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# ACHIEVING INDUSTRIAL GROWTH: CHALLENGES AND STRATEGIES

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## 1. Introduction

Once upon a time, economists believed that the developing world was full of market failures and the only way to escape from the poverty traps was through forceful government interventions. Then there came a time when economists started to believe that government failure was by far the bigger evil, and that the best thing that government could do was to give up any pretense of steering the economy. Reality has not been kind to either of these.

Import substitution industrialization (ISI) and state ownership did produce some successes, but wherever they became entrenched and ossified over time, they have led to colossal failures and even crises. Economic liberalization and opening up have benefited export activities, financial interests, and skilled workers, but more often than not, they resulted in economy-wide growth rates – in labour and total factor productivity – that fell far short of those experienced under the bad old policies of the past.

Today, few economists seriously believe that state planning and public investment can act as the driving force of economic development. Even economists of the Left show a healthy respect for the power of market forces and private initiative. At the same time, it is increasingly recognized that developing economies need to embed private initiative in a framework of public action that encourages restructuring, diversification, and technological dynamism beyond what market forces on their own would generate.

The softening of convictions in both camps presents a rare historic opportunity for the development of industrial policy that takes an intelligent intermediate stand between the extremes of the two positions. Market forces and private entrepreneurship would be in the driving seat in this policy framework, but the governments would perform the strategic and coordinating role in the production sphere beyond simply ensuring:

- property rights;
- contract enforcement, and
- macroeconomic stability.

## 2. Ghana's Industrial Policy

The Ghana Industrial Policy document produces an account of the consultative processes that led to the outcome of the document. It states:

> In all, over 500 Policy Options were developed and presented to stakeholders at a first Roundtable in September 2008 and Second Roundtable in November 2009. These consultations involved the Government, Ministries, Public Sector Implementation Agencies, Private Sector, Educational Institutions, Research Institutions and Civil Society. They afforded stakeholders the opportunity to make recommendations, deselect some of the policy options and add new ones. This constituted the fourth and fifth phases of the exercise. In the sixth and final phase, the Ministry of Trade and Industry reviewed in detail the recommendations of the second Roundtable and made a final determination in respect of all policy recommendations. These final recommendations are what have been presented as the Industrial Policy prescriptions in this Policy document (emphasis added).

The problem that nevertheless remains is that of roles. It leaves the government in the driving seat and the private sector passive followers making demands by way of incentives to do what business must be doing for itself in the first place.

Far from the government accepting the role of providing "the enabling environment for the private sector to effectively perform its role as the engine of growth in a dynamic and competitive economy" the Industrial Policy document "….seeks to address an array of challenges faced by the manufacturing sector that affect production capacity, productivity and product quality" (emphasis added).
In the introduction, the document states as follows:

> Ghana's manufacturing sector has not responded well to the various economic and trade policy reforms pursued over the past decade. Manufacturing firms have faced considerable challenges in the form of increased competition in the domestic and export markets and high production and distribution costs arising from:
>
> - high interest rates;
> - aged and obsolete equipment;
> - inefficient infrastructure services; and
> - low productivity.

To address these challenges Government will initiate and implement policies to:

- develop requisite skills;
- ensure adequate and cost-competitive production of inputs and services; and
- provide needed finance for industrial development.

The document goes on:

> The critical success factor in local production and distribution of goods is the availability of cost-competitive and quality raw materials and other inputs supply. Major local raw material supplies are [and right from the very beginning have been] inadequate and costly

> and local fabrication of plant and machinery is [and has been] virtually non-existent. Local manufacturers have [had to and continue] to rely on imported raw materials and equipment [sustained on large subsidies through the exchange rate and import licenses in the control regime].

Government, according to the new Industrial Policy document, "will initiate policies to increase local content in the manufacturing process by encouraging the production of local raw materials and the fabrication of plant and machinery".

The document also observes (Section 1.1.4) that imported raw materials (on which most manufacturing enterprises rely) "tend to be costly. And access to competitively priced raw materials is essential for ensuring continuous production". So, predictably, government would take steps to "ensure availability of competitively priced imported raw materials for manufacturing".

On Plant Machinery and Equipment — Section 1.1.5 — the document notes: The deployment of modern technology is essential in determining the competitiveness of industry. In Ghana, most industrial plants and machinery are aged and obselete making manufacturing operations inefficient (little wonder that domestically manufactured goods are unable to face the competition "in the domestic and export markets" noted in the Introduction). So once again, being in the driver's seat, government promises to do whatever is necessary, as a policy objective, to "ensure the adoption [by business enterprises!] of modern technology and the deployment of state-of-the-art machinery in industry".

The Ghana Business and Finance journal reported in its Jan-February 2011 issue that on the occasion of its 50th Annual General Meeting (AGM), held by the AGI on November 25 2010, the Minister for Finance and Economic Planning was invited as Guest of Honour "to help members of the association clear doubts in their minds about how policies outlined in the 2011 budget would stimulate economic growth and expand job creation".

In his address, Dr. Duffuor assured the AGI that:

> The private sector is the engine for real job creation and this underscores the proposed deployment of significant resources in the 2011 budget to support the sector to be more competitive and create the much needed jobs for the people.

The Trade and Industry Minister, Madam Hannah Tetteh, corroborated her colleague saying that the 2011 budget had "underlined the significant role of infrastructural development in accelerating economic growth especially at this stage of the country's development".

For his part the AGI President stressed that the data from the Ghana Statistical Service on the manufacturing sector "are a true reflection of the sad realities on the ground, as a result of which the manufacturing sector had experienced declining fortunes in recent years". As the journal saw it, the official position as expressed by the 2011 budget and explained by the two Ministers present at the AGM is: "Stimulating growth and development for job creation", but in its view "not many local industrialists seem to agree that the policies contained are business and investor friendly.

Specifically, the AGI President noted about the 2011 budget that "it contained several government proposals that would particularly hurt manufacturing and industry in general".

## 3. The role of the state and private sector in economic development: the contrasting cases of Latin America and East Asia

Prevailing ideology in Latin America considered industrialization as a necessary step towards 'economic independence' and national autonomy. An active role of the state was also thought crucial to further stimulate this process. As industrialization went on, however, it became more and more reliant on imports of intermediate inputs and capital goods. In the context of stagnant export earnings, however, the natural consequence was recurrent Balance of Payments crises that imposed a stop-go pattern to the economic performance of the Latin American countries.

Industrialization in the Asian Tigers was also initially based on import substitution. In the late 1960s and early 1970s, however, the path started to diverge. Basically, the Tigers were not able to generate enough foreign exchange through exports of primary commodities as the Latin American countries were able to do. This forced them to adopt export-oriented industrialization strategies.

Nevertheless, this change did not involve a weakening of the role of the state in the allocation of resources. Domestic markets remained protected and financing continued to be heavily subsidized through overvalued exchange rates and negative real interest rates. The main difference was the capacity of the government to discipline domestic industries by means of:

- Export targets;
- Government supervision; and
- Credible time limits to protectionist policies in order to make their production more efficient and competitive in foreign markets.

As a picturesque example of the disciplinary power of the state in East Asia is Park's dictatorship in Korea. Shortly after taking power, he imprisoned the principal businessmen of the country, accusing them of having illegally enriched themselves during the previous regime. Even though they were set free shortly afterwards, this only occurred after these businessmen committed themselves to carrying out specific investments requested by Park.

The macroeconomic context, however, was substantially different in East Asia from that in Latin America. Although state economic intervention was a common feature with the Tigers this was combined with sound macroeconomic policies that resulted in:

- Robust public finances;
- Low levels of inflation; and
- Less volatility.

The combination of an adequate mix of policy incentives – 'sticks and carrots' – and a stable macroeconomic environment was key to provide the private enterprises with the requisite business climate for allocating their resources in productive activities and planning longer-term investment projects.

In contrast, despite extreme protectionism and significant subsidies – both in terms of export drawbacks and financing with negative real interest rates – Latin American industries never became mature and internationally competitive.

A closed economic environment, the politically biased management of state-owned enterprises (SOEs) and the pervasiveness of unfair regulation favouring the interests of small but powerful groups, led to a context where rent-seeking behaviour tended to prevail over entrepreneurship. Such behavior arises, for example, when businessmen and/ or self-interested bureaucrats use their position or discretionary power for personal gain without reciprocating any benefits back to society through wealth creation. Whether legal or illegal, rent-seeking activities can impose large costs on an economy as they do not create any value.

Moreover, political populism was the main resort by which governments in Latin America attempted to manage conflicts and income distribution.

Rent-seeking and political populism caused the public sector to display chronic fiscal deficits, basically financed by printing money (the 'virtual cedi' in Ghana – at the time of independence, the virtual cedi bought US $1; today 16,000 of these cedis are required to buy US $1). This explains the worse performance of Latin America compared to East Asia from the mid-60s both in terms of inflation and long-term economic growth.

The contrasting performance points to an important lesson:

> ISI failure in Latin America ha less to do with its alleged inherent weaknesses; it had more to do with inadequate implementation and government failure.

Historically, Latin America as a whole grew faster between 1930 and 1975 than in any previous or subsequent period of its history. Furthermore, industrial exports began to expand in the mid-1960s in some of the largest Latin American economies – especially Brazil and Mexico. In fact, Brazil was among the fastest growing economies in the world.

Moreover, in most countries economic growth was accompanied by significant progress on income distribution and therefore poverty alleviation. These improvements however, were almost exclusively based on:

- Direct subsidies;
- Tax deductions; and
- Subsidized credit at negative real interest rates mainly financed with the surpluses of the pay-as-you-go pension systems and the inflation tax.

In sum, the ISI model implemented in Latin American countries proved unsustainable in the long-run. Their limitations became more severe in the 1970s, as fiscal imbalances increased, inflation rates accelerated and economic activity tended to deteriorate pari passu with the worsening of external conditions arising from the oil shocks at the beginning and end of the decade.

External difficulties aside, two domestic elements are crucial to understanding of the breakdown of the ISI in Latin America.

(i) The failure of the state to work as an engine of growth. The large inefficiencies of SOEs and the government's inability to appropriately combine the subsidies granted to private enterprises with suitable controls and penalites in case of their improper use, not only induced chronic fiscal deficit and short-term macroeconomic instability; it also undermined overall productivity and long-run growth. Populist redestributive policies, moreover, heightened fiscal imbalances and at the same time, impinged on the returns of the most productive economic sectors.

(ii) Extremely inward orientation of industrialization induced by extended and protracted protectionism. This prevented Latin American economies from taking advantage of foreign markets as a disciplining device to gradually enhance the competitiveness of domestic enterprises.

Indefinite postponement of the opening up of the economy to foreign competition kept the domestic market mostly in the hands of the oligopolistic enterprises with fewer incentives to enhance productivity than to preserve their market shares by resorting to rent-seeking practices.

Moreover, protectionist policies crystallized a structure of relative prices with a strong anti-export bias, particularly harming tradable sectors. And availability of aid contributed to the postponement of the inevitable change of development paradigm for ISI – for the Latin American economies on account of OPEC surpluses.

Each country needs to find their own mix of market incentives and state intervention consistent with economic development under their specific circumstances. The fact that the emergence of dynamic economic activities is not necessarily an endogenous outcome of liberalized markets alone needs to be acknowledged. Rather than replacing private initiative, public officials should aim at fostering linkages between the most dynamic enterprises and sectors with the rest of the economy.

Social objectives should be mainstreamed in economic policy. The benefits of economic growth will not trickle down spontaneously to the less favoured groups in society. Besides fostering democracy, institutional development and the quality of our political systems, we will have to build proper safety nets (better still safety ropes) and put in place efficient redistribution policies in order to achieve this goal.

The strong social coalition prevented the progressive transformation of ISI into an export-led industrialization strategy, as happened in East Asia, supporting the status quo including:

- Industrial enterprises benefiting from ceptive domestic markets and public subsidies;
- Industrial workers, favoured by low prices of food staples and utilities; and
- Public bureaucrats taking advantage of the power given by the discretionary channels of public funds.

### 4. Guidelines to the effective design and formulation of industrial policy

Industrial Policy is a set of economic policies for economic restructuring in favour of more dynamic activities. There is no evidence that suggests that the types of market failures that call for industrial policy are necessarily located predominantly in industry. Industrial policy is thus aimed at activities in agriculture and services as well.

The nature of industrial policies is that they complement – what opponents would say 'distort' – market forces: they reinforce or counteract the allocative effects that the existing market would otherwise produce. The objective of an Industrial Policy then, is to maximize its potential to contribute to economic growth while minimizing the risk that it will generate waste and rent-seeking.
The conventional approach to industrial policy consists of enumerating market failures – technology and other externalities – and then targeting policy interventions on these market failures. The discussion then revolves around administrative and fiscal feasibility of these policy interventions, their informational requirements, their political economy consequences, and so on.

But the task of industrial policy is as much about eliciting information from the private sector on significant market failures and their remedies as it is about implementing appropriate policies. The right approach for industrial policy is not that of an autonomous government applying the appropriate taxes or subsidies, but of strategic collaboration between the private sector and the government with the aim of uncovering the most significant obstacles to restructuring and determining what interventions are most likely to remove them. Therefore, the analysis of industrial policy needs to focus not on the policy outcomes – which are inherently unknowable ex ante – but on getting the policy process right.
We have to concern ourselves with how to design a forum in which private and public actors come together to solve problems in the production sphere, each side learning about the opportunities and challenges faced by the other.
The fact to underline is that the public sector is not omniscient and indeed typically has even less information than the private sector about the location and nature of the market failures that block diversification and restructuring. Consequently, the policy settings has to be one in which public officials are able to elicit information from the business sector on an ongoing basis about the challenges that exist and the opportunities that are available. It cannot be one in which the private sector is kept at arm's length and autonomous bureaucrats issue directives: industrial policymaking has to be embedded within a network of linkages with private groups.

At the same time, however, industrial policy is open to corruption and rent-seeking. Any system of incentives designed to help private investors venture into new activities can end up as a mechanism for the transfer of rents to unscrupulous businessmen and self-interested bureaucrats.

The natural response to avoid this occurrence is to insulate policymaking and implementation from private interests and to shield public officials from close interaction with businessmen. The need to 'keep bureaucrats and businessmen distant from each other", however, is diametrically opposed to the previous one, above, arising from the need for information flows. The critical challenge for successful industrial policy, therefore, is to find an intermediate position between full autonomy of public official and full embededness of public and private actors. Too much autonomy for the bureaucrats and you have a system that minimizes corruption, but fails to provide the needed incentives to the private sector. Too much embededness for the bureaucrats and they end up in bed with or even in the pockets of business interests.

Moreover, there is the overriding need for the process to be democratically accountable and to carry public legitimacy. This may very well be the most critical challenge to the design of a viable industrial policy.

## 5. SMEs and access to credit

It is generally assumed that the banking system is able to provide banking services to both large enterprises and small and medium scale enterprises (SMEs) alike. Yet, the expectation is also that, so long as development objectives are not confused with commercial objectives, the banking system will always deploy scarce capital into the most profitable opportunities.

The Financial Sector Adjustment Programme (FINSAP), launched by the Government of Ghana in 1988, was expected to increase access to credit for SMEs that were seen as having been marginalized under the "repressive regime" that had previously operated in the country. This regime was characterized by government regulation of interest rates and credit allocation which resulted in steeply negative real interest rates and an inability of the banks to supply credit to priority sectors which financial policies aimed to support – in fact most of the available domestic credit was channeled, rather, to the public sector.

The objectives of FINSAP, therefore, were to:

- ensure competitive banking practices,
- improve resource mobilization, and
- increase the quantity and quality of investments to a greater number of enterprises at market prices than had hitherto been the case.

In spite of these and other efforts, however, SMEs continue to be marginalized from the credit market. This is because lending to SMEs is regarded by the regulatory body and the banks alike as more risky. Thus, although overall credit to the private sector has grown steadily into the last quarter of 2011, access to credit by SMEs has been tightened through the use of additional collateral requirements.
Screening SME loan applications, then monitoring the performance of these loans is expensive and obviously much "less profitable and glamorous" than lending to large and relatively less risky enterprises. Moreover, when a bank lends to SMEs, the regulations and practices of the banking system would require that more capital be put up by the bank to support those loans. Thus, in practice, the riskier the loans to SMEs are perceived to be:

- the larger is the amount of capital required by the regulatory body to back it up,
- the greater is the collateral demanded by the banks of the SMEs, and
- the higher are the interest rates charged to the SMEs.

Hence, the regulatory framework and practices within the banking system contribute to some of the challenges that SMEs face in terms of access to credit and high cost of funds.
For their part, SMEs would need to develop a culture of maintaining proper and transparent book keeping in order to improve their credit worthiness and reduce the perception of risk that is associated with them.

As Alhassan Andani of Stanbic puts it “improving the credit culture is about honesty and sincerity – people representing themselves properly when they come for credit.” Without these improvements, lending rates to SMEs cannot be expected to fall.

The lack of credit and associated high cost of funds are, however, not the most important constraints on local enterprise development. This finding is the result of a study by Gockel and Akoena of reasons why SMEs may not ordinarily qualify for bank credit in a liberalized financial regime. Their study shows that most credit demands are in fact requests for “unbankable projects” and as such do “not necessarily reflect genuine credit demand.” Most loan applications are, therefore, rejected not because banks lack funds but because of the shortcomings of these applications”. Rather than a substantial number of viable projects vainly chasing scarce credit, excess credit has been vainly chasing viable projects.

Merely applying to a bank for credit does not by itself constitute effective demand for credit. An effective demand is one backed by at least preparedness to meet a spectrum of requirements such as:

- Liquidity cushion in the form of equity financing;
- A loan purpose related to an economic activity
- Measures to contain the effects of probable risks,
- Interest rate and collateral requirements etc.

Finance is a binding constraint only when all other ingredients for successful investment are available, and when finance can conveniently activate these other ingredients for positive returns on the investment. What the rejected applications and subsequent accrual of large amounts of non-performing loans (NPLs) by banks in Ghana suggest is the shortage of creditworthy projects. Out of 102 enterprises that benefitted from a Fund for Small and medium Scale Enterprise Development (FUSMED) 45 percent defaulted in repaying their loans. Such a high default rate together with the high loan application rejection rate by banks provides the basis for the above conclusion on the demand for credit.

The findings of the study thus caution against merely increasing the availability of funds to SMEs without at the same time dealing with other constraints to their effective performance. Such credit may not necessarily have a positive impact on enterprise development. Measures must be taken to correct the defects in credit demand and enterprise weaknesses. Managerial deficiencies and lack of demand for products – one of the key factors identified by the AGI business barometer is the lack of market – are often more significant constraints on enterprise development than lack of finance.

The financial system in post –Independence Ghana evolved against the background of perceived credit scarcity to local enterprises that were seen as marginalized by the pre-Independence banking arrangements. Hence, the pre –FINSAP reforms were typically geared to the creation of institutions (such as the Ghana Commercial Bank) and the adoption of policies that would make credit available to local enterprises. Credit policies therefore included:

- Sectoral targets for lending for all banks, and
- Government determined interest rates, typically different for different sector credit programmes

Unfortunately, however, by 1998, both institution building efforts and directed credit programs had failed to make the expected impact on credit delivery for SMEs. The consequences of pre-FINSAP reforms were the emergence of a repressive regime referred to earlier.

**APPENDIX TABLES**

**TABLE A.1: KEY CHALLENGES FACING MANUFACTURING ENTERPRISES**

| | QTR 1 | QTR 2 | QTR 3 | QTR 4 | Total | Ranking |
|---|---|---|---|---|---|---|
| Access to Credit | 3 | 1 | 1 | 1 | **6** | **1st** |
| High Cost of Credit | 4 | 2 | 3 | 2 | **11** | **2nd** |
| High Level of Taxation | 2 | 3 | 4 | 4 | **13** | **3rd** |
| High Utility Tariffs | 4 | 3 | 4 | 3 | **14** | **4th** |

**TABLE A.2: KEY CHALLENGES BY SIZE OF ENTERPRISE**

| | QTR 1 | QTR 2 | QTR 3 | QTR 4 | Total | Ranking |
|---|---|---|---|---|---|---|
| **SMALL & MEDIUM SIZE ENTERPRISES (SMEs)** | | | | | | |
| Access to Credit | 1 | 1 | 1 | 1 | **4** | **1st** |
| High Cost of Raw Materials | 2 | 2 | 4 | 2 | **10** | **2nd** |
| High Levels of Taxation | 3 | 3 | 3 | 3 | **12** | **3rd** |
| Low Purchasing Power | 4 | 4 | 2 | 4 | **14** | **4th** |
| **LARGE ENTERPRISES** | | | | | | |
| High Utility Tariffs | 1 | 3 | 3 | 1 | **8** | **1st** |
| Competition from Import Substitutes | 3 | 2 | 1 | 2 | **8** | **1st** |
| High Cost of Credit | 2 | 1 | 2 | 4 | **9** | **3rd** |
| Depreciation of the Cedi | 4 | 4 | 4 | 3 | **15** | **4th** |
| **AFRICAN GIANTS** | | | | | | |
| High Levels of Taxation | 2 | 1 | 3 | 3 | **9** | **1st** |
| High Utility Tariffs/Prices | 1 | 3 | 2 | 4 | **10** | **2nd** |
| Delayed Payments | 3 | 2 | 4 | 2 | **11** | **3rd** |
| Poor Infrastructure | 4 | 4 | 1 | 4 | **13** | **4th** |
| Competition from Import Substitutes | 4 | 4 | 4 | 1 | **13** | **4th** |