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Tinga Tinga art from Tanzania
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What's driving Africa's growth

The rate of return on foreign investment is higher in Africa than in any other developing region. Global executives and investors must pay heed.

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Africa's economic pulse has quickened, infusing the continent with a new commercial vibrancy. Real GDP rose by 4.9 percent a year from 2000 through 2008, more than twice its pace in the 1980s and '90s. Telecommunications, banking, and retailing are flourishing. Construction is booming. Private-investment inflows are surging.

To be sure, many of Africa's 50-plus individual economies face serious challenges, including poverty, disease, and high infant mortality. Yet Africa's collective GDP, at \$1.6 trillion in 2008, is now roughly equal to Brazil's or Russia's, and the continent is among the world's most rapidly growing economic regions. This acceleration is a sign of hard-earned progress and promise.

While Africa's increased economic momentum is widely recognized, its sources and likely staying power are less understood. Soaring prices for oil, minerals, and other commodities have helped lift GDP since 2000. Forthcoming research from the McKinsey Global Institute (MGI) shows that resources accounted for only about a third of the newfound growth.¹ The rest resulted from internal structural changes that have spurred the broader domestic economy. Wars, natural disasters, or poor government policies could halt or even reverse these gains in any individual country. But in the long term, internal and external trends indicate that Africa's economic prospects are strong.

Each African country will follow its own growth path. We have developed a framework for understanding how the opportunities and challenges differ by classifying countries according to levels of economic diversification and exports per capita.

This approach can help guide executives as they devise business strategies and may also provide new insights for policy makers.

More than a resource boom

To be sure, Africa has benefited from the surge in commodity prices over the past decade. Oil rose from less than \$20 a barrel in 1999 to more than \$145 in 2008. Prices for minerals, grain, and other raw materials also soared on rising global demand.

Yet the commodity boom explains only part of Africa's broader growth story. Natural resources, and the related government spending they financed, generated just 32 percent of Africa's GDP growth from 2000 through 2008.² The remaining two-thirds came from other sectors, including wholesale and retail, transportation, telecommunications, and manufacturing (Exhibit 1). Economic growth accelerated across the continent, in 27 of its 30 largest economies. Indeed, countries with and without significant resource exports had similar GDP growth rates.

The key reasons behind this growth surge included government action to end armed conflicts, improve macroeconomic conditions, and undertake microeconomic reforms to create a better business climate. To start, several African countries halted their deadly hostilities, creating the political stability necessary to restart economic growth. Next, Africa's economies grew healthier as governments reduced the average inflation rate from 22 percent in the 1990s to 8 percent after 2000. They trimmed their foreign debt by one-quarter and shrunk their budget deficits by two-thirds.

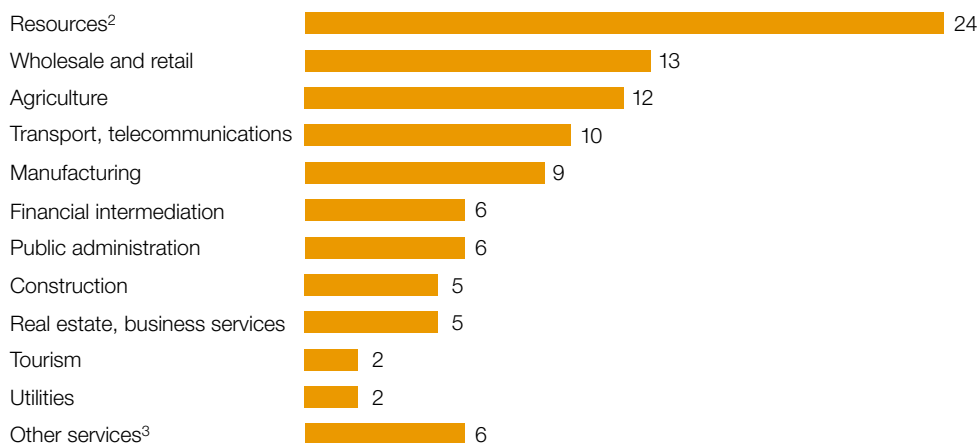
¹ McKinsey Global Institute, *Lions on the move: The progress and potential of African economies*, to be published in July 2010. The report will be available online at mckinsey.com/mgi.

² Resources contributed 24 percent of GDP growth. Government spending from resource-generated revenue contributed an additional eight percentage points.

Exhibit 1

Africa's growth was widespread across sectors.

Sector share of change in real GDP, 2002–07
100% = \$235 billion¹



¹In 2005 dollars.

²Government spending from resource-generated revenue contributed an additional eight percentage points.

³Education, health, household services, and social services.

Source: McKinsey Global Institute analysis

Finally, African governments increasingly adopted policies to energize markets. They privatized state-owned enterprises, increased the openness of trade, lowered corporate taxes, strengthened regulatory and legal systems, and provided critical physical and social infrastructure. Nigeria privatized more than 116 enterprises between 1999 and 2006, for example, and Morocco and Egypt struck free-trade agreements with major export partners. Although the policies of many governments have a long way to go, these important first steps enabled a private business sector to emerge.

Together, such structural changes helped fuel an African productivity revolution by helping companies to achieve greater economies of scale, increase investment, and become more competitive. After declining through the 1980s and 1990s,

the continent's productivity started growing again in 2000, averaging 2.7 percent since that year. These productivity gains occurred across countries and sectors.

This growth acceleration has started to improve conditions for Africa's people by reducing the poverty rate. But several measures of health and education have not improved as fast. To lift living standards more broadly, the continent must sustain or increase its recent pace of economic growth.

Promising long-term growth prospects

A critical question is whether Africa's surge represents a one-time event or an economic take-off. The continent's growth also picked up during the oil boom of the 1970s but slowed sharply

when oil and other commodity prices collapsed during the subsequent two decades. Today, individual African economies could suffer many disappointments and setbacks. While short-term risks remain, our analysis suggests that Africa has strong long-term growth prospects, propelled both by external trends in the global economy and internal changes in the continent's societies and economies.

Global economic ties

Although Africa is more than a story about resources, it will continue to profit from rising global demand for oil, natural gas, minerals, food, arable land, and the like. MGI research finds that over the next decade, the world's liquid-fuel consumption will increase by 25 percent—twice the pace of the 1990s. Projections of demand for many hard minerals show similar growth. Meanwhile, Africa boasts an abundance of riches: 10 percent of the world's reserves of oil, 40 percent of its gold, and 80 to 90 percent of the chromium and the platinum metal group. Those are just the known reserves; no doubt more lies undiscovered.

Demand for commodities is growing fastest in the world's emerging economies, particularly in Asia and the Middle East. Despite long-standing commercial ties with Europe, Africa now conducts half its trade with developing economic regions ("South–South" exchanges). From 1990 through 2008, Asia's share of African trade doubled, to 28 percent, while Western Europe's portion shrank, to 28 percent, from 51 percent.

This geographic shift has given rise to new forms of economic relationships, in which governments strike multiple long-term deals at once. China, for example, has bid for access to ten million tons of copper and two million tons of cobalt in the Democratic Republic of the Congo in exchange for a \$6 billion package of infrastructure investments,³

including mine improvements, roads, rail, hospitals, and schools. India, Brazil, and Middle East economies are also forging new broad-based investment partnerships in Africa.

The global race for commodities also gives African governments more bargaining power, so they are negotiating better deals that capture more value from their resources. Buyers are now willing to make up-front payments (in addition to resource extraction royalties) and to share management skills and technology.

At the same time, Africa is gaining increased access to international capital. The annual flow of foreign direct investment into Africa increased from \$9 billion in 2000 to \$62 billion in 2008—relative to GDP, almost as large as the flow into China. While Africa's resource sectors have drawn the most new foreign capital, it has also flowed into tourism, textiles, construction, banking, and telecommunications, as well as a broad range of countries.

The rise of the African urban consumer

Africa's long-term growth will increasingly reflect interrelated social and demographic changes creating new domestic engines of growth. Key among these will be urbanization, an expanding labor force, and the rise of the middle-class African consumer.

In 1980, just 28 percent of Africans lived in cities. Today, 40 percent of the continent's one billion people do—a proportion roughly comparable to China's and larger than India's (Exhibit 2). By 2030, that share is projected to rise to 50 percent, and Africa's top 18 cities will have a combined spending power of \$1.3 trillion.

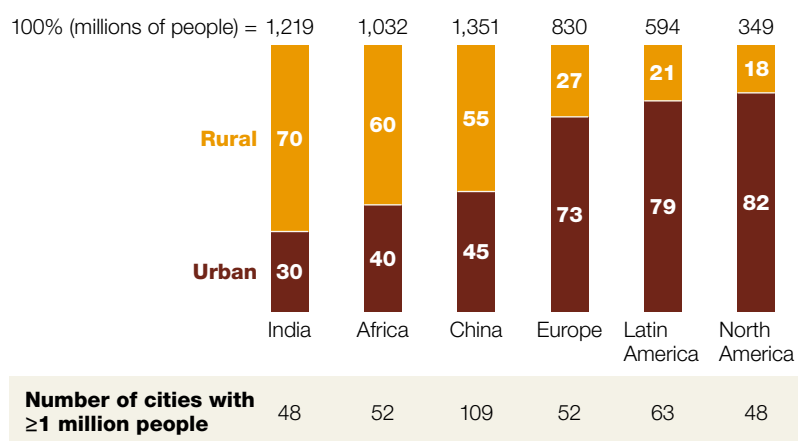
To be sure, urbanization can breed misery if it creates slums. But in many African countries, urbanization is boosting productivity (which rises as

³ Aspects of this agreement have been challenged in court because of disputes over the mining rights. The deal was originally valued at \$9 billion. As of this writing, \$6 billion has been finalized and \$3 billion in funding is under discussion.

Exhibit 2

Africa is nearly as urbanized as China is and has as many cities of one million people as Europe does.

Share of population by region, 2010, %



Source: United Nations; McKinsey Global Institute analysis

workers move from agricultural work into urban jobs), demand, and investment. Companies achieve greater economies of scale by spreading their fixed costs over a larger customer base. And urbanization is spurring the construction of more roads, buildings, water systems, and similar projects. Since 2000, Africa's annual private infrastructure investments have tripled, averaging \$19 billion from 2006 to 2008. Nevertheless, more investment is required if Africa's new megacities are to provide a reasonable quality of life for the continent's increasingly large urban classes.

Meanwhile, Africa's labor force is expanding, in contrast to what's happening in much of the rest of the world. The continent has more than 500 million people of working age. By 2040, their number is projected to exceed 1.1 billion—more than in China or India—lifting GDP growth. Over the last 20 years, three-quarters of the continent's

increase in GDP per capita came from an expanding workforce, the rest from higher labor productivity. If Africa can provide its young people with the education and skills they need, this large workforce could become a significant source of rising global consumption and production. Education is a major challenge, so educating Africa's young has to be one of the highest priorities for public policy across the continent.

Finally, many Africans are joining the ranks of the world's consumers. In 2000, roughly 59 million households on the continent had \$5,000 or more⁴ in income—above which they start spending roughly half of it on nonfood items. By 2014, the number of such households could reach 106 million. Africa already has more middle-class households (defined as those with incomes of \$20,000 or above) than India. Africa's rising consumption will create more demand for local

⁴ Measured in terms of purchasing-power parity (PPP), which takes into account the relative prices of nontradable goods in different countries.

products, sparking a cycle of increasing domestic growth.

Africa's diverse growth paths

While Africa's collective long-term prospects are strong, the growth trajectories of its individual countries will differ. Economists have traditionally grouped them by region, language, or income level. We take another approach, classifying 26 of the continent's largest countries⁵ according to their levels of economic diversification and exports per capita. This approach highlights progress toward two related objectives:

- Diversifying the economy. In the shift from agrarian to urban economies, multiple sectors

contribute to growth. The share of GDP contributed by agriculture and natural resources shrinks with the expansion of the manufacturing and service sectors, which create jobs and lift incomes, raising domestic demand. On average, each 15 percent increase in manufacturing and services as a portion of GDP is associated with a doubling of income per capita.

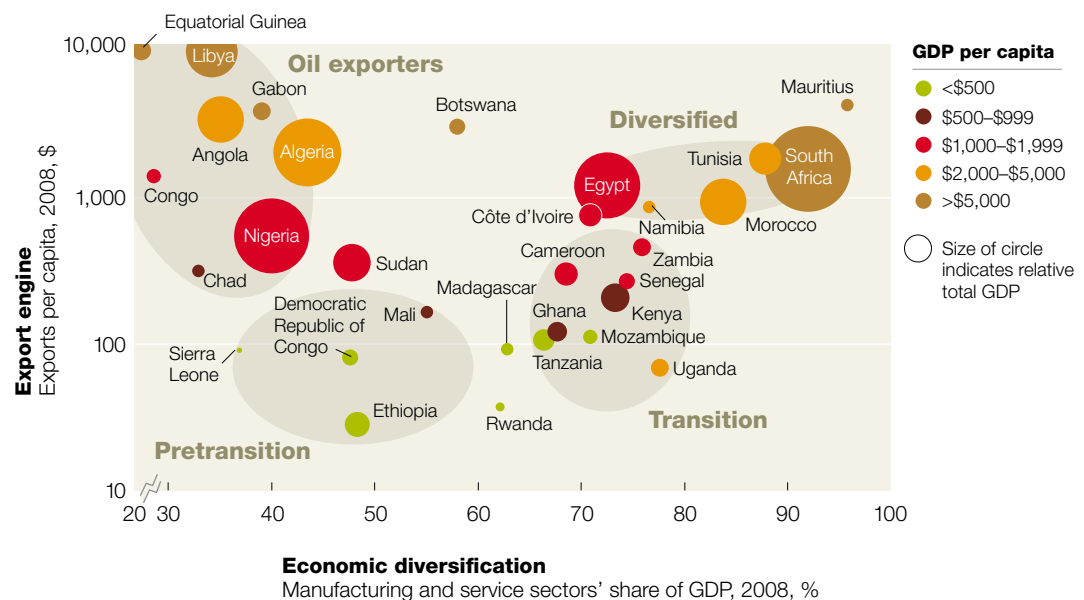
- Boosting exports to finance investment. Emerging markets require large investments to build a modern economy's infrastructure. Exports are the primary means to earn the hard currency for imported capital goods, which in Africa amount to roughly half of all investment. This is not to say that African countries must

⁵These countries had either a GDP of roughly \$10 billion or more in 2008 or a GDP growth rate greater than 7 percent a year from 2000 to 2008.

Exhibit 3

Segmenting African countries by exports per capita and by economic diversification reveals how growth opportunities and challenges vary across the continent.

Country segments in Africa¹



¹Includes countries with 2008 GDP ≥\$10 billion or real GDP growth rate of ≥7% from 2000–08; excludes 22 countries, which accounted for 3% of African GDP in 2008.

Source: Organisation for Economic Co-operation and Development (OECD); World Bank World Development Indicators; McKinsey Global Institute analysis

follow an Asian model of export-led growth and trade surpluses, but they do need exports to finance the investments required to diversify.

History shows that as countries develop, they move closer to achieving both of these objectives. Most African countries today fall into one of four broad clusters: diversified economies, oil exporters, transition economies, or pretransition economies (Exhibit 3). Although the countries within each segment differ in many ways, their economic structures share broad similarities. Our framework is useful for understanding how growth opportunities and challenges vary across a heterogeneous continent. Although imperfect, this framework can guide business leaders and investors as they develop strategies for Africa and can provide new perspectives for its policy makers.



Diversified economies: Africa's growth engines
The continent's four most advanced economies—**Egypt, Morocco, South Africa, and Tunisia**—are already broadly

diversified. Manufacturing and services together total 83 percent of their combined GDP. Domestic services, such as construction, banking, telecom, and retailing, have accounted for more than 70 percent of their growth since 2000. They are among the continent's richest economies and have the least volatile GDP growth. With all the necessary ingredients for further expansion, they stand to benefit greatly from increasing ties to the global economy.

Domestic consumption is the largest contributor to growth in these countries. Their cities added more than ten million people in the last decade, real

consumer spending has grown by 3 to 5 percent annually since 2000, and 90 percent of all households have some discretionary income. As a result, consumer-facing sectors such as retailing, banking, and telecom have grown rapidly. Urbanization has also prompted a construction boom that created 20 to 40 percent of all jobs over the past decade.

Looking ahead, these diversified economies face the challenge of continuing to expand exports while building a dynamic domestic economy. Apart from Egypt, their exports have grown much more slowly than those of other emerging markets, in part because they have unit labor costs (wages divided by output per worker) two to four times higher than those in China and India. Like other middle-income countries, such as Brazil, Malaysia, and Mexico, these African states must move toward producing higher-value goods. They have started to do so—witness South Africa's and Morocco's automotive exports—and should continue to build on their comparative advantages, which include proximity to Europe and facility with European languages.

Along with other countries seeking to make this jump, Africa's diversified economies need to improve their education systems. Broadly speaking, they already have the continent's highest rates of literacy and school enrollment; the next step will be to increase secondary and tertiary enrollments and improve the overall quality of their education systems.

Another priority for the diversified economies is to continue building their internal service sectors, which will be important sources of future employment. (MGI research finds that internal services account for virtually all net job creation in high-income countries and for 85 percent of net new jobs in middle-income ones.) The diversified economies can also expand manufacturing, particu-

larly in food processing and construction materials, for local and regional markets. This move could increase exports and reduce the need for imports, easing these countries' current-account deficits.



Oil exporters:
Enhancing
growth through
diversification

Africa's oil and gas exporters have the continent's highest GDP per capita but also the least diversified eco-

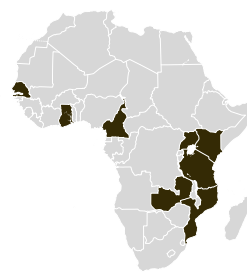
nomies. This group—**Algeria, Angola, Chad, Congo, Equatorial Guinea, Gabon, Libya, and Nigeria**—comprises both countries that have exported oil for many years and some relative newcomers. Rising oil prices have lifted their export revenues significantly; the three largest producers (Algeria, Angola, and Nigeria) earned \$1 trillion from petroleum exports from 2000 through 2008, compared with just \$300 billion in the 1990s. For the most part, Africa's oil and gas exporters used this revenue well, to reduce budget deficits, fund investments, and build foreign-exchange reserves.

Economic growth in these countries remains closely linked to oil and gas prices. Manufacturing and services account for just one-third of GDP—less than half their share in the diversified economies. The experience of emerging-market oil exporters outside Africa illustrates the potential for greater diversification. In Indonesia, manufacturing and services account for 70 percent of GDP, compared with less than 45 percent in Algeria and Nigeria—even though all three countries have produced similar quantities of oil since 1970.

Nigeria provides an example of an African oil exporter that has begun the transition to a more

diversified economy. Natural resources accounted for just 35 percent of Nigeria's growth since 2000, and manufacturing and services are growing rapidly. Banking and telecom, in particular, are expanding thanks to a series of economic reforms. Since 2000, the number of Nigeria's telecom subscribers increased from almost zero to 63 million, while banking assets grew fivefold.

The oil exporters generally have strong growth prospects if they can use petroleum wealth to finance the broader development of their economies. The experience of other developing countries shows it will be essential to make continued investments in infrastructure and education and to undertake further economic reforms that would spur a dynamic business sector. But like petroleum-rich countries in general, those in Africa face acute challenges in maintaining political momentum for reforms, resisting the temptation to overinvest (particularly in the resource sector), and maintaining political stability—in short, avoiding the “oil curse” that has afflicted other oil exporters around the world.



Transition economies: Building on current gains

Africa's transition economies—

Cameroon, Ghana, Kenya, Mozambique, Senegal, Tanzania, Uganda, and

Zambia—have lower GDP per capita than the countries in the first two groups but have begun the process of diversifying their sources of growth. These countries are diverse: some depend heavily on one commodity, such as copper in Zambia or aluminum in Mozambique. Others, like Kenya and Uganda, are already more diversified.

The agriculture and resource sectors together account for as much as 35 percent of GDP in the transition countries and for two-thirds of their exports. But they increasingly export manufactured goods, particularly to other African countries. Successful products include processed fuels, processed food, chemicals, apparel, and cosmetics. As these countries diversified, their annual real GDP growth accelerated from 3.6 percent a year in the 1990s to 5.5 percent after 2000.

Expanding intra-African trade will be one key to the future growth of the transition economies, because they are small individually, but their prospects improve as regional integration creates larger markets. If these countries improved their infrastructure and regulatory systems, they could also compete globally with other low-cost emerging economies. One study found that factories in the transition countries are as productive as those in China and India but that the Africans' overall costs are higher because of poor infrastructure and regulation—problems that the right policy reforms could fix.⁶ The local service sectors (such as telecommunications, banking, and retailing) in the transition economies also have potential. While they are expanding rapidly, their penetration rates remain far lower than those in the diversified countries, creating an opportunity for businesses to satisfy the unmet demand.

the diversified countries. Some, such as Ethiopia and Mali, have meager commodity endowments and large rural populations. Others, devastated by wars in the 1990s, started growing again after the conflicts ended. But many pretransition economies are now growing very fast. The three largest (the Democratic Republic of the Congo, Ethiopia, and Mali) grew, on average, by 7 percent a year since 2000, after not expanding at all in the 1990s. Even so, their growth has been erratic at times and could falter again.

Although the individual circumstances of the pretransition economies differ greatly, their common problem is a lack of the basics, such as strong, stable governments and other public institutions, good macroeconomic conditions, and sustainable agricultural development. The key challenges for this group will include maintaining the peace, upholding the rule of law, getting the economic fundamentals right, and creating a more predictable business environment. These countries can also hasten their progress with support from international agencies and new private philanthropic organizations that are developing novel ways to tackle poverty and other social issues.

In a more stable political and economic environment, some of these countries could tap their natural resources to finance economic growth. The Democratic Republic of the Congo, for example, controls half of the world's cobalt reserves and a quarter of the world's diamond reserves. Sierra Leone has about 5 percent of the world's diamond reserves. Ethiopia and Mali have 22 million and 19 million hectares of arable land, respectively. If these countries could attract businesses to help develop their resources, they could push their economies upward on the path of steadier growth.



Pretransition economies: Strengthening the basics

The economies in the pretransition segment—the **Democratic Republic of the Congo, Ethiopia,**

Mali, and Sierra Leone—are still very poor.

The GDP per capita of just \$353 is one-tenth that of

⁶Alan Gelb, Vijaya Ramachandran, and Manju Kedia Shah, *Africa's Private Sector: What's Wrong with the Business Environment and What to Do About It*, Center for Global Development, Washington, DC, 2009.



If recent trends continue, Africa will play an increasingly important role in the global economy. By 2040, it will be home to one in five of the planet's young people, and the size of its labor force will top China's. Africa has almost 60 percent of the world's uncultivated arable land and a large share of the natural resources. Its consumer-facing sectors are growing two to three times faster than those in the OECD⁷ countries. And the rate of return on foreign investment is higher in Africa than in any other developing region. Global executives and investors cannot afford to ignore this. A strategy for Africa must be part of their long-term planning.

⁷Organisation for Economic Co-operation and Development.

The time for businesses to act on those plans is now. Companies already operating in Africa should consider expanding. For others still on the sidelines, early entry into emerging economies provides opportunities to create markets, establish brands, shape industry structures, influence customer preferences, and establish long-term relationships. Business can help build the Africa of the future. And working together, business, governments, and civil society can confront the continent's many challenges and lift the living standards of its people. ○

The authors wish to acknowledge the contributions of the following colleagues to this article: Martijn Allesie, Charles Atkins, Mutsa Chironga, Norbert Dörr, Reinaldo Fiorini, Michael Kloss, Corrado Ruffini, Sven Smit, Amine Tazi-Riffi, Till Zeino-Mahmalat, and Nadia Terfous.

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