

# SMEs/SMIs centered industrialization for inclusive and sustainable growth in Africa – How can Japan help?

Elumba Jean Denis Nkongolo  
GRIPS Development Forum (Senior Research Associate)

## Abstract

Various industrialization strategies have been pursued to achieve economic development in Africa without much success. Lack of ownership of a development process rooted in African conditions is often cited as chief amongst multiple causes for failure. This report, emphasizes that, because of the central role of Small and Medium Scale Enterprises (SMEs), and particularly Small and Medium Scale Industries (SMIs) in the private sector in Africa, and considering the shifting dynamic in the world – globalization, emergence of new centers of power, global climate change and a paradigm shift across the economy (green and bio-technologies) – there is a unique opportunity for a new SMEs/SMIs focused industrialization strategy for Africa that Japanese SMEs can be incentivized to support to achieved inclusive and sustainable economic growth on the continent.

**Key words:** Small and Medium Enterprises (SMEs), Small and Medium Industries (SMIs), Industrialization, Growth.

## Introduction

African colonial economies evolved around an artificially created division of labour where Africa traded in natural raw materials while “mother” countries exported manufactured products to Africa. Very limited manufacturing took place in the continent while this artificially created division of labour existed.

Ever since independence in the 1960s, most African countries have sought to support political independence by strengthening their economic autonomy. Various strategies to achieve industrialization and economic modernization have been proposed and implemented. From import substitution of the 1960s -1970s, to the current neo-liberal export-oriented paradigm through structural adjustment programs of the 1980s – 1990s, all along the international donor community (mostly former colonizers turned benefactors) supplied financial capital, and knowledge experts who designed and continued to run – by proxy - the new economies. The takeoff that was expected has never materialized. The dynamics involved in this transformation perhaps constitute the very basis of the African problem: economic development programmed and forced on Africa from the outside and therefore not part of a deep philosophical concept of what the mass of the African people need.

Before being an economic problem, development is primarily a political one. Therefore, we believe the models for Africa’s economic development so far proposed by the international donor community – to serve their economic and politico-strategic interests - are bypassing the central issue of a balanced and equitable multilateral system<sup>1</sup>.

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<sup>1</sup> Developed countries, donors and trading partners might also note the devastating impact of past policies, investment approaches and inequitable trade regimes on the economies of African countries.

A good strategy for Africa, to a large extent, must be based on agriculture and tailored to a people-centered model of development. It must also have catching-up and forging-ahead policies built into the model.

## **Purpose of this report**

This report is prepared to contribute an African perspective to the "Africa growth initiative" brainstorming discussions conducted by the GRIPS Development Forum to feed into the new development assistance program to effectively support economic growth in Africa.

The discussions have centered, amongst other things, around the instruments Japan can use to help revitalize the productive sector in Africa including (i) long-term policy dialogue, (ii) joint drafting of industrialization strategy, (iii) infrastructure development, (iv) human capital development, etc.

Considering prevailing conditions in Africa, we argue in this report that in order to generate inclusive and sustainable growth and integrate Africa into the world economy, a SMEs/SMIs centered industrialization strategy would be best suited to Africa.

Given the important role of SMEs and entrepreneurship for economic development on the African continent, and based on the experiences of India and China – countries that have resisted the neo-liberal Washington consensus ideology and integrated the global economy on their own terms – it is the purpose of this report to (i) underline the centrality of SMEs/SMIs in the gradual industrialization of African economies, (ii) affirm the strategic importance of Africa to economic and political interests of Japan, and (iii) offer recommendations of what in our view are the instruments Japan can use to support such an approach.

The report draws on information gathered from interviews with individuals working in development-related fields. They include policy makers, African and Japanese intellectuals, participants to the African growth initiative, African Ambassadors to Japan, and other opinion makers.

## **Literature review**

### **History of industrialization in Africa**

The importance of industrialization in a country's economy does not need much introduction. Classifying developing countries and developed countries is mainly based on the extent of industrialization of a country. The industrial development of a country starts from production and export of primary products, moves to the production and export of technology-based capital and intermediate goods, before finally producing hi-tech goods.

Having inherited, at independence in the 1960s and 1970s, a fragmented continent with enclave economies (many small states) geared towards export of mainly primary commodities, African governments recognized early on the need to industrialize (to develop their manufacturing sector) and set up a common trade area as key to economic development [Hopkins 1973].

Most governments therefore embarked on a path to rapid industrialization and pursued the strategy billed as 'catch-up industrialization' for import substitution. However, instead of designing strategies for catching up on the industrialized nations' route to development, they introduced state-of-the-art technologies to leapfrog at one bound the long and laborious path that had led to this level. When the intended substitutes for imports were actually produced, they cost more than the equivalent imports due to fluctuations in the exchange rates, shortage in electricity supply, rising costs of inputs due to high inflation, and small markets.

Naturally, this strategy failed, leaving massive white elephants and the resulting debt burden that stifles economic growth in Africa till today. One reason often cited for the failure is the fact that "the strategies pursued focused on setting up large capital-intensive concerns, in total disregard of the huge knowledge gap that existed – and still exists – rather than promoting a gradual industrialization through the growth of existing small-scale and micro-enterprises" (W. S. Barthold, 2002). Moreover, governments heavily relied on state-owned industries to implement their strategy. As a result, private enterprises – majority of which are SMEs – rarely got incentives from their governments.

In the 1980s and 1990s, structural adjustment programs (SAPs) were designed to restore internal and external macroeconomic stability. Although Africa emerged with more open and "competitive" economies, and smaller governments, again, these programs did not bring about the expected economic growth. Moreover, because these programs blatantly ignored the social fabric and needs of the African society for education, health and social cohesion, they contributed to further weakening of already weak states (Mkandawire Thandika and Soludo, Charles, 1999).

From the 1990s onwards, globalization and export-oriented industrialization became the new paradigm for economic development in Africa, where countries were literally forced to open up to free trade. Growth expectations have not materialized in most cases. In general, Africa's level of industrialization has not change significantly. This is reflected in most country's manufacturing contribution to GDP which show still heavy dependence on the agriculture sector.

So many development strategies have been tried in Africa, none have delivered sustained growth. If present conditions remain unaltered and the trend we see were to continue, then being more enmeshed within the global economy would only mean that by force of circumstances, Africa would be made to stay on the margins of the global economy

Judging from the experience of early industrializers and the newly developed countries, what worked is economic policies creating an environment sufficiently attractive for investment and technology transfer to begin taking place. Once the growth process is initiated with sufficient vigour, expectations change in such a way that favours the processes that support growth, such as investment in human capital and institutional change.

Africa is experiencing record growth rates in many countries in a new era of relative peace, political stability, improved governance and macroeconomic reform; Africa's fortunes seem to have changed for the better. The challenge is to ensure that this growth - without much diversification – and attributed to high oil and commodity prices (and windfall investments from China and India) is sustainable and trickle down to reduce poverty. The fact that this has not happened calls into question the

continued relevance of many of the policies being followed. Increased revenues must be used to address problems of skills shortages, enabling environment, infrastructure development, increased access to finance for entrepreneurs and improved health.

With the recent focus on economic growth, the international donors community has been conducting "growth diagnostics" – the identification and removing of binding constraints to economic growth. However, enough resources have been used for theorizing, debates, and grand plans. What Africa needs is action; to take ideas and turn them into bricks and mortar.

### **New industrialization strategy and SMEs**

Many economists and development professionals have called for a new direction for the growth away from the Washington consensus that was followed in the 1980s (with devastating effect). A common thread that ran through the various reports and studies was a call to enhance Africa's industrialization and manufacturing capacity - manufacturing generates value-adding activities based on the existing economic resources of the country - to enable it to integrate and trade with the world. Africa needs broad based industrialization that will restructure its enclave economies and reduce its vulnerability to the fluctuations of world commodity prices. Manufactured products constitutes only 21 percent of total African exports worldwide. (Yutaka Yoshino Policy Research Working Paper 4575)

In order to ensure that African industry could catch up on the development that Europe and North America had once gone through, we should begin with what already exists and build up and expand the industrial sector from the ground up and internally in pace with the development of the other sectors. A good start would be to identify sector(s) with the best potential to stimulate growth engine(s).

To realize the objective of economic growth through competitiveness on the one hand and employment generation and income distribution on the other, SMEs assume a critical role. Also, not only do SMEs dominate the African private sector, the future is geared towards more flexible, modular and small-scale industries due to their socio-economic and socio-ecological benefits. Therefore, a comprehensive growth strategy tailored to substantially engage the SMEs would achieve the dual objective of growth with equity and collective empowerment of the people to fully participate in the design and management of long-lasting development paradigms.

### **Intra-Africa trade**

Intra-African trade has tremendous potential that has yet to be fully exploited. For Sub-Saharan Africa, regional integration is not just a matter of choice. It is a matter of survival in the jungle of international trade. Improved intra-African trade and building regional complementarities should be a goal to enlarge the markets so that successful companies can attract more investors and expand their businesses.

Trade is important for Africa. Not only because the world economy has become more integrated, but also because it is an important leverage for growth. At the international level African exports in world trade dropped due, among other reasons, to their concentration on a few primary agricultural and mineral products; to the low level of integration in dynamic production and distribution networks; and because of their weak industrial and technological bases.

IMF trade data show that at the regional level, Africa's trade within itself remains poor compared to the internal trade of other regions such as Europe and Asia. WTO 2006 international trade statistics show that, intra-African trade as percent of total exports was only 9.8% and 8.9% in 2000 and 2005 respectively. An average of between 9% and 10% of intra-African trade is what has been consistently witnessed. In contrast, the same data show that intra-Europe export trade, was 72.7% in 2001 and 73.2% in 2005, and has consistently been high. Among the 25 countries of the European Union, the figures are 66.8% and 66.7% respectively. Further comparison of Africa's intra-export trade with South and Central America and Asia revealed that Asia's intra-trade as a percentage of the total exports of the region was 51.2% in 2005, while South and Central America's was 24.3%. These comparative statistics have clearly revealed the unenviable record of Africa in terms of its intra-regional trade, and hence the need for the continent to do something to raise this low level of trade compared to what is achieved in other regions. (It is often said that intra-African trade is perhaps greater than what the official trade data portrays because it does not take into account trade in the informal sector, which is perceived to be significant.)

Although Africans have always realized the importance of trading between themselves, the capacity to implement such regimes is very low, and often than not hampered by other agreements. Nevertheless, we should acknowledge these regimes are complex and take time to be effectively implemented.

The focus on intra-African trade raises the question as to whether one should discount international trade in favor of intra-African trade; certainly not. International trade has played an important role in African economies and will continue to do so.

To underline the link between SMEs driven industrialization and intra-Africa trade, data from the World Bank policy research working paper 4575 showed that while small in absolute size, exports of manufactured products are a large share of intra-Africa export (43% of total intra-African trade), compared to exports to other regions. Intra-Africa exports have also grown by almost 20% per annum on average from 2001 to 2005, which is the highest growth for African manufacturing exports among destinations. (Yutaka Yoshino: 2008)

However, various challenges continue to plague intra-African trade including among others (i) structural deficiencies, (ii) economic development challenges, and (iii) half-hearted commitment to trade liberalization programs due to inherent difficulties and (iv) accession to the World Trade Organization (WTO) or participation in Economic Partnership Agreements. Take for example the transport sector, according to UNCTAD, transport costs in Africa constitute over 15% of total cost of any product compared with 8% for other developing countries and 5% for developed countries.

### **Importance of SMEs/SMIs focused industrialization**

SMEs are important to almost all economies in the world, and particularly to Africa with her multitude of development challenges.

SMEs represent the biggest share in business establishments in practically all countries and play a key role in the industrialization of a developing country. They

have unique characteristics on their own, as they are extremely flexible and can readily adapt to today's rapidly changing environment.

Although the term "small and medium enterprise" has various definitions, such definitions are basically based on volume of turnover and number of persons employed in a particular firm. Variations are function of the level of economic development of a country. For our purposes, SMEs and SMIs cover firms that employ between 10 and 100 persons. (A typical Japanese SME is larger than its African counterpart given the larger scale of Japanese operations).

SMEs centered industrialization would be most suitable for Africa for the following reasons: (Provided a good business environment exists)

1. SMEs enable better use of existing local capacity, thereby establishing the basis for sustained long-run growth, and the opportunity to expand that capacity in the future – we need to start with what we have;
2. They are naturally more labor intensive and central to job creation and contribute to a more equitable distribution of income.
3. SMEs provide an increasing measure of national self-reliance - the future of entrepreneurship in Africa should be in the hands of Africans themselves;
4. They are easier to start up as they require lower investment - SMEs are in the reach of Africa, and would enable them to take full ownership their development and management;
5. Because of their large number in different sectors in Africa there is likelihood to adapt new technologies in response to competitive pressure in domestic and regional (or international) markets;
6. They play the role of invisible colleges that impart tacit knowledge through 'On the Job Training Units' for various kind of labor force for the entire economy;
7. They focus on small markets – mostly domestic and regional markets (intra-Africa trade).
8. They are one of the push factors for foreign investors to invest in a particular country. The potential to be reliable suppliers is credited by foreign investors who may wish to outsource their non-core activities to local suppliers.
9. They are also necessary for the structural change of a country's economy, from agriculture-dependent economy to an industrial and service-oriented economy.
10. They expand economic space and develop capacities in various industrial sectors whose combined impact will have profound implications for long-term economic transformation.

Within the new SMEs/SMIs focused industrialization 'a la India', the main economic value in Africa of some of the required infrastructure, especially the social and cultural elements (e.g. human capacity development), does not lie in the direct contributions they make to GDP. Rather, the value is seen in the supporting role it provides in building an environment conducive to entrepreneurship *and* innovation.

Instead of a mega project driven utilization of comparative advantage, which is essentially a short-term strategy, an SMEs focused industrialization strategy is much more long-term as it would accelerate the economy's shift of tomorrow's comparative advantage into higher value-added, higher return products and can help in securing the economy's place in higher potential industries.

We can not go on playing the “catch up” game without a serious industrialization policy as firms in the more productive economy can outcompete firms in the less productive one across many sectors. Given their potential to address both the growth and distributional concerns of economic policy, it is imperative that appropriate attention is given to the promotion of SMEs in Africa.

## **Japan and Africa**

Historically, Africa has generally been considered to fall outside the scope of Japan’s concerns. However, in a changed international context, and an increasingly interdependent world, Africa has assumed new importance to Japan and Japan can no longer afford to ignore Africa's challenges - from HIV/AIDS pandemic, extreme poverty, environmental degradation to international terrorism - or disregard its potential economic - Africa will continue to be an important source of strategic minerals (significant reserves of rare metals in the world are known to be in Africa) and other natural resources, for some foreseeable future - and political relevance (~53 votes in the UN general assembly). In 1993, the Tokyo International Conference for Africa’s Development (TICAD) process initiated by Japan firmly moved African concerns from the margins of Japan foreign policy to the center.

In recent years, Japan and its trading houses have scrambled to court resource-rich African countries as competition has intensified with the EU/USA and China/India to secure natural resources.

Foreign direct investment from Japan to Africa is rising fast as many companies seek access to increasingly precious resources. The amount of Japanese FDI to Africa in 2007 reached \$1.1 billion, up from \$899 million in 2006 and \$25 million in 2005, according to the Japan External Trade Organization (JETRO). We believe this positive trend could substantially increase if Japanese SMEs potential is tapped for investment in Africa.

## **Africa at the cross roads**

Although Africa is endowed with huge natural resources, it is recognized that many natural resources are finite. Therefore, if properly managed, the wealth they generate should be invested in other forms of capital, particularly human, social and physical to engender growth and multiplier effects on the continent. However, this hinges on ensuring Africa's ownership of the development process, strengthening governance systems, reinforcing institutional capacity, investing natural resources wealth in the creation of knowledge for economic innovation, negotiating better terms with external partners, and integrating the natural resources sector into national development frameworks.

For the first time, there are centers of power that understand Africa’s development challenges. Because of their development experiences, China and India offer valuable models for Africa as the continent seeks to achieve economic growth. African governments should take advantage of this opportunity, which they have not had for decades to determine the terms of engagement to diversify their economies and make them more robust. Africa should use this new relationship to convert her comparative advantage into competitiveness.

## **The best approach for Africa**

Anyone who designs a strategy that would be used to develop African economies must ensure that it would generate an economy that includes the poor. The strategy, to a large extent, must be based on agriculture and tailored to a people-centered model of development. It must also have catching-up and forging-ahead policies built into the model.

The issue as to how African countries can develop their manufacturing capabilities is one of the most important policy issues facing governments in Africa. We believe that SMEs driven industrialization strategy would bring about a broad based growth with re-distributive justice to reverse decades of economic decline and marginalization. Therefore our recommendations that governments pursue SMEs focused industrialization model that can

1. Achieve the extractive final stage processing. That is, value addition of natural products before exports by extraction of main ingredients instead of exporting raw materials;
2. Support and expand import substitution industries. This model would greatly help the industrialization process by helping the emergence of light and heavy industries in Africa. The idea being to manufacture most of the goods locally as well as accelerate technology transfer.

## **How can Japan help?**

Besides, (i) supporting infrastructure development, (ii) providing market access to African products, (iii) supporting human capital development - vocational and tertiary education with emphasis on science and technology – the following areas of support would go a long way in making Japan's assistance more effective:

### **Increasing the number and tenure of "Africa specialists"**

It takes an incredibly long amount of time to know about a culture, generally 10 to 15 years. With the recent interest and increased involvement of Japan in Africa, African studies could be stepped up in such a way that more research units are Africa based.

### **Help reshape Africa's image in Japan**

The imaging and visioning of Africa in development literature has perpetuated myths and half-truths about the continent that would make any rational entrepreneur think twice. The reshaping of Africa's image (in Japan) could be facilitated by mapping out a detailed framework of political risk analysis for Africa to address the perception of Africa as a "high risk investment destination" and differentiate the risk between countries.

We may not go a long way restructuring the international economic order during this era of globalization but we can provide a trans-cultural education on Africa that will educate consumers, investors, and the general public and lead to a rethinking of its people's ideologies and socio-economic reality.



## **Promote SMEs investment in Africa**

To our knowledge, only a very small number of SMEs have ventured into Africa, mainly into the tourism, trading in used vehicles and equipments and some agro-processing. Interviews with a few SMEs have revealed that this trend is likely to increase should there be a government policy to support such initiatives. Despite this lack of promotion, the importance of Japanese SMEs FDI should not be underestimated.

Promote outward FDI (including technology transfer) to Africa through government designed schemes to help to reduce the information gap in Japan surrounding an investment in Africa and reduce the need for superficially high ex-ante, risk unadjusted rates of return. For various reasons, there is a noted reluctance to rely on African led investment promotion seminars.

Expanding outward promotion activities in Africa would be useful to collect up to date business information. Currently, the Japan External Trade Organization (JETRO) only has 4 offices in Africa covering (nominally) 53 countries.

A new fund to promote Japanese private sector investments in Africa is a new vehicle that can incentivize the Japanese SMEs sector to consider Africa as an investment destination. It is hoped the SMEs would have a greater share of this fund.

## **Collaboration in green- and Bio-technologies**

Green technologies (Biotechnology) offer Africans the potential to leapfrog entire stages of economic development and solve globally worrisome strategic problems associated with the environment, population, food production, energy, poverty, and health care. At the moment, Africa commands little attention among world technologists, leaving the field open to those who might wish to take a commanding leadership role quickly and, perhaps, largely unchallenged.

In the age of global climate change, where new technologies, including biotechnology, green chemistry and nanotechnology will drive greater eco-efficiency, resource productivity and a paradigm shift across the economy, Japan could help Africa strengthen its capacity to harness renewable resources as a means to preserve the stock of non-renewable resources for future generations.

In the biotech industry particularly, it is not necessarily large firms that are poised to take market advantages and enlarge industrial inequalities. Countries such as India, Cuba and China have demonstrated that small enterprises can acquire technological and market niches in modern biotechnology. Japan could help Africa harness biotechnology in order to develop Africa's rich biodiversity and improve agricultural productivity and develop pharmaceutical products. There is also similar potential in Agricultural Biotechnology, Forestry biotechnology, Health and medical biotechnology (diagnostic kit), Environmental biotechnology (using bacteria to treat contaminated groundwater), Environmental biotechnology.

## **Conclusion**

The history of economic development is replete with cases in which governments have tried unsuccessfully to promote the use of new technologies to accelerate growth. This may be the case with efforts to transform Africa from a colonial

economy (extractive economy) to a manufacturing economy. These efforts have been in most cases disappointing. The many reasons for failure include poor governance, flawed policy design, and weak implementation. Nevertheless, African policy makers have continued to look for innovative ways to increase economic growth. The challenges they face are daunting, not least because global competition is rising and taking new forms, driven by rapid technological change and the growth of global production networks in which sophisticated skills and capabilities are required at the entry level. A lesson learned from past failures is that any industrialization strategy must be evaluated against the fact that there exist significant gap between national aspiration and actual capability. In this report we have argued that a SMEs driven approach to economic growth will be the most suitable under current Africa circumstances. As manufacturing economy requires a very different set of supporting infrastructure from that of a colonial economy, African governments together with their development partners, including Japan must make the necessary changes to facilitate the transition – enabling environment for technology transfer and adaptation and innovation, physical infrastructure, human development to operate in the knowledge economy, etc.

There is need to go beyond acknowledging historical injustices to determining where Africa's self interests lie and steer the world appropriately by establishing stronger economic blocs within Africa and mutually beneficial partnerships outside Africa. Africa has that responsibility and needs to determine an adequate framework for herself - a framework that is sensitive to international realities and opinions and which can get the buy-in from the rest of the World. This window of opportunity to redefine Africa's role in the global community must not be wasted.

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