KfW Research
Focus on Economics

››› Economic prospects for sub-Saharan-Africa and the role of urbanisation

No. 180, 18 August 2017

Author: Dr Claudia Skibbe, phone: +49 221 4986-1157, Claudia.Skibbe@deginvest.de

Africa comes in 2nd to Asia in terms of being one of the regions with the highest urbanisation rates in the world. In theory, Africa's urbanisation offers great potential for private industrial companies to expand their operations in order to serve the ever-growing domestic demand. However, (economic) development is not keeping pace with the influx of people into the cities, meaning that Africa has hardly been able to benefit from urbanisation to date. Due to deficient framework conditions, the positive aspects of urbanisation (e.g. creation of jobs in the industrial sector, higher productivity and growth) are outweighed by its negative consequences (e.g. formation of slums, overburdened infrastructure). At the same time, a productive urbanisation process is of utmost importance to Africa. This is because after a 20-year period with average annual growth of 5.3 % in real terms, the slump in commodity prices has had a severely dampening effect on momentum in sub-Saharan Africa. To initiate a productive urbanisation process, it is necessary to overcome the „inactivity trap" of African cities. This trap results from the fact that no actor wants to invest first, and that the decisions of different actors (companies, city governments etc.) are dependent on one another. Merely expanding infrastructure is therefore not enough to overcome it. Rather, concerted efforts at the political level aiming to mobilize all actors simultaneously are required.

Introduction

Sixty years ago, there was not a single city in all of sub-Saharan Africa with more than 1 million inhabitants. Today, there are 28 cities with over 2 million inhabitants and a further 25 that are home to anything from 800,000 to 2 million people. Unlike during the industrialisation of Europe in the 19th century or of Asia in the 20th century, urbanisation in Africa is not giving rise to world cities but rather to squalid megacities, with two-thirds of African urban population growth taking place in slums. Although many African cities have football stadiums and cinemas, basic infrastructure (roads, power generation, sewage, water) is deficient or even lacking. Yet, three of the world's ten most expensive cities can be found in Africa. Unlike New York and London, for example, African cities are not expensive because all the necessary inputs and resources are available within a condensed area, but rather because they do not exist at all. Consequently, there are hardly any incentives for manufacturing companies to set up in African cities, so African cities lag far behind their counterparts in other regions in terms of industrial production, foreign direct investment and exports.

On the one hand, the emergence of (mega) cities constitutes an opportunity, given that cities generally provide more and better jobs, public goods and healthcare than rural areas and therefore offer a way out of poverty. However, the emergence of giant agglomerations in Africa is also enormously challenging because the population growth of African cities is not accompanied by the necessary structural change.

Urbanisation in Africa has not yet yielded the positive effects that are usually associated with the rise of cities. However, the need to organize urbanisation in a productive manner is of crucial importance for the future of Africa. This is because some countries – particularly those rich in raw materials – have been struggling for some years with serious problems (e.g. low growth rates, low tax and foreign exchange revenue, inflation), following the economic slowdown in China and the resulting lower commodity prices. In addition, rapid population growth necessitates sustainably high economic growth rates.

Economic development in sub-Saharan Africa

Since the mid-1990s, growth in sub-Saharan Africa has considerably outpaced that of the global economy with an average of 5.3 % p.a. in real terms during the period from 2000 to 2015 (see figure 1). At the end of 2014, growth in sub-Saharan Africa declined following the slump in raw material prices; in 2016, it fell to a 20-year low of 1.4 %. This development was largely influenced by China, which had become the most important trading partner to sub-Saharan Africa over the years.[i] In this respect, sub-Saharan Africa benefited from the fact that China's longstanding boom was largely driven by investments, which in turn fuelled demand for African raw materials, particularly energy and metals. Raw materials do not only dominate production but also account for almost 80 % of sub-Saharan Africa exports. The other side of the coin is that Africa is now affected to a great extent by the economic slowdown in China and the country's increased orientation towards domestic consumption – firstly through the falling demand for raw materials and secondly through low commodity prices.

A more detailed analysis shows that the slowdown is not necessarily typical of all 49 countries in Africa, but can be attributed mainly to problems experienced by countries that are rich in raw materials, and above all to the three largest economies in sub-Saharan Africa: Nigeria, South Africa and

[i] African exports to China grew from USD 4 billion in 2000 to an all-time high of USD 63 billion in 2013; during this time, the proportion of African exports attributable to China rose from 4 to 16 %.

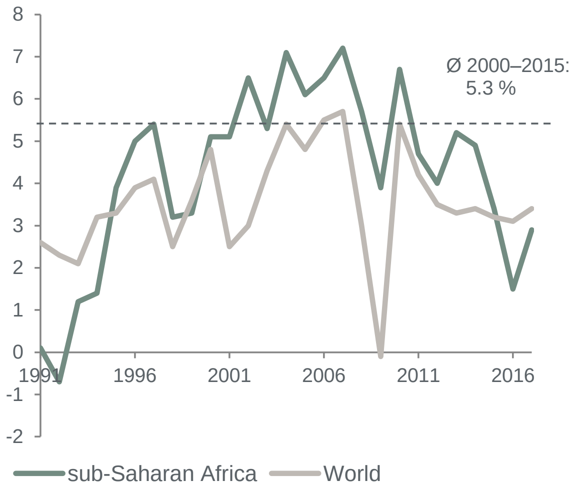
Angola. The International Monetary Fund (IMF) even speaks of a “two-speed Africa” (see Figure 2). It makes a distinction between:

- 23 raw material-exporting countries which are under considerable pressure. Although oil exporters are particularly affected, metal exporters such as Zambia also find themselves under pressure.

- The remaining 22 countries, whose growth has also slowed down in part, but not to the same extent. This group recorded growth of 5.5 % in 2016.

Figure 1: Real GDP growth in sub-Saharan Africa

(in per cent)



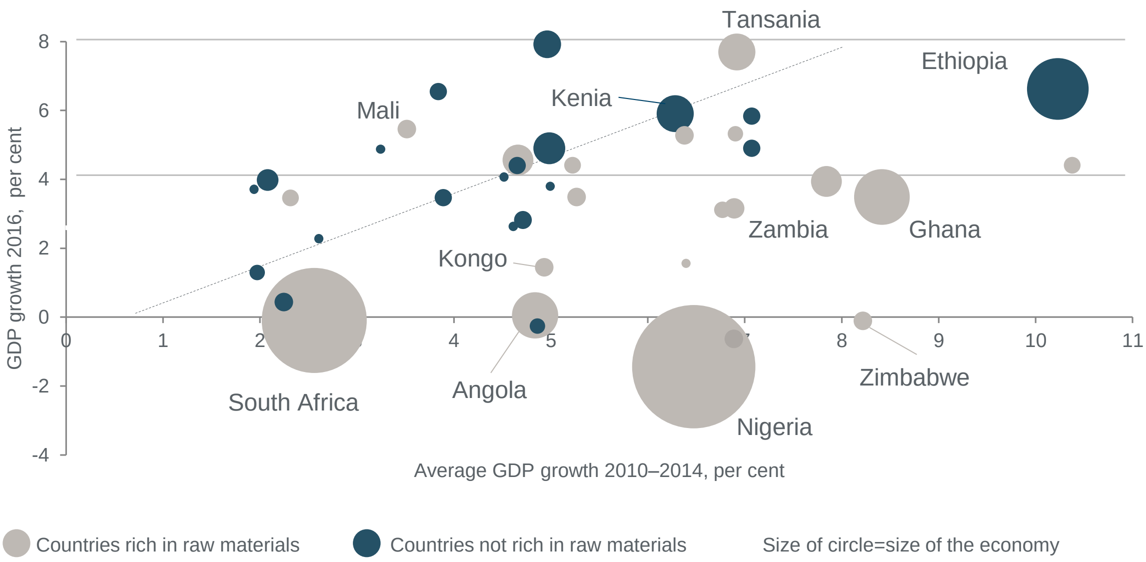
Source: Own presentation, based on IMF, World Economic Outlook 2016

The divergent development of the two country groups intensified in the years following the slump of raw material prices at the end of 2014. This is because the initial shock in countries that are rich in raw materials gradually spread to all areas of their economies. For instance, the oil-exporting countries suffered from declining state and foreign exchange revenues, falling demand and rising inflation following the depreciation of their currencies. In addition, financial institutions in a number of countries (Angola, Gabon, Ghana, Nigeria and Zambia) were unwilling to provide loans to the private sector on account of lower growth prospects, inflation and challenges in the banking sector. There is a risk that the problems in the real sector will spill over into the banking sector, leading to an increase in non-performing loans.

By contrast, those countries which are not rich in raw materials benefit from lower oil prices and from having invested continually in infrastructure to make up for the lack of resources, thereby improving overall conditions for investment. However, in 2016, economic growth in a number of these countries was also lower than in previous years. This can be attributed to an unusually strong El Niño, which led to parts of East and South Africa experiencing the most severe drought in 35 years. The drought affected both countries that are highly dependent on agriculture (in particular Ethiopia) and countries that are dependent upon hydropower (Zambia, Uganda). Unfortunately, the better overall performance of countries which are not rich in raw materials did not have a knock-on effect on the other country group because sub-Saharan countries have few economic ties with one another.

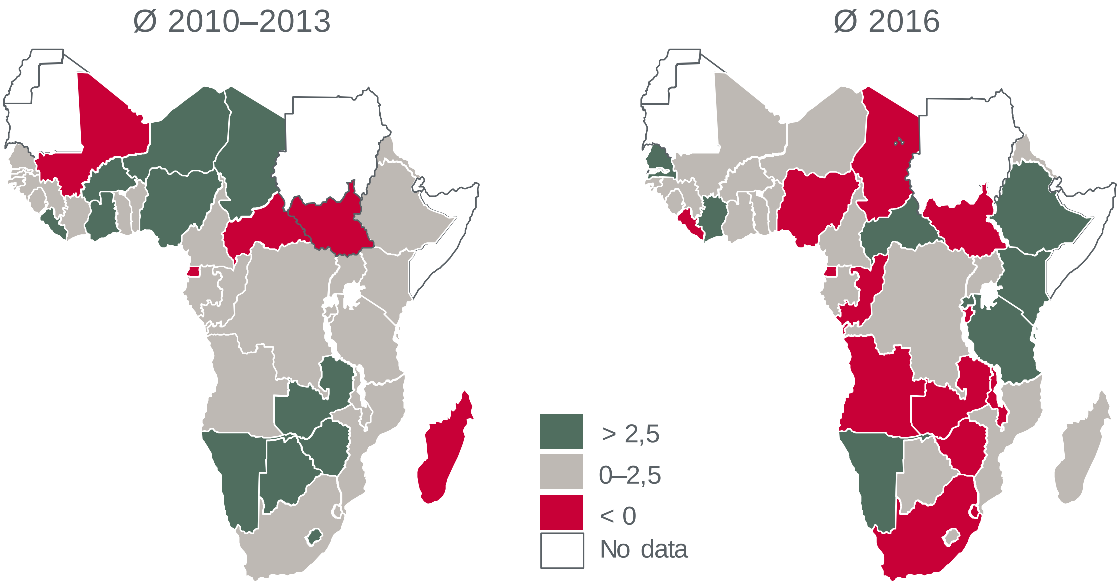
The different economic realities in the region become evident when examining the development of per capita GDP (Figure 3). Per capita GDP is still increasing by 1.75 % per year in the median country in 2016. However, for the first time in 22 years, the average per capita GDP in sub-Saharan Africa fell (by 0.9 %) in 2016, pushed down by the 15 countries with shrinking per capita GDP. Given that the poverty level in sub-Saharan Africa was still at 43 % in 2012 (most recent available figure), this is a very serious development.

Figure 2: Two-speed Africa



Source: Own presentation, based on IMF, World Economic Outlook 2016

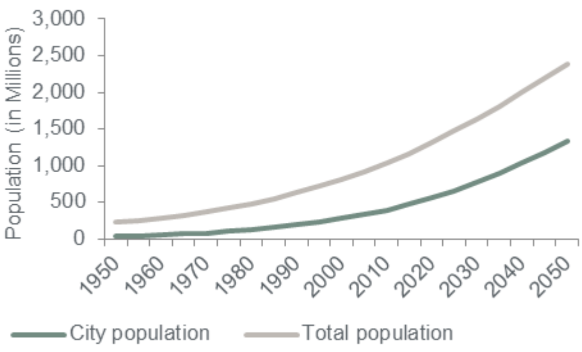
Figure 3: Falling per capita income in sub-Saharan Africa – Growth of real per capita GDP (in per cent)



Source: IMF 2016

Per capita GDP is influenced both by GDP growth and by population trends. Figure 4 illustrates that the African population is growing very rapidly and is set to double from 1 billion people in 2010 to 2 billion in 2040. Despite the phase of extraordinary economic growth between 2000 and 2015 which was dubbed the era of "Africa rising", the poverty-reducing effect of this growth was rather limited: given the high population growth of 2.8 %, the average economic growth of 5 % amounted to merely 2.2 % in net terms. This is because prosperity, measured as per-capita-GDP, increases only if the economy grows faster than the population. In other words, the situation did not improve as dramatically during the good years as appeared to be the case. Sub-Saharan Africa requires growth of 6 to 7 % in order to make noticeable progress in combating poverty.

Figure 4: Africa – Rapid population growth and urbanisation



Source: Own presentation, based on data by the United Nations

Explosive growth of African cities

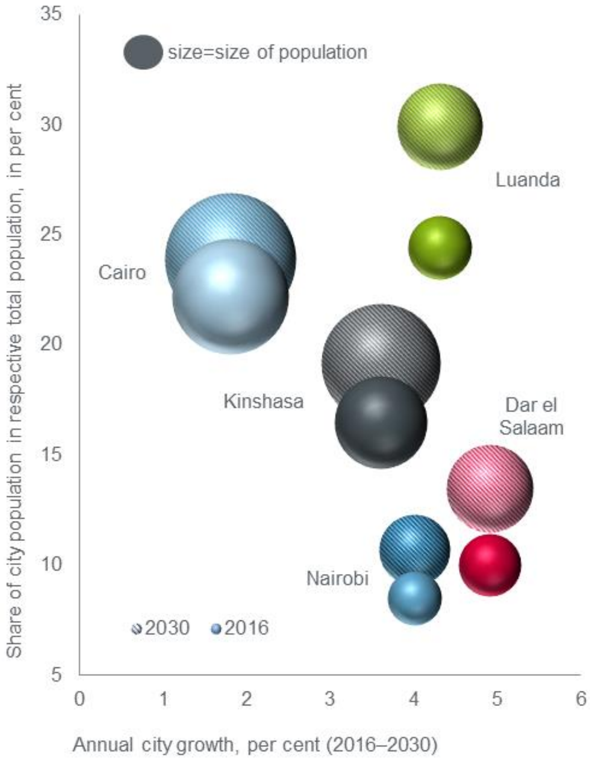
The population living in cities is set to double in an even shorter period of time: from 500 million people in 2016 to 1 billion in 2040 (see Figure 4). This means that the number of people living in African cities will increase by approximately 20 million every year between now and 2040. By comparison, the number of city dwellers is growing by 11 million yearly in India and by 9 million in China. This development is not expected to level off until 2050. Accordingly, the urbanisation process in Africa (and in Asia) happens at twice the rate of the urbanization process in Europe at the time. The African urbanization process is also noteworthy in absolute terms. It is forecast that, as early as 2020, Africa will have the world's second-highest number of city dwellers (560 million) after Asia (2.4 billion). However, the provision of urban infrastructure and services is not keeping pace: over 50 % of city dwellers in sub-Saharan Africa live in slums and, since 1990, still only 40 % of the urban population has access to better sanitary facilities in spite of the fact that the urban population has grown substantially in absolute terms.

Figure 5 shows the development of African cities. For example, Dar el Salaam is growing yearly by 5 % – this is equivalent to a daily population increase of 1,000 people. Following this development, the proportion of the overall population represented by city dwellers will also increase between 2016 and 2030.

Contribution of urbanisation to development

Cities make an important contribution to structural change within an economy, i.e. shifting economic resources from areas of low productivity (such as traditional agriculture) to areas with higher productivity such as the manufacturing sector. Key drivers for urbanisation processes in Europe and the USA were 1) the increase of agricultural productivity, which led rural workers to migrate to cities (=push factor) and 2) industrial development in the cities, which enticed rural workers with the prospects of higher wages (=pull factor).

Figure 5: Development of African cities



Source: Own calculation, based on data by the United Nations

As jobs in the manufacturing industry have a higher level of productivity than jobs in the agricultural sector and involve "learning on the job", cities benefit from more human resources, income and demand over time. In the course of urbanisation processes in the past, a positive cycle between urbanisation and development was set in motion, promoting the shift from an agricultural to an industrial society. "Agglomeration effects", which are typical of cities, contributed to a great extent to this process. Agglomeration effects include low transport costs, dynamic labour markets benefiting employees and employers alike, a large local market and the concentration of knowledge and human resources, facilitating the exchange of knowledge and the generation of innovations. All these effects combined boost productivity and, in turn, the growth of cities.

Consumer cities versus production cities

The aforementioned push and pull factors cannot explain the rapid growth of African cities, as neither a green revolution nor a significant industrial revolution has taken place there to date. Rather, Africa appears to be skipping the industrialisation stage: although the continent has an urbanisation rate of 60 %, the proportion of GDP attributable to manufacturing industry remains unchanged at 10 %. By contrast, in the case of non-African countries, the proportion of manufacturing industry increased to 20 % with the same degree of urbanisation. Rather, the services sector is the most important driver of growth, accounting for almost 60 % of African GDP in 2014.

The relatively high contribution made to GDP growth by services is closely related to the fact that the growth of many African countries is based on the extraction of raw materials. As the profiteers of raw material extraction concentrate their spending in cities, the demand for locally consumable services (e.g. restaurants) increases, encouraging people to move to the cities. However, the emergence of "consumer cities" (rather than "production cities") means that most workers migrate to low-skilled jobs in the informal services sector.

One factor preventing the emergence of a manufacturing industry is that raw material exports tend to lead to an appreciation of the respective currency, which in turn creates a negative incentive for exporting industrial goods (= Dutch disease). This means that most goods are imported from other countries and only construction sector products are bought locally. Another factor is that, because African cities are experiencing population growth but not economic growth, the economies of scale that typically allow agglomeration effects in cities are absent. African cities …

- are overcrowded rather than condensed, because investments in infrastructure, industrial and commercial structures (e.g. industrial estates) and affordable housing have not kept pace with population growth. Accordingly, the costs of urban concentration (overcrowding, congestion) outweigh the benefits. The infrastructure deficits are the result of decades of underinvestment, which in turn can be attributed to institutional and regulatory limitations (e.g. inefficient land markets, overlapping property rights and insufficient urban planning processes).

- are fragmented rather than interlinked, i.e. they consist of a large number of unconnected districts. The lack of a reliable transport infrastructure necessitates long journeys, which limits the job opportunities for members of the workforce.

- are therefore expensive for households and for companies: Because the costs of food, housing and transport are so high, companies are forced to pay high nominal wages. Investors are put off by high labour and transaction costs, particularly in regionally and internationally tradable sectors, because costs ultimately need to be covered by the price of products that are sold in a global competitive environment.

As a result, companies largely stick to producing locally traded goods and services. This also curbs the growth of cities, given that economies of scale are scarcely possible for companies catering to the urban, rather than regional or global market. Export markets are therefore crucial for a dynamic industrial sector; in addition, employment growth could be generated most readily by developing an African export sector.[ii]

[ii] The growth of many developing countries since the 1980s is founded on exporting industrial products at low prices made possible by low labour costs.

Overcoming the „inactivity trap“

Africa’s cities are overcrowded and fragmented and therefore expensive for companies and city dwellers alike. Knowing that African cities are rather dysfunctional with regard to the provision of public services, efficient labour markets and economies of scale, potential investors tend to stay away.

As a result, African cities are caught in an “inactivity trap”: entrepreneurial investments do not take place because they do not only depend on the availability of infrastructure, but also on the decisions of other companies (customers, suppliers and specialist service providers) and on whether suitable housing is available for employees. However, investing in new housing is only worthwhile when higher wages create a rising demand for housing. Cities ultimately need economic growth that generates tax revenue in order to be able to provide funds for expanding infrastructure – and whether a city develops economically depends once again on entrepreneurial decisions.

As no player wants to make the first move and the decisions of the various players are dependent on one another, merely expanding infrastructure is not enough to avoid the “inactivity trap”. Rather, a concerted approach is required: in addition to infrastructure, it is necessary to improve the efficiency and quality of urban planning processes, to modify and/or modernise ownership and land use rights and to reduce overregulation. The reluctance of companies to be the first to invest can be overcome by means of a credible coordinator, e.g. a group of companies that harmonise their plans, a large project developer or a local government that can bring about its vision with extensive investments in infrastructure. Only with such an extensive package of measures will it be possible to render African cities more attractive to potential investors.

Conclusion

African companies need to overcome a large number of obstacles. In addition to the well-known challenges of corruption, lack of financing, small domestic markets and unreliable infrastructure, the fragmented nature of African cities burdens companies with high costs by curbing agglomeration effects and pushing up wages. Essentially, African companies only have the option to produce non-tradable goods (mainly services). This hampers the development of a manufacturing industry and perpetuates low growth in African cities. In addition, owing to the weak performance of the industrial and services sector, most people working in cities have very little job security.

The fact that Africa has not yet been able to build up a meaningful manufacturing industry and thus jobs in this sector is a cause for great concern. Theoretically, industrial production could be doubled from USD 500 billion to USD 930 billion in 2025 (see McKinsey 2016, page 8). Currently, Africa imports one-third of its food needs. In the future, three-quarters of increased production could be provided by African companies serving domestic demand, with the remaining quarter being produced for export. Through the accelerated industrialisation, up to 14 million stable jobs could be created over the next ten years.

Building up a manufacturing industry in Africa depends greatly on shaping the urbanisation process in a productive manner. For this to be achieved, a positive cycle needs to be initiated through concerted efforts on the political front and through the inclusion of various players. Insofar as this is successful and underlying conditions for the private sector improve, DEG will also be able to further increase its activities in Africa. ■

References:

Barofsky, J. Grabinski, J. and E. Siba (2017): Can rapid urbanization in Africa reduce poverty? Causes, opportunities and policy recommendations. Washington DC, Brookings Institution

International Monetary Fund (2016): Subsaharan Africa – Multispeed Growth. Regional Economic Outlook.

McKinsey (2016): Lions on the move II.

OECD (2016): African Economic Outlook – Sustainable cities and structural transformation.

Raschen, M. (2016): With good politics, sub-Saharan Africa can make up more lost ground. Fokus on Economics, KfW Research.

United Nations (2017): Urbanization and industrialization for African Transformation. Economic Report on Africa 2017.

World Bank (2017): Africa’s cities – opening doors to the world.