Firm capabilities: Rwanda's trade performance and policies to create export dynamism.

Professor Ricardo Hausmann

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Professor Ricardo Hausmann is Director of the Centre for International Development and Professor of the Practice of Economic Development at Harvard University. Previously, he served as the first Chief Economist of the Inter-American Development Bank (1994-2000), where he created the Research Department. He has served as Minister of Planning of Venezuela (1992-1993) and as a member of the Board of the Central Bank of Venezuela. He also served as Chair of the IMF-World Bank Development Committee. He was Professor of Economics at the Instituto de Estudios Superiores de Administracion (IESA) (1985-1991) in Caracas, where he founded the Center for Public Policy. His research interests include issues of growth, macroeconomic stability, international finance, and the social dimensions of development.

Professor Ricardo Hausmann provided insights on the role of firm capabilities and a country's product space in economic growth. Knowledge is accumulated stepwise, transitioning from simple to complex products. Making the right choices and providing a welcoming business environment will accelerate the process. Professor Hausmann indicated areas of potential strategic interest to Rwanda as well as important steps to take in order to attract investment and foster knowledge creation.

The Macro picture of Rwanda

After four decades of virtually no increase in per capita income, the rate of growth since 2000 is impressive. Rwanda is one of the best performing economies in the developing world, lagging only major resource exporters. Income per capita nonetheless remains below LDC average. Investment has been on the rise, inflation has remained moderate and exports have increased significantly – including export of services. The overall level of exports however remains low relative to countries of comparable per capita income. Exports remain concentrated in non-complex products in geographically distant markets while nearby markets demand more complex products that Rwanda can produce.

IGC Rwanda
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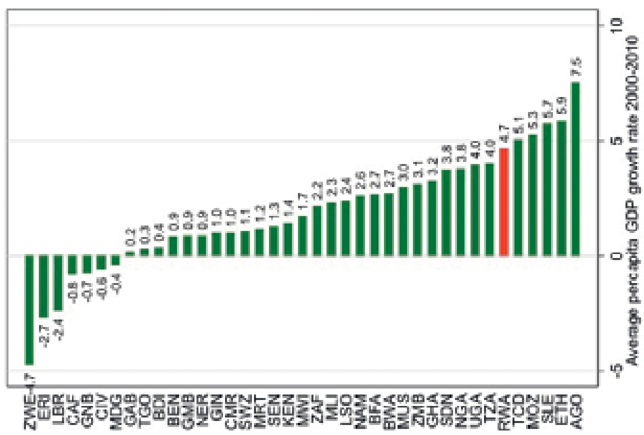
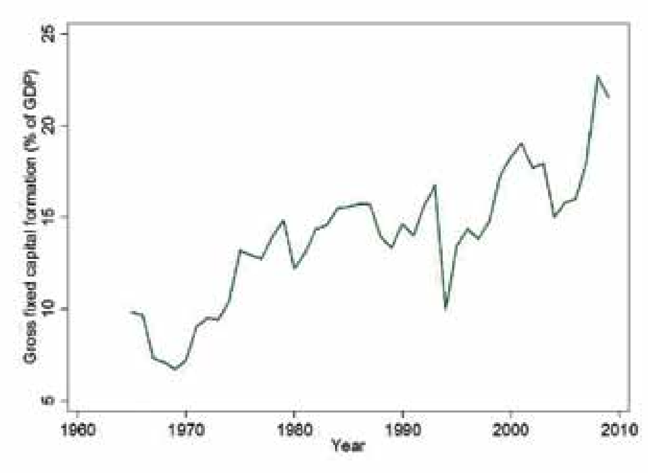
GDP per capita in constant USD

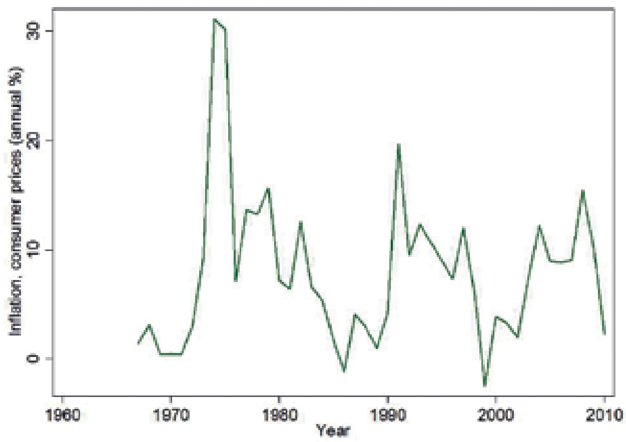
Average pc GDP growth 2000 - 2010



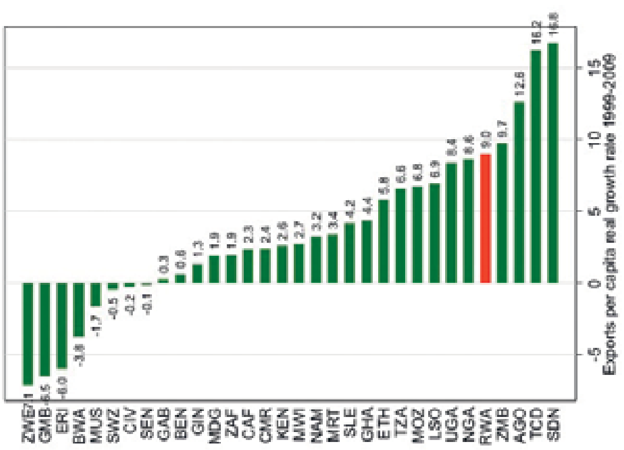
Gross fixed capital formation as % of GDP



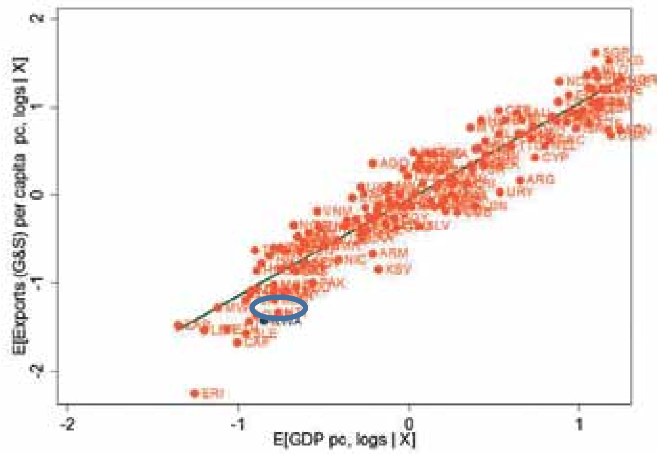
CPI inflation, annual percentage change



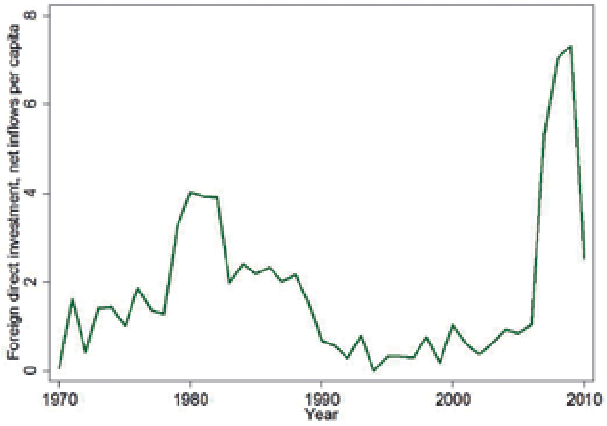
Growth in exports per capita 1999 – 2009



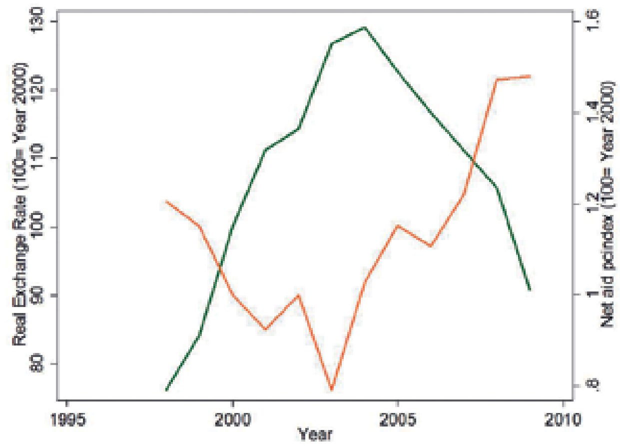
Exports in relation to GDP



Net FDI inflows per capita



Real exchange rate and aid flows



FDI has shown little dynamism as shown in the green graph on the left below. Aid flows (in orange above) have increased and are associated with appreciation of the real exchange rate (green – down means appreciation) and making exports more difficult.

The secret of growth

Countries that have more knowledge can make more complex products; however, they do not stop producing simple products. This results in many countries producing similar simple products and few countries diversifying in more complex products. It is possible to measure how similar products are to each other – and implicitly how similar the capabilities required to produce them are; the more similar are the capabilities needed to produce two different products, the easier it is to "jump" from one to the other. Thinking of the product-space as a forest is illustrative: monkeys in a forest can only jump to nearby trees, the same way a firm can only diversify into products that require similar capabilities to what they already have. The more capabilities a country has, the more diversified the products it can produce and the faster it is likely to grow. Speed of growth also depends on how well placed a country is in the product space: the more close products there are to its existing capabilities the faster it can diversify and therefore grow.

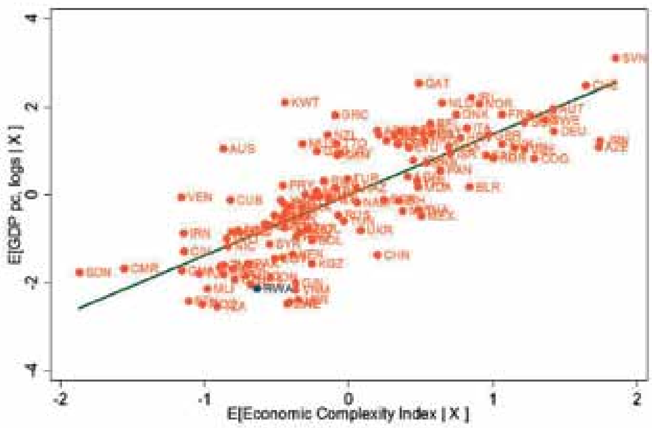
Thinking of where to diversify is a strategic choice: a monkey can face two trees at the same distance, behind one is the desert, behind the other is a forest, there is a clear opportunity value behind industrial policy choices that can lead to faster or slower growth.

Implications for Rwanda

Rwanda has successfully expanded its product space in the last decade increasing the complexity of its knowledge (see the presentation slides for a graphical representation) and is expected to grow as a result. Its location in the product space however is tricky and strategic choices on where to diversify are important.

Given Rwanda's high density and rapid population growth, it needs activities that are scalable such as manufacturing and business services. High transport cost will make manufacturing exports difficult in distant destinations. Local markets however present an opportunity if Rwanda can cater to demand for the more complex products. Two opportunities to be explored are food processing and construction materials – both are relatively close in capabilities to Rwanda position in the product space, and would move Rwanda closer to denser areas in the 'forest'.

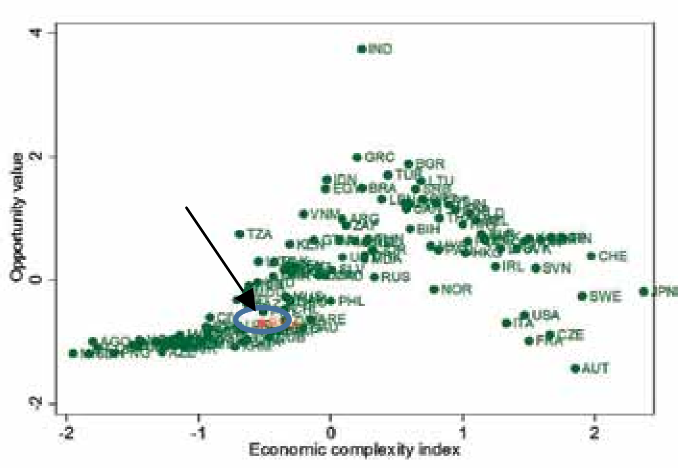
Growth and economic complexity



Business services are already Rwanda's second largest services export. Rwanda's good business environment and its bilinguism make it a good candidate to serve central and eastern Africa.

Stepping up the game will require an active and well thought out industrial policy. Three activities the government should consider are:

Opportunity value and economic complexity



Investment promotion – An active development board engages directly with potential investors, learns about the constraints and bottlenecks to investment and works with the government to remove them. RDB's approach should be "tell us what the problems are and we will fix them". Rather than ad-hoc solutions on a case by case basis, solutions should be applied economy-wide to progressively improve the business environment. Ireland and Mexico provide excellent examples of successful investment promotion.

Development banking – a development bank can provide finance for projects that may struggle to find it otherwise, but may have substantial payoffs from the learning generated. The performance of a development bank should be judged by the learning it generates relative to the money lent. The money is a cost, not something that should be targeted.

Industrial and business zones – Rather than offering tax incentives (which weaken the stake that government has in future profits) or generic Special Economic Zones, the government should aim to find ways to increase the productivity of investments – creating value for both the investor and Rwanda. The government should care about attracting investment and increasing productivity because that brings higher revenue in taxes. Tax incentives are counterproductive and often ineffective. Industrial zones should be about easing the constraints – in terms of infrastructure, land, energy, transport, etc – that investors might face elsewhere in the country. Industrial zones can be privately run, so that the company running them has all incentives to make them as attractive as possible to investors and make profits by renting them out. Good examples can be found in Colombia and the Dominican Republic.

The IGC in Rwanda

The IGC is directed and organized from hubs at the London School of Economics and Oxford University and is funded by UKaid from the Department for International Development (DFID). The IGC was created to provide demand-led policy advice based on frontier research.

The IGC's Rwanda country office was established in November 2010, and the core team includes Country Director, Richard Newfarmer, Lead Economist Mans Soderbom and Country Economists Jonathan Argent and Michele Savini. The IGC's activities in support of government programmes focus on four core thematic areas: trade and diversification; agriculture; infrastructure; and finance.

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