has fallen significantly since 1998; if disbursements continue to stagnate while donors scale up bilateral ODA, the MDBs will represent only about 6 percent of total ODA flows by 2010. This poses important questions for the international community over the implications of declining multilateralism, or of the shifting multilateralism to other agencies, primarily the UN system and the European Union.

Debt relief under the MDRI has further potential repercussions for IFI financing, in particular for AfDF and IDA, which have provided debt relief extending out to 40 years. The MDRI commits donors to providing additional resources, on a "dollar-for-dollar" basis over four decades, to ensure that the cost of debt forgiveness does not undermine these institutions' overall financial integrity or ability to provide future financing. Firm financing commitments cover 10 percent of the total cost, and qualified commitments another 56 percent, leaving a gap of 34 percent between total costs and commitments for the MDRI. IDA 15 will be an important test of donors' intentions regarding the MDRI and future role of the MDBs.

Results management. The Third Roundtable on Managing for Development, held in Hanoi in February 2007, provided a venue for many country delegations to compare experiences and learn from them. The Roundtable included a meeting of the Asian Community of Practice, and the launching of a similar Community of Practice in the Africa region. Five factors were highlighted as important in building country capacity to manage for development results: leadership and political will, strong links between results and planning practices, evaluation

and monitoring tools to generate feedback on programs, mutual accountability between donors and country partners, and statistical capacity (both to supply, and help generate greater demand for, managing for results). The need to scale up both financial and technical support for statistical capacity-building was underscored as an essential element of the agenda—particularly as the financial costs of strengthening systems are relatively modest.

The Common Performance Assessment System (COMPAS) is an interagency effort to develop a common system across the MDBs for monitoring their results orientation, particularly with regard to their internal practices. Its three-pillar structure was described in detail in the 2006 GMR. A report for 2006, prepared under the leadership of the Inter-American Development Bank (COMPAS' chairmanship rotates), examines the seven performance categories that were developed for the 2005 report. In 2006, however, changes were made to improve the indicators, limiting performance comparisons over the two years. A number of findings emerged, including the need to better communicate the results of COMPAS within each MDB.

IFIs and the Paris Declaration. Results of the country-level monitoring of the implementation of the Paris Declaration's mutual commitments, which took place for the first time in 2006, will serve as a baseline to review progress in 2008 and against the 2010 targets. They suggest that substantial actions are being taken by the MDBs in many areas of harmonization and alignment, including the use of joint or collaborative country assistance strategies, but that continued efforts will be needed to achieve the 2010 targets. Over half the country analytic work of the MDBs is joint with other donors and/or partner governments, relative to the target of 66 percent, but only 21 percent of MDB missions are joint with other donors, relative to a target of 40 percent, and there is an urgent need to reduce the large number of parallel implementation units.

Questions to Ministers in the Development Committee

1. Global monitoring Report 2007

1. Although there is a consensus on the need to scale up aid, progress to date has been disappointing. This is in spite of recent progress–better growth performance, improved governance in many countries, improving macro policies, and evidence of increased absorptive capacity. **What *convening, advocacy* and *technical* roles should the World Bank and the IMF play to promote scaling up of aid, including addressing adequate absorptive capacity and supporting collaborative work with countries and other donors?**

2. Given the changing architecture of aid, and recognizing that aid quality can be compromised by the proliferation of aid agencies, inadequate predictability of aid, increased resource earmarking, and often weak alignment with strategic priorities, **what do Ministers view as the priority roles for the World Bank in helping to improve aid coherence and reduce fragmentation? How can the Bank best work with donors, recipient countries, and other multilateral agencies (including the UNDP, the EU, the OECD-DAC, and other MDBs) to address emerging problems and help to develop medium-term financing mechanisms that could improve aid predictability? How can the efforts of new players be better integrated in country-owned programs?**

3. The needs of fragile states in terms of aid are more highly focused on institution and capacity building, and delivery of basic services. Fragmented and uncoordinated aid in these countries results in greater inefficiency, which in turn may discourage donors. **What specific role should the World Bank play in improving aid effectiveness to fragile states, including through better inter-agency collaboration and coordination?** Similarly, given the particular challenge posed in this year's GMR on advancing gender equality, **are there**

particular actions Ministers support for strengthening Bank efforts to 'mainstream' activities in these areas and to strengthen the monitoring and evaluation of current interventions?