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Policy commitment arrangements for Africa: Implications for aid, trade and investment flows

by

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1. Introduction

Most African governments have weak credibility. They have trouble living down the past and hence continue to suffer from their own reputations (in countries where economic reform has not been accompanied by political change) or by the lingering reputation of their predecessors. Although this credibility problem is currently more severe in Africa than in other regions, it is far from a uniquely African problem. Currently, several countries of the former USSR have a similar problem. In the early postwar era most West European governments faced credibility problems at least as daunting. They overcame these problems by a combination of performance and commitment arrangements. Clearly, the most important means by which a government can build reputation is through its performance. The role of commitment arrangements is primarily to accelerate the building of reputation beyond that which would occur purely through good performance.

In the limiting case a government that is resolved to maintain good performance simply uses commitment mechanisms as a signalling device. That is, the commitment mechanism merely signals to private agents that the government has resolve, rather than in any way changing government behaviour. If the signal is effective the commitment mechanism may be very useful in accelerating the building of reputation and hence in raising investment. However, a government might wish to use a commitment mechanism not only as a signal but as a discipline that changes its own behaviour. For example, a government might resolve to avoid large budget deficits, but nevertheless find that the promulgation of a cash budget procedure provides a commitment mechanism without which it is unable to implement its resolve. In general, commitment mechanisms have both these features: they are signals to private agents about government intentions, and they are also specific procedures for converting good intentions into realized policies. In turn, a mechanism that manifestly converts intentions into realized policies will enhance credibility with private agents. The cash budget not only signals to private agents that the government is resolved to avoid large fiscal deficits, it reassures them that a viable means has been put in place for achieving this resolve.

This paper focuses on the commitment mechanisms a government can use to build credibility in trade and investment policies. We refer to commitment mechanisms as "agencies of restraint". We classify such agencies according to their domicile and the source of their power. Their domicile can be purely domestic, purely external or a hybrid. For example, a national central bank is a purely domestic agency, donor conditionality is purely external, and regional agreements are partly domestic and partly external. Agencies of restraint can derive their power through being based on penalties, through the devolution of authority or through some combination. For example, by establishing an independent central bank a government is able to restrain itself from interfering with the setting of interest rates. It achieves this through authority-shedding. However, an independent central bank thereby also acquires a role as a restraint over the fiscal policy of the government. If the government chooses to run a large fiscal deficit the central bank can raise interest rates. In turn this inflicts political costs on the government since electors dislike the increase in interest rates. Hence, an independent central bank is both a restraint upon monetary policy, based upon authority-shedding, and a restraint upon fiscal policy, based upon penalties.

We begin, in Section 2, with commitment mechanisms in the area of investment. Investor fears arc partly specific to property rights over their investment, and partly much more wide-ranging with respect to the management of the economy. Investment will be deterred both if investors fear that their assets will be confiscated and if they fear that the economy will collapse into hyperinflation and a crash in the exchange rate. Between these two extremes investors are also concerned about the extent to which changes in trade policy will alter the relative prices they face. Section 3 focuses explicitly on commitment mechanisms in trade policy.

2. Investment and capital flows

Africa was the first continent to integrate into the global capital market with some 70% of African private wealth shifted outside the continent between 1970 and 1990. However, it has been the last continent to attract an inward flow of investment. Recently, this has begun to change: over the period 1989–1994 net investment from the Organization for Economic Cooperation and Development (OECD) economies was $8 billion, a fourfold increase over the period 1983–1988. To date, however, this investment has been inward looking and confined to a small section of the world's companies that happen to have an informational advantage about Africa.

Evidence on the inward-looking nature of foreign investment to Africa comes from a survey conducted of foreign investors to five East African countries conducted in 1994. It found that virtually none had considered a location outside East Africa for their project. Presented the other way round, this shows that East Africa is not on the shortlist for internationally footloose investment projects. It was considered only for those projects could not be located elsewhere, presumably either because of natural resources, or because the investment was intended to serve the local market. As long as this inward orientation continues, foreign investment cannot power African growth: it will be growth dependent, rather than growth generating.

Evidence on the informational segmentation of corporate investment in Africa comes from its geographic composition. Over 60% of OECD investment in Africa during 1989–1994 came from just two medium-sized OECD economies, Britain and France. That investment in Africa was so skewed towards the two former main colonial powers suggests that other potential investors were deterred by a lack of knowledge. Investment in Africa appears to have been only for the cognoscenti: those firms that had long-established links with Africa, overwhelmingly British or French, were in a position to detect the improved investment climate and respond to it. Other foreign firms did not invest because of a lack of knowledge.

In these two senses Africa has yet to globalize. It is not attracting investment from a global pool of investors, and it is not attracting investment that is globally, rather than domestically oriented. The same 1994 survey found that the single most important impediment to foreign investment was the fear of policy reversal. Investors doubted that reforms would be maintained. This section discusses the nature of investor fears and how African governments can use commitment strategies to allay them.

Investor fears

If a potential investment is not profitable at current prices then it is unlikely to take place. This paper is concerned not with the policies necessary to make an investment currently profitable, but with the policies necessary to induce investment for a project that is profitable at current prices. Supposing an investment to be currently profitable, investors must still be concerned about its prospects. We can distinguish between general concerns about the performance of the economy, and specific concerns about the rights of the investor. The former are straightforward: investors fear macroeconomic instability arising from unsustainable fiscal or external deficits. The latter are more complex and can be divided into concerns about property rights, about costs and about markets.

Property rights

The investor purchases an asset that generates a stream of profits. The property rights over this asset can be attacked either directly, or via the stream of profits. Vulnerability to confiscation is the most obvious, though probably not the most important of the fears of foreign investors; at times various African governments have nationalized foreign assets, with or without compensation. Property rights can also be undermined without confiscation, for example, simply by raising taxes.

The asset will normally have greater value to the company owning it than to prospective purchasers. Hence, the company will lose not only if the asset is confiscated, but if it is forced to sell. For example, if the government withdraws permission for the company to operate, then the company will incur a loss relative to its own valuation in selling the asset. The government of Kenya recently withdrew from DHL its right to operate with in Kenya and this will have imposed costs on DHL even though it is free to sell its assets and repatriate the proceeds. Property rights are thus vulnerable to arbitrary changes in competition policy.

The most obvious area of investor concern is over rights of repatriation of profits. The government can restrict such rights either by overt taxation of remitted profits or by using a multiple exchange rate, or by preventing repatriation and limiting the range of domestic financial assets in which they can be held.

In attempting to guarantee property rights to a foreign investor the government faces a time inconsistency problem. That is, once the investor has made an irreversible investment the government has an incentive to break any commitment to the rights of the investor. While the relations between any single investor and the government have this structure, the problem may be overcome if investors see themselves as a group subject to equal treatment and if there is a flow of new investment. The flow of new investors then constitutes to existing investors, then it will also discourage potential investors. The problem of time inconsistency arises either if investors do not believe that the government will treat investors equally, or if the benefits from the flow of future investment are outweighed by the benefits of consication of past investments.

The last days of the Soviet Union provide a good example of the credibility problem and how it is affected by discrimination. Gorbachev recognized that the Soviet Union had a credibility problem that was inducing investors to hold off. However, he announced to an audience of potential investors:

> Those [companies] who are with us now have good prospects of participating in our great country.. [whereas those who wait] will remain observers for years to come—*we will see to it.*
>
> (*International Herald Tribune,* 5 June 1990, quoted in Williamson, 1994: 187).

His solution was thus to threaten discriminatory action on the part of the Soviet government. Yet the threat of discriminatory action may paradoxically have worsened the credibility problem. His statement in effect conceded that it was perfectly possible within the Soviet system for the government to behave in a discriminatory fashion: Gorbachev's promise was that early investors would be treated more favourably than later investors. However, if the Soviet Union was a rational agent and free to discriminate, it would end up not only breaking this promise, but reversing it: when the time came, late investors would be treated more favourably than existing investors because the latter were already captive. This, in effect, was the strategy adopted by the Mugabe government during the 1990s: the rules on the repatriation of profits were much more generous for new investors than for existing investors. Hence, there is an interaction between the time consistency problem and discriminatory behaviour.

A second factor in the time consistency problem is the rate of growth. A fast growing economy has a lower risk of confiscation than a slow growing economy because there is more investment to be deterred. The most severe problems arise in slow growing economies in which there are potentially large investments that have a high risk of failure, offset by a chance of high profitability; the main example of such investments is mining prospecting. A prospecting company depends on recouping its costs of mainly failed searches by strikes that are then highly profitable. A government in a slow growing economy may have a huge incentive to confiscate a mining discovery because it is more profitable than the damage done to future investment. Knowing this, firms will not invest in prospecting and so the government is stuck with a time consistency problem.

To summarize, property rights are less credible where the government can be discriminatory in its treatment of investors without hindrance from the law, where the rate of growth is low, and where there are high risk, lumpy investments. Thus, the government of Hong Kong, with a rising stream of small manufacturing investments and a robust legal system, faces less of a time consistency problem than, say, the government of Niger.

Costs

A potential investor may also be deterred from a currently profitable investment by fears over rising costs. The most likely areas of concern are taxes, prices and controls. Taxation is among the leading concerns of investors in Africa. It is not that current tax rates are particularly high, but rather that their imposition is in practice often arbitrary. There are also so many temporary tax exceptions for new investors that the tax burden for longstanding investors is necessarily fairly high. The tax system thus discourages long-term investment. The one component of the tax system that is much higher in Africa than elsewhere is taxes on trade. Import duties on inputs are common, and in some countries there are also export taxes. For example, Malawi recently imposed export taxes on tobacco. Among price concerns, exchange rates and interest rates probably predominate. Real exchange rates have been highly volatile in Africa, so that an activity will switch between profitability and unprofitability. Several countries have also had a history of real and nominal interest rate shocks. The control regimes previously common in Africa imposed both costs of rationing and costs of corruption. A common complaint among businesses accords with the model of Schleiffer and Vishny: because corruption is not centralized into a "one-stop-shop", there are too many people able to stop a project for it to be viable to buy them off. This is a consequence of decentralized regulation: local governments, ministries and licensing authorities all have powers of obstruction. Such decentralized power is not in itself undesirable, and is indeed common in Western societies.

However, in Africa it is less restrained by transparency and civil society. Investors fear decentralized, and therefore uncoordinated, arbitrary power.

Markets

Markets are heavily influenced by trade policy. Domestic markets are most obviously affected. The partial, but nevertheless large, trade liberalizations of the past decade in much of Africa have radically altered markets, exposing formerly monopolistic firms to competition. For example in Zimbabwe in the early stages of trade liberalization, only 7% of manufacturing firms regarded competition as a problem; after two years of liberalization this had risen to 36%. Conversely, the ability of firms to lobby for increased protection creates a risk for investors who use inputs that might be so protected: high cost (and possibly low quality) inputs would threaten profits. We defer consideration of these market concerns until Section 3.

Commitment strategies for macroeconomic stability

We first consider the use of commitment mechanisms to allay investor fears of macroeconomic instability. We start with two purely domestic agencies of restraint, an independent central bank and a cash budget. We then introduce two external agencies, capital account convertibility and donor conditionality, and finally the hybrid of regional convergence criteria.

Independent central bank

Granting independence to the central bank is the classic way in which the government can restrain itself. The perceived effectiveness of the Bundesbank, the Federal Reserve and the Reserve Bank of New Zealand has induced a widespread move towards the institution. In 1997 the British government gave the Bank of England independence over monetary policy and the planned European Monetary Institution will extend independence to most of Europe. Many African governments have adopted legislation that devolves power onto central banks and protects the governor from dismissal. However, the evidence on the effectiveness of central bank independence in developing countries is not encouraging. Cukierman et al. (1992) found no relationship between their degree of legal independence and the rate of inflation. Rather, it was the tenure of the governor that was important, suggesting that power relationships remained personalized rather than being embedded in the legal framework. The recent shift to democracy in Africa is likely to change this, making central bank independence a reality rather than a legalfiction. However, it will take time for legally independent central banks to establish their own credibility with private agents. In the short term central banks face the same credibility problem as the government and so are not an important means for credibility enhancement. It is also likely that the penalty inflicted on the government when the central bank raises interest rates is less politically costly in African than in developed economies. Interest rates inflict political costs in developed countries mainly because a substantial proportion of the electorate have mortgages and blame the government if rates rise.

While a central bank may have only limited effectiveness in retaining the fiscal deficit, it may have a more important function in restraining the external deficit. For example, the Central Bank of Chile is required to limit the external deficit to below 4% of GDP, the maximum amount judged to be sustainable. Such management of external deficits may be of considerable importance in reassuring investors and so avoiding currency crises.

A final area of central bank restraint, of evident importance in view of the East Asian crisis, is on the commercial banking system. In some countries this function is hived off into an independent agency responsible for banking supervision. The advantage of such a separation of functions is that the resulting agency has a clear and limited responsibility for the probity of the banking system.

Cash budget

To date the most effective domestic agency of restraint upon governments has been the cash budget. The power of this rule derives from its simplicity and its conversion of what is intrinsically a continuum into a specific quantitative target, namely a zero deficit. The principle that spending should not exceed income is readily defensible in cabinet, even though as an economic proposition it is not in fact correct. The economically correct proposition, that a deficit should not over the course of a business cycle exceed the level consistent with sustainable debt accumulation, does not produce a precise target. As a result, it does not provide a defense in cabinet against incremental spending requests.

While cash budgets have proved effective in the short term, given their lack of economic rationale it seems unlikely that they can persist as long-term restraints. They therefore gradually need to be replaced by more sustainable restraints, conceivably by independent central banks.

Capital account convertibility

Capital account convertibility provides a restraint upon the government because unsustainable policies are punished by capital flight. The experiences of Britain in 1992, of Mexico in 1994 and of East Asia in 1997 demonstrate the power of this mechanism to inflict punishment. However, the very fact of these currency crises also demonstrates that governments have sometimes failed to take the threat sufficiently seriously. A few African governments have recently adopted full convertibility. Since capital controls have been ineffective, the adoption of convertibility is usually unlikely to produce transitional capital flight, although this occurred in Zambia where the adoption of convertibility preceded fiscal stabilization. Rather, the expectation would be that convertibility would lead to an initial increased inflow of capital. The potential withdrawal of this capital would then constitute the penalty-based restraint mechanism. In several economies private capital inflows have become bunched into euphoric surges that have appreciated the exchange rate and financed consumption booms.

There is clearly a need for macroeconomic management to prevent such unsustainable behaviour. One possibility is for the taxation of short-term capital flows as done in Chile. However, this carries a high cost. It signals to potential investors that the government reserves the right tax them, and reduces the liquidity of their investment, thereby confirming investors' fears about African governments. Further, it is likely to be ineffective in practice because investors can find many illegal routes for removing capital. Potentially, any commitment to capital account convertibility could be lodged either with an extension of the remit of the International Monetary Fund, or with the World Trade Organization (WTO) role in trade in financial services.

Donor conditionality

Donor conditionality has been used extensively as a macroeconomic policy restraint mechanism. Governments reach agreement with the IMF on monetary targets, which are then monitored. Breaches of the targets in principle attract aid penalties both directly through IMF enhanced structural adjustment facility (ESAF) financing and indirectly through cross-conditionality between IMF programmes and the aid programmes of other donors. In practice, donor conditionality—has been quite ineffective as a means of enhancing credibility despite being the major recipient of such conditionality, Africa is rated as the riskiest continent for investment. One reason for this is that fully three-quarters of IMF ESAF programmes have missed their targets sufficiently badly for the programme to be canceled or interrupted. As a result of this history, donor conditionality now faces its own credibility problem as a restraint.

Regional convergence criteria

A hybrid agency of restraint that has yet to be used in Africa is regional agreements on "convergence criteria". Such criteria have recently proved highly effective in Europe. European governments agreed on targets for fiscal deficits (3% of GDP) and for government debt (60% of GDP). As with cash budgets, there is no particular economic rationale for these precise numbers, but their promulgation has a powerful political effect for two reasons. First, the quantitative target converts something that is intrinsically a continuum into something precise. This changes the politics of incremental public expenditure. While the cost of deficits is viewed as a continuum (which is correct in terms of economics), no single proposal for additional spending can be vetoed on the grounds of the clear and unacceptable cost of an increased deficit. By contrast, once there is a quantitative target, the political costs of incremental expenditure cease to rise as a continuum but become discrete: any proposal that would push the deficit over the target incurs high political costs and so can be rejected. Second, the power of the convergence criteria rests on the fact that governments that are accepted as peers have reached agreement on them and that many of these governments will meet them. Failure to achieve the target thus signals to the domestic electorate that its government has failed on its own terms. The European agreement on convergence criteria will eventually include fiscal penalties, but these are probably incidental to effectiveness. To date there have been no fiscal penalties, yet the criteria have already radically changed fiscal behaviour as governments take painful fiscal decisions in order to achieve the targets. This demonstrates that it is the existing political penalties rather than the prospective fiscal penalties that give the institution its power.

There is scope for African governments to use their regional groupings, and indeed their continental groupings (Economic Commission for Africa, African Development Bank, Organization of African Unity) to determine convergence criteria. The fiscal and debt targets need not be the same as the European criteria, nor indeed need the coverage of an agreement include or be confined to fiscal deficits and debt. However, the principle should be that African governments would themselves agree on what constituted unacceptably bad economic policies. By delineating such policies and agreeing to avoid them, governments would build political penalties against their adoption that would reduce the perceived risk to investors. This process has dramatically reduced interest rates across Europe in the past year and it can have a similar effect on investor confidence in Africa.

Commitment strategies for investor rights

We now move from general fears about the macroeconomy to specific fears about investor rights. We consider four agencies of restraint: parliament, public insurance arrangements, credit syndication and investment charters.

Parliament

One of the concerns of investors is that they should not be disadvantaged by the more favourable treatment of subsequent investors. This is a major problem with any discretionary tax incentive system. The only concession that provides safety for an incoming investor is total tax exception, because anything less than this may be trumped by a future competitor. The governments of Ghana and Kenya have attempted to enhance the credibility of fair tax treatment by removing the ministerial right to offer tax exceptions. All tax concessions must be approved by parliament.

Public insurance agencies

The most direct way to cope with risks is to insure against them. However, the political and policy risks that concern investors in Africa are only to a very limited extent covered by commercial insurers. Instead, several OECD governments have created public insurance schemes for investment and exports from their countries, notably Overseas Private Investment Corporation (OPIC) in the USA and ECGD in Britain. More recently, the World Bank has created its own insurance arm, MIGA (the Multilateral Investment Guarantee Agency), building on the example of the Inter-Arab Investment Guarantee Corporation. Although ostensibly insurance arrangements, these agencies are in fact better thought of as commitment mechanisms that can be used by the host government. That is, they are agencies of restraint.

The public insurance schemes act as agencies of restraint because the government of the country receiving the investment is a party to a legal agreement that commits it to compensate the insurance company for any pay-outs. For example, OPIC recovers from host governments 80% of the money it pays out to firms on claims. OPIC thus acts as an intermediary more than an insurer. Its function as an intermediary is nevertheless valuable. Firms gain comfort from the fact that their claim will be assessed impartially and payment will not be delayed. Thus, however suspect is the legal system in the host country, or however impecunious the government, if the firm has a legitimate case it will receive swift compensation. The shifting of the task of recovering compensation from the firm to the insurance agency also increases the chances that the government will indeed pay the compensation. This works in two ways: investor coordination and cross-conditionalities.

Whereas a single firm is likely only to be in dispute once with a host government that, say, arbitrarily confiscates its assets, the insurer and the government are in a long-term relationship. If the government fails to adhere to its agreement with the insurer the insurer can refuse further business in the country. This acts as a substitute for direct coordination among future private investors. Clearly, such coordination would be impossible because most firms that will become future investors do not know that they will do so. Private firms cannot, therefore, make credible threats of investment strikes in response to government behaviour. The threat of withdrawal of insurance for future investors thus acts as an indirect coordination mechanism. Were the risks instead covered by a private competitive insurance market the insurance companies would not be able to achieve the same degree of investor coordination unless they themselves acted collectively. However, collective action among competitors encounters problems of free-riding. With political risk insurance effectively supplied only by MIGA and a few national agencies such as OPIC and ECGD, the scope for collusion is much greater.

Although this coordination of investors weakens the power of the host government, it is something that it can find valuable. The government faces a problem brought about by the lack of credibility of its own assurances to individual investors, since ex post of investor commitment, the government is in such a strong position. The main consequence of this is not that the government is able to benefit from exploiting naive foreign investors, but that it forfeits the potential benefits of investment as street-wise investors go elsewhere. Investor coordination can thus be in the interests of the host government. An analogy is the way the French government of the eighteenth century rebuilt its reputation with potential creditors after a history of bond defaults. The government itself initiated bondholder coordination by creating an officially recognized association with which it dealt. With bondholder collective action facilitated (thereby increasing bondholder power vis-a-vis the government), French government bonds became less risky and so the government was able to raise more finance.

While the public insurance agencies work in part by indirect investor coordination, their main power probably comes from cross-conditionality. Behind OPIC stands the American government with its multiple powers of enforcement, including financial flows both from the US Agency for International Development (USAID) and through diplomatic channels. Behind MIGA stands the World Bank. Cross-conditionality between insurance claims and these other relationships does not have to be explicit to be effective.

The combined effect of investor coordination and cross-conditionality is that the public insurance agencies function as effective agencies of restraint. Because they recover around 80% of claims their premiums are correspondingly much lower than the underlying nature of the risks involved and so are much lower than would be charged by a competitive private insurance market.

The public insurance agencies have three disadvantages from an African perspective. First, they do not provide cover for domestic firms. Second, they are highly selective in the business they accept. Third, partly because of highly conservative capital requirements for its guarantees, MIGA is reaching the limits of its capital.

The restriction of coverage to foreign firms clearly places domestic firms at a disadvantage. In the limit this would give rise to a situation in which African wealth was held in the OECD economies, while the African capital stock was owned by OECD-based firms. Nevertheless, African firms are able to benefit indirectly from the public insurance agencies in two ways. First, they commonly seek joint enterprises with foreign firms. Association with a foreign firm increases the security of the domestic firm vis-a-vis its own government. Second, the presence of foreign firms that have protection from government abuse of power provides some defense for domestic firms. The standards the government must adopt towards foreign firms may spill over towards its treatment of domestic firms. More interestingly, foreign firms may regard the way in which the government treats its domestic firms as a signal of its true intentions towards the business sector as a whole, and thus as a guide to their own long-term security. As a result, the government may feel constrained in its behaviour towards its captive domestic firms by the response of non-captive foreign investment.

Despite these indirect benefits, if public insurance were the main agency of restraint in Africa it would clearly disadvantage domestic firms. Although this pro-foreign bias is not Africa-specific, since risk is much more important for investors in Africa than in other continents, its effect in Africa will be disproportionately great.

The public insurance agencies have been accused of "cherry picking", in effect, restricting their cover to the lowest risk propositions. One reason for this may be that their capital base does not permit them to expand their business very rapidly. The present practice is for an investment guarantee to require capital backing to the full extent of the guarantee. This highly conservative practice has led to MIGA rapidly reaching the limit of its capital base.

The combination of restriction to foreign companies and selectivity among them leaves much of the potential African investment uncovered by political risk insurance. Hence, it remains important to reduce the risks facing investors through the use of other agencies of restraint.

Credit syndication

Credit syndication provides a further opportunity for a restraint mechanism. It relies for its effectiveness on the same two processes used by the public insurance agencies: investor coordination and cross-conditionality. For example, when large mining houses make investments in high-risk locations they typically build syndicates of as many as 60 banks from different countries. The rationale for this is not that the mining companies need the finance, since they are often among the largest financial entities in the world. Rather, by involving the banks of many OECD countries in their investment, they seek to maximize the international damage that would be done to the host government in the event of default. First, the large network of banks provides a degree of indirect coordination among the unknown population of prospective investors. Second, there is an element of cross-conditionality both because the banks that are party to the default are less likely to lend to the government, and because they are liable to lobby their own host governments for redress. Syndication functions to orchestrate the response to a default, thereby increasing the penalties and so reducing the underlying risk. Thus, while ostensibly a *risk-sharing* mechanism, it is better regarded as a risk-reducing mechanism.

Investment charters

Recently, African governments have started to promulgate investment codes. Warner (1996) proposes the essential elements any such charter should contain: basic obligations, specific obligations and a dispute resolution mechanism. The basic obligations are of transparency, the right of establishment and the right to equal treatment. The specific obligations are the adoption of international standards with respect to compensation for expropriation; the avoidance of double taxation; prohibitions of corrupt practices; and a commitment to principles of competition, including the prohibition of cartels. There should be a binding settlement mechanism for disputes between investors and states, a model being that set out in the North American Free Trade Agreement (NAFTA) treaty. At present African investment charters do not usually meet these requirements. Several national charters have recently been issued by investment authorities, but they tend not to have independent dispute resolution mechanisms, leaving the power of interpretation with either the government itself or with national courts. There have been some investment charters at the regional level. For example, both Economic Community of West African States (ECOWAS) and the

Preferential Trade Area (PTA) include investment codes. However, these are very general and the basis for their enforcement is unclear. An alternative advocated by Warner is for African governments to sign up to multilateral investment charters. There are currently schemes for an Asia-Pacific investment code and an OECD-sponsored multilateral agreement on investment that might be lodged with the WTO. Warner suggests that African governments would gain more credibility by signing up to one of these charters than from producing one that was Africa-specific.

3. Trade policy

We now turn from investment policy to trade policy. The need for policy commitment arrangements is particularly acute in the case of trade policy. While there have been extensive trade reforms in Africa, trade policy in most countries is still extremely restrictive. On one measure of trade policy Africa was not only classified as the region with the most restrictive trade policies, but also the distance (on this measure) between Africa and next most restrictive region, the Middle East, was less than the distance between that region and East Asia, the most open region (Dollar, 1992). The growing literature on growth regressions is unanimous in identifying trade policy as a major reason for Africa's disappointing growth performance.[1] While the consensus on the harmfulness of African trade restrictions is growing and many countries have embarked on trade liberalization, typically in the context of structural adjustment programmes, the results have been mixed.

The main problem to date has been that progress on trade reform has often not been sustained. One of the most striking facts about African trade liberalizations is that in many cases they are reversed, either partially or wholly. Oyejide et al. (1997) document this for a sample of ten countries, seven of which experienced at least one major trade policy reversal. Trade policy reversals have undermined the confidence of private investors. As a result, the question of how governments can credibly commit themselves to trade reform has become a key policy issue.

A government with a weak reputation obviously cannot rely on self-restraint. Its policies will be seen as credible only if other institutions, internal or external agencies of restraint, effectively limit its room for manoeuvre. We consider in turn domestic commitment arrangements and four forms of external agencies of restraint: donor conditionality, North-South reciprocity, regional cooperation and the WTO. There exists a substantial literature on the effects of some of these arrangements, e.g., on the welfare effects of regional trading blocs. In this paper we focus on the effectiveness of these arrangements in locking in trade reform and hence in achieving credibility. The concern with credibility is a corollary of the evidence that uncertainty about government policies, including trade policies, is a major deterrent to private investment.

Domestic agencies of restraint

The literature on agencies of restraint on trade policy in Africa is (with the exceptions of a few passing remarks) exclusively concerned with external agencies: donors, regional groupings or multilateral institutions such as the WTO. Domestic agencies of restraint on trade policy are, of course, conceivable but have so far received little attention. By contrast, in the field of monetary policy there has been a lively discussion of the merits of independent central banks. The difference is

[1] We see Wang and Winters (1997) for a survey of the evidence for Africa on the detrimental effects of trade restrictions. Collier and Gunning (1997) give a survey of growth regressions estimates and discuss the various trade policy measures used in that literature.

instructive. Unlike monetary policy, trade policy is ideal for conferring benefits to particular interest groups, making it an ideal target for lobbying activity. This places demands on domestic agencies of restraint that as yet are difficult to meet. There are few countries in which the legislative and judicial branches are sufficiently independent to offer the scope for effective restraint on the executive. In particular there seems to be little scope for an effective appeal to the courts against discretionary trade policy changes in response to lobbying or bribery (see Widner, 1997). Since constitutional and judiciary reform is likely to be slow, proposals for policy commitment arrangements have focused on external agencies.

Donor conditionality

Donor conditionality is a possible, but far from obvious choice as an instrument for achieving credibility in trade policy. Indeed, many authors have argued that in this role conditionality can be counterproductive: the limited credibility of many African trade liberalizations may well be a consequence of donor involvement (e.g., Rodrik, 1989; Collier and Gunning, 1992; Gunning, 1994). However, the ineffectiveness of conditionality in achieving credibility is not inevitable; the effect of conditionality on credibility very much depends on the donor's objectives.

Both the bilateral donor agencies and the various multilateral aid institutions pursue multiple objectives when they attach conditions to aid. In the case of aid to Africa one of the most prominent objectives of conditionality at present is that of *inducement* the donor uses the offer of aid to induce the recipient government to change its policies.[2] In structural adjustment programmes this has in fact become the essence of aid; the aim of adjustment lending is to induce the government to adopt policy changes it would not have been willing to implement without the offer of aid. Indeed, structural adjustment is often analysed as a principal-agent problem with the donor (the principal) having an agenda different from that of the recipient government (the agent). The resentment generated in Africa by many adjustment programmes is a measure of the extent of divergence in objectives between the government and the donor.

Inevitably, in this case, the relationship between the donor and the recipient government is not fully consensual. Clearly, if the two sides fully agreed on the desirability of policy reforms then there would be no need for inducement. An implication is that when conditionality is used for inducement then the reforms may well be reversed subsequently: the government has an incentive to maintain the reforms only as long as this is needed to obtain the aid. Sustained reform then is *time inconsistent*. Since aid is temporary the government will have an incentive to reverse policies once the inducement is removed. Private agents who know the government's preferences will be able to infer this time inconsistency problem and will therefore consider sustained reform incredible.[3]

By its very nature conditionality aiming at inducement is incompatible with ownership. Obviously, if the government fully owned the programme it would require no inducement.

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[2]We have argued elsewhere (Collier *et al.,* 1997a) that inducement conflicts with each of the other four possible objectives of conditionality: with paternalism, selectivity, restraint and signaling. While the use of conditionality for inducement has generally been ineffective, it has an opportunity cost in terms of these other objectives.

[3]One indication that private agents attach low credibility to conditionality as currently practiced is the finding of Rodrik (1996) that agreements with the IMF *reduce* private capital flows.

This problem of ownership does not arise if the donor acts as an agency of restraint, in fact offering the recipient government a mechanism for "lock-in" of its policies. Such a mechanism must be based on a (credible) threat, the threat that the donor will "punish" policy reversal with reduction or cessation of aid. The essence of lock-in is that the recipient government *chooses* to reduce its own room for manoeuvre, submitting voluntarily to this form of restraint.[4]

This aspect of voluntarism is important. There have been numerous instances of donors "punishing" African governments for policy reversals by stopping aid temporarily. However, in these instances cutting off aid was not the action of a restraint agency; punishment was a unilateral action of the donor rather than the outcome of an agreed procedure, requested by a government as a means of binding itself. When the objective of conditionality is restraint rather than inducement then what the donor tries to overcome is not the unwillingness of the government to adopt or maintain desirable policies, but rather its possible inability to do so.

If the penalty is sufficiently heavy then this will achieve lock-in and thereby credibility. Pressure on the government (or one of its successors) by interest groups to reverse trade reform can be resisted effectively if the government can credibly point out that reversal would carry unacceptably heavy penalties.[5] The aid package agreed by the donor and the recipient would then be conditional on trade reform being maintained. Such a use of conditionality for restraint would be novel.[6]

Aid has been remarkably unsuccessful in achieving policy change in Africa. Redesigning aid to make it function as an agency of restraint may well improve its effectiveness. Indeed, such a redesign may be attractive for donors who have become disillusioned by the perceived lack of success of traditional forms of aid. However, there are several necessary conditions for credible lock-in through aid.

First, as noted, the arrangement must be voluntary. This is best achieved by relying on self-selection. An African government perceiving a need for an external agency of restraint would take the initiative to request donors to make aid conditional on maintaining policies. Second, the imposition of the penalty (the reduction or cessation of aid) must be semi-automatic. This requires a very clear specification of the circumstances in which policy reversal is deemed to have occurred. For the mechanism to be credible there should, for example, be no room for debate about whether a particular set of trade policy changes (tariff increases or the reintroduction of quantitative restrictions call for imposition of the penalty. Third, the mechanism can be effective only if the penalty is

[4]It may be note that in the case of inducement, aid is used by the principal (the donor) to ensure that a policy is *adopted* by the agent (the recipient government), while in the case of restraint the objective is that an existing policy is *maintained*. However, it would be wrong to see restraint as negative inducement. The essential difference is that the relationship between the two parties is fully consensual in the latter case, but not in the former.

[5]Since here we consider donor conditionality the penalty would be the loss of aid. Another possibility would be the loss of access to the donor's market. This case we consider below.

[6]Such redesign of conditionality has been proposed as a possible option on a "menu" of a future Lomé treaty. The idea is that aid from the European Union to the ACP countries would not necessarily take this form, but that countries that wanted to use the EU as an agency of restraint could choose this option from the menu. Hence restraint would be entirely based on self-selection. See, e.g. Collier *et al.*, (1997).

obviously unacceptable. This suggests that there is little scope for individual donors (with the possible exception of the World Bank or the European Union) to act as agencies of restraint. The threat that a minor donor will cut off aid may well be credible, but it will obviously not be effective. A possible solution would involve a recipient government asking its consultative group to commit itself collectively to cutting off aid in case of policy reversal. However, achieving the required degree of donor coordination may well be problematic.

It is conceivable that using conditionality for restraint would conflict with performance-based lending, which is a system where aid is conditional (ex post) on outcomes (for example, economic growth) over a period of a number of years (unlike the "short-leash" lending currently practiced, which is based on high-frequency monitoring).[7] A conflict could indeed arise if aid were conditional both on outcomes over a particular period and on the maintaining of trade liberalization throughout. For in that case a trade policy reversal would trigger an aid cut-off, irrespective of changes in outcomes. While this may be seen as a drawback, this possibility seems rather academic: if the policy measures and performance indicators are chosen sensibly, then a trade policy reversal sufficiently serious to trigger the agreed penalty will also show up (eventually) as a deterioration of the performance indicators.

While conditionality aimed at restraint avoids the problem of lack of ownership, it may suffer from two other problems that currently characterize aid to Africa: that of incommensurate penalties and that of defensive lending. The problem of incommensurate penalties arises because the larger the penalty, the more the recipient government will want to avoid it. However, at the same time the larger the penalty (relative to the infraction that triggers its imposition) the more reluctant the donor may become to impose it, feeling that the damage inflicted (e.g., a macroeconomic crisis as a result of an aid cut-off) is incommensurate with the reversal of trade reform.

This raises the issue of the credibility of the donor rather than that of the recipient. There clearly is no iron-clad solution to this problem. The objection does highlight the importance of basing enforcement on rules rather than discretion. This may be facilitated by relying on multilateral enforcement, as in the consultative group scheme suggested above. The temptation to revert to discretion is likely to be much greater in a bilateral donor-client relationship than in a multilateral framework.

The problem of defensive lending arises if the imposition of the penalty would lead to a default of the recipient government on debt service to the donor. The donor might then have an incentive to avoid imposing the penalty so that the threat to do so would not be credible. As in the previous case the problem might be mitigated by relying on multilateral rules. However, negotiating a multilateral agreement might be quite difficult (as in the case of debt relief) since donors differ in their vulnerability to a default. To take an extreme example, aid from the European Union is entirely in the form of grants but World Bank aid is in the form of loans (or International Development Association "credits").

These practical difficulties in using conditionality to help a government to restrain itself are formidable. The case of the aid provided by the EU seems the most promising, for several reasons. First, the menu approach advocated in the European Commission's Green Paper on the future of the Lomé treaty can accommodate self-selection quite naturally. Second, the European Union is a major

[7] For a detailed discussion of performance-based lending, see Collier et al. (1997a).

donor in most of Africa, so that it will usually be in a position to impose sufficiently severe penalties. Further, as noted, the issue of defensive lending does not arise.

This leaves the inherent problem of incommensurability. The greater the penalty the more effective it will be if credible, but also the lower the donor's credibility. It seems doubtful whether a donor such as the EU will (even at the request of the "victim") be willing to impose punitive damages. Clearly, if the EU is not fully credible in its commitment to cutting off aid in case of policy reversal then it fails as an agency of restraint.

North–South reciprocity

Under donor conditionality the penalty on trade policy reversal is the loss of aid. Alternatively, the penalty can be the loss of export markets. In principle this could be achieved within an African regional grouping, a case we will consider below. However, the potential for intra-African trade (other than that involving South Africa) is still quite limited. Hence such regional groups as yet cannot impose sufficiently severe penalties.

By contrast, loss of (preferential) access to a developed country market might impose severe damages. This is the basis for a proposal in a series of papers[8] to use North–South reciprocity to achieve lock-in of African trade reform, very much on the model of NAFTA. The European Commission's White Paper on the future of the Lome treaty takes North-South reciprocity as its preferred option in negotiating with Africa–Carobbean–Pacific (ACP) countries on their future relation with the EU.

Under this proposal an African country (or, alternatively, a group of countries) would liberalize its trade policy, gaining preferential access to the market of the European Union in return. It would achieve lock-in by agreeing beforehand that if it reversed its trade reform it would thereby automatically lose the preferential access to the EU market.

The asymmetry in a North-South arrangement makes it likely that such an arrangement would be self-enforcing. Revoking the valuable access to the European Union is a credible threat precisely because the EU has relatively little to lose and is therefore less likely to be tempted not to impose the penalty.[9]

It is noteworthy that such a combination of asymmetry and valuable access characterized both NAFTA (which the Salinas administration saw as an effective lock-in mechanism) and the Europe agreements (which offered Eastern European countries preferential access to the EU and the prospect of full EU membership).

Obviously, the proposed mechanism can be effective only if what is at stake for the African government, the preferential access to the European market, is valuable. Since European tariffs are

[8]For example, Fine and Yeo (1994), Collier and Gunning (1995a/b), Collier et al. (1997).

[9]This is an important difference with the use of conditionality as a restraint mechanism. In that case the "North" (i.e., the donor) may indeed be tempted not to impose the penalty because he does have much at stake: the debt service on pervious loans. As noted above, this may lead to defensive lending.

already quite low, there does not remain much scope for valuable tariff preferences.[10] The main area in which Europe retains significant trade restrictions on African imports is that of agricultural products. However, the history of the negotiations between the EU and South Africa on a free trade area suggests that the EU is quite unwilling to grant significant concessions for agricultural products.

What would be quite valuable for African exporters, however, is protection from anti-dumping actions by the EU. There is wide scope for the use of such actions under WTO. Indeed, this was the price demanded by some developed countries, including the United States, for making a successful completion of the Uruguay Round possible. Where exporting involves significant set-up costs, the threat of anti-dumping actions can be a powerful deterrent to a would-be exporter. EU member countries have of course agreed not to bring anti-dumping actions against each other. Similarly, in a trade accord between the EU and Iceland the EU has recently agreed to refrain from anti-dumping against Iceland. This is the model that could be adopted to assist in locking-in African trade reform. An African country (or group of countries) electing to use the EU as external agency of restraint would be offered protection from anti-dumping, conditional on its maintaining its liberal trade policy.[11]

An obvious objection is that such a proposal would give a new lease of life to preferential trade policy arrangements (e.g., Wang and Winters, 1997). There are two counters to this. First, as we discuss below, the multilateral alternative simply does not exist: the ties that bind an African government under WTO rules are much too loose to make its trade policy credible. Second, such an arrangement could and should be as explicitly designed as temporary, creating a window in which reforming governments can achieve credibility.

The need for this is illustrated by the evidence on risk ratings (discussed in Collier and Gunning, 1997). This suggests that there is an African dummy in the sense that the risk ratings of African countries are significantly and substantially worse than can be explained in terms of observable indicators such as GDP growth and debt ratios. There is also evidence that when policies are improved risk ratings are adjusted, but only extremely slowly. Uganda, long considered as a star performer, achieved an Institutional Investor risk rating of 20 (still quite poor) only in September 1997.

This suggests that even without policy reversals it is extremely difficult for a government to achieve credibility and to attract foreign direct investment. North-South reciprocity can then be seen as a much-needed boost in credibility, enabling a reforming government to build up a reputation much more quickly than would otherwise be possible.

Another objection, also voiced by Wang and Winters, is that preferences are typically granted for short periods and unilaterally. What is so granted can be so withdrawn: preferential treatment is unreliable and therefore fails as a lock-in device. This is an important consideration. However, it

[10]Indeed, as Wang and Winters (1997: 24) point out" Africa faces lower bound tariffs on average than other developing countries—i.e., its exports are concentrated, on average, on low-tariff products—and the differences are all significant.

[11]Such protection would be politically feasible only if offered for a limited period. We have suggested elsewhere (Collier et al., 1997) that this type of North–South reciprocity might be one of the options in a future Lomé treaty. The anti-dumping protection would then be automatically limited to the period of the treaty, probably five years.

does not apply to the specific form we have proposed, namely, reciprocal concessions enshrined in a five-year treaty with the EU.

Regional trade blocs

A regional trade bloc, operating as a free trade area or as a common market, can also function as an agency of restraint, based on reciprocal preferential market access. Indeed, this is the form that many developed countries have used to achieve lock-in of liberal trade policies. The European common market, for example, is based on a system of (implicit) reciprocal threats: a member country introducing trade restriction would immediately face retaliation. African regional groups can adopt the same system where breach of the rules by any member would lead to expulsion from the group and hence to loss of preferential access to the markets of the other member countries. However, as we have already noted above, this penalty would be unlikely to be sufficiently severe to deter policy reversal since in Africa intra-regional trade is as yet very modest (Foroutan, 1993; Oyejide et al., 1999).

This is not to say that regional integration in Africa cannot contribute effectively to enhanced credibility of trade policy, but rather that this will take time. The present acute need for a *rapid* improvement in credibility can in our view not be met in this way.

WTO

The WTO offers two alternative ways of achieving lock-in. First, the WTO is in fact set up as an external agency of restraint: a member country binds itself by accepting the GATT/WTO provisions. This is the aspect of the WTO that is usually emphasized in discussion of Africa's role in the world economy. Unfortunately, a major limitation of the WTO is that it does not restrain trade policy very much. Notably, foreign exchange rationing, until recently the preferred trade policy instrument of many African governments, is in fact legal under WTO rules. Hence the WTO is of limited use to a reforming African government wishing to bind itself. Similarly, the WTO offers little defense against developed countries' protectionism. We have already noted above that there is wide scope for anti-dumping actions under WTO. However, there are some precedents for extending policy binding to non-tariff concerns.

What the WTO does offer is dispute settlement procedures. Since the Uruguay Round these have become faster and (while still extremely expensive in terms of legal costs) more accessible for developing countries. There is evidence that use of these procedures by these countries is increasing rapidly (Keyzer and Merbis, 1997).

The second way in which lock-in can be achieved through the WTO is through the traditional GATT process of reciprocal concessions. Usually it is implicitly assumed that this route offers little to Africa. Wang and Winters (1997) have recently shown that this view is mistaken. African countries have negotiating rights (entitling them to initiate negotiations) on a substantial part of their exports to the EU. Under the GATT "request and offer system" country A can request country B to reduce a tariff on one of A's exports (in return, of course, for a reciprocal concession on a tariff imposed by A on one of B's exports) only if A is the principal supplier of that good to country B. This system would seem very much to favour large countries: they would have the right to initiate negotiations even for goods that in relative terms were unimportant to them, accounting for a small proportion of their total exports.

Wang and Winters (1997, Table 3) have investigated whether this in fact dooms African exporters to passivity in future trade negotiations. Interestingly, they find that many African countries are principal suppliers of at least some goods and, more importantly, that these goods account for a substantial part of their exports. These goods are therefore relatively important to the exporter. However, rather surprisingly, where African countries are the principal supplier they often account for a large part of European imports. This suggests that African exporters may have considerable leverage. In some of these cases substantial tariffs still remain. Hence there are unsuspected and unexploited opportunities for Africa in future negotiations.

"By offering suitable reciprocal concessions they should be able to achieve significant liberalizations in these areas" (Wang and Winters, 1997: 3). Eventually this could lead to lock-in as an exporters lobby for maintained liberalization would develop. This is likely to be a slow process, however.

WTO participation therefore involves two serious limitations. First, the discipline it imposes is still quite weak. Second, the negotiating process at the heart of the WTO cannot offer African countries the rapid improvement in credibility that at present they urgently need.

4. Conclusion

Africa currently faces a credibility problem that is deterring investment. This is particularly severe in the areas of macroeconomic policy, investor rights and trade policies. If an African government maintains good polices in these three areas it will, over time, overcome the credibility problem. The question we have posed in this paper is whether this process can be accelerated by the use of commitment mechanisms. We have reviewed a variety of agencies of restraint. Many of these are potentially useful for Africa. There is particular scope for hybrid agencies that involve cooperation between African governments, sometimes in conjunction with OECD governments. There is scope for the gradual evolution of purely domestic agencies from the present heavy reliance upon cash budgets to reliance upon independent central banks. There is also scope for greater use of instant restraints, notably capital account convertibility.

In the field of trade policy we have suggested that some possible agencies of restraint can be effective only after a long delay. This would apply to domestic agencies of restraint that require constitutional changes and reform of the courts. It would also apply to reliance on reciprocal concessions within the WTO. Africa has made little use of the WTO. Active membership would offer the form of restraint that has proved most effective in restraining the trade policies of developed countries. We have stressed that African countries not only have much to gain from the WTO negotiating process but actually have substantial leverage. While this route must be followed it does not offer the quick improvement in credibility that African countries now most need.

Donor conditionality has often made trade reform time inconsistent. It has thereby undermined credibility. Donors could make a useful contribution by abandoning the current counterproductive form of conditionality. We have suggested that conditionality can strengthen credibility if it is aimed at restraint rather than inducement. The European Union is in a position to function in this positive role, as an external agency of restraint for African countries that would self-select participation in such a system. In this case aid would be conditional on sustained trade reform. We have expressed some doubts about the credibility of the EU in fact cutting off aid in the case of trade policy reversal.

North-South reciprocity would involve reciprocal preferential access between Europe and an African country or regional bloc. We have suggested that preferential access of Africa to the European market might take the form of a temporary safeguard against anti-dumping actions. While this is not a mechanism for achieving long-run lock-in, it is at present the most promising option for a quick improvement in trade policy credibility. The evidence on risk ratings indicated that such a quick improvement is highly desirable.

Agencies of restraint may collectively be effective in accelerating the improvement in risk assessments, and so raise investment rates. However, two important questions remain unresolved. The first is which agencies are most effective in which environments. Some agencies, such as cash budgets, are probably effective initially but are not sustainable. Others, such as independent central banks, may gradually accumulate effectiveness. The second question concerns the trade-off between rules and discretion. Rules inflict some costs on the economy because they limit the ability of the government to respond to unanticipated circumstances. Further, it may be that the only rules that are sufficiently simple to be politically feasible are unable to accommodate shocks and so inflict high real costs to shock-prone economies. A classic unresolved trade-off of this type is between fixed and flexible exchange rates. The current trend in policy outside Africa, however, is to shift more policy choices from discretion to regulation, often in the context of their internationalization. African governments may find that if they choose not to participate in this trend they will further marginalize their economies.

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