AFREXIMBANK

Contemporary Issues in African Trade and Trade Finance

CIAT

Volume 4 • Number 1 • December 2018

INSIDE

ISSN 2409-3688

Contemporary Issues in African Trade and Trade Finance

CIAT

Volume 4 • Number 1 • December 2018

THE AFRICAN EXPORT-IMPORT BANK

CONTEMPORARY ISSUES IN AFRICAN TRADE AND TRADE FINANCE (CIAT)

ISSN 2409-3688
ISBN 978-92-95097-15-5

HEAD OFFICE
African Export-Import Bank
72(B) El Maahad El Eshteraky Street
Heliopolis, Cairo 11341
P O Box 613 Heliopolis
Cairo 11757, Egypt
Email. info@afreximbank.com
Website: afreximbank.com

The *Contemporary Issues in African Trade and Trade Finance (CIAT)* is introduced by the Bank to provide a platform for the staff of Afreximbank and other individuals knowledgeable in African trade and trade finance to publish articles in the areas of trade, trade finance and economic development in Africa. The CIAT publishes technical and non-technical papers. Edited by a Committee, drawn from both internal and external sources, it also publishes relevant papers presented at conferences or seminars and those presented at the Bank's internally organized Knowledge Sharing Sessions. The journal welcomes editorial comments and responses which will be considered for publication to the extent that space permits.

THE AFRICAN EXPORT-IMPORT BANK

CONTEMPORARY ISSUES IN AFRICAN TRADE AND TRADE FINANCE (CIAT)

Volume 4 • Number 1 • December 2018

FOREWORD

Lapses in corporate governance triggered the US subprime mortgage crisis which morphed into the first global financial crisis of the 21st century. The crisis highlighted the risks associated with poor corporate governance and its implications for global economic growth and trade. The economic and social costs of the crisis were significant, not only for the US—the epicenter of the crisis, but also for the rest of the world, perhaps reflecting the speed of international transmission of risks in a context of deepening financial globalization.

The process of recovery from that global financial crisis was also protracted, reflecting the fact that banking crises tend to be long-lasting. While several steps and measures were taken by global regulatory bodies to strengthen corporate governance with a view to mitigating the risk of future financial crises and contagion, several regulatory and macroprudential reforms were also undertaken at national levels to promote financial soundness. The 2015 Amendment of the Zimbabwean Banking Act and, more recently, measures implemented by the Bank of Ghana highlight the scope of reforms undertaken by these and other African countries to strengthen corporate governance and promote financial soundness for sustainable economic growth.

Recent developments in the global economic and trade environment have also been dominated by the end of the commodity super-cycle. Although Africa is home to most of the fastest-growing economies in the world, the sharp deterioration of commodity terms of trade highlighted the risks of excessive reliance on primary commodities and natural resources for growth and export earnings. Nonetheless, exposure to adverse commodity terms of trade needs not be a death knell for countries in the region. For one, there are a host of policy options which could be used to reduce the incidence of price volatility on balance of payments, including hedging against downside risks. At the same time, the shift towards increased value addition along commodity value chains can accelerate the process of export diversification while at the same time raising prospects for domestic resource mobilization.

At the same time, the world is going through a profound transformation of business and organizational activities and processes. These changes have been triggered by the digital transformation which offers tremendous opportunities for optimization and efficiency gains, as well as innovation and economic transformation. They are already transforming the global trade and payment systems, with the potential to accelerate financial inclusion and intra-African trade. Developing the right model to leverage the opportunities of a mix of digital technologies and their accelerating growth and development impact is the new challenge facing African Sovereign and corporate entities.

Volume 4 Issue 1 of CIAT, looks at the challenges of promoting trade and transformation of African economies in a rapidly changing regulatory and technological environment where digital transformation is set to impact all aspects of economic development. It brings together articles assessing the implications of strengthening corporate governance standards for financial soundness, papers assessing opportunities for industrialization in the digital age, and those exploring options for mitigating the risks associated with increased global volatility in commodity prices, as well as prospects for using commodities for domestic resource mobilization.

Following an overview of new global corporate governance standards adopted after the global financial crisis, the first paper outlines reforms which have been undertaken by governments across the continent to foster a culture of good corporate governance in support of financial soundness and economic growth. It highlights ongoing efforts to strengthen bank supervision, monitoring and control mechanisms and to systematically conduct customer due diligence.
The second paper reviews the challenges of implementing the African Continental Free Trade Area agreement to accelerate the process of industrialization in a digital age. It suggests that the digital economy which is transforming value chains, skill development, production processes and trade could be an accelerator of industrial development, especially if countries draw on industrial leapfrogging to diversify the sources of growth and boost intra-African trade.

The third paper reviews the macroeconomic implications of heightened volatility in agricultural commodity prices for macroeconomic management, focusing on the global dynamics of the wheat market. It shows that large net importers of wheat within the region can mitigate the macroeconomic management challenges associated with global volatility in commodity markets by balancing their growing demand for wheat with price cycles in commodity markets.

The last paper discusses the challenges and implications of over-dependence on commodities by African economies. It draws on successful experiences to show that Africa's abundant natural resources offer great opportunities for the region to sustainably increase domestic resource mobilization to engineer economic transformation and enhance its integration into the global economy.

It is with great pleasure that I recommend these well-articulated papers to readers. The articles are very topical and introduce readers to important issues of interest to those working on African trade and economic development.

Professor Benedict O. Oramah
President and Chairman of the Board of Directors
The African Export-Import Bank

PROMOTING GOOD CORPORATE GOVERNANCE FOR FINANCIAL SOUNDNESS: LESSONS FROM THE ZIMBABWEAN EXPERIENCE [1]

Denys Denya

Abstract: Although corporate governance is not a panacea that ensures growth and economic development, a review of recent experiences in Zimbabwe shows that lapses in the governance of both government and corporate entities have exacerbated the economic crisis triggered by sanctions imposed by the European Union and the United States. This paper reviews the contours of the new Zimbabwean Banking Act and outlines a framework for fostering a culture of good corporate governance, to mitigate the occurrence of systemic risks and to sustain economic growth within the region.

Keywords: Accountability, Corporate Governance, Zimbabwean Banking Act

1. Introduction

Corporate governance issues have attracted much attention since the 1980s, in both the policy and the academic arenas. Interest in the subject increased further after the 2007-08 global financial crisis, which was largely due to lapses in corporate governance in a worldwide economic and financial environment that was dominated by inadequate risk management by executives and boards of directors, abuse of management power, excess executive remuneration, and corporate social and environmental irresponsibility (Sun et al., 2011;

1 This paper is an expanded version of the keynote address that Denys Denya delivered during the 2017 Excellence in Corporate Governance Awards ceremony, organized by the Institute of Chartered Secretaries and Administrators in Zimbabwe.

Hussein, 2011). Arguably, recent interest in the subject—particularly among policy makers—stems from both the devastating effect of the financial crisis on the global economy and the strong link between corporate governance and economic growth (OECD, 2015; Fofack, 2017).

While initially, the promotion of good corporate governance usually was concentrated in advanced economies, recent events in the developing world have highlighted the prohibitively high costs of poor corporate governance on economic growth and welfare. For instance, Bank of Ghana liquidated five distressed banks in early 2018, citing a systemic failure of corporate governance and poor risk management practices that led to a high rate of nonperforming loans and capital deficiencies (Bank of Ghana, 2018).[2] Zimbabwe has endured an economic crisis for the last decade that is caused by sanctions imposed by a few leading economies, as well as the near collapse of its financial system, which was in part triggered by poor corporate governance practices (Shingirai, 2015).[3] Throughout Africa, the collapse of many financial institutions in a number of countries and the rapid emergence of major African corporations in the last two decades have heightened the need for establishing good corporate governance practices in the continent.

Although the literature on this topic points to a strong positive correlation between good corporate governance and financial stability—as well as between good corporate governance and economic growth—mainstreaming the culture of good corporate governance remains a challenge, at both the national and the corporate levels. Creating robust corporate governance policies and frameworks requires a clear understanding of the current situation. This paper attempts to provide a comprehensive overview of the state of corporate governance in Africa, with emphasis on the financial industry. Drawing on recent developments in Zimbabwe, the paper also reviews the challenges to fostering a strong culture of good corporate governance that would drive sustainable economic growth and financial soundness across the region.

Section 2 reviews the state of corporate governance in the current global economic and financial environment of increasingly stringent regulations and enforcement of sanctions. Section 3 discusses the challenges of corporate governance in the financial system, considering recent development in Zimbabwe. Section 4 highlights the contours and a framework for strengthening corporate governance across Africa. Section 5 revisits the link between corporate governance and economic growth, with emphasis on a sequence of steps that must take place. The last section draws conclusions.

2. Corporate Governance: A Global Perspective

In the last two decades, developments in corporate governance include a notable increase in the number of codes and principles, as well as a range of improvements in structures and mechanisms. The core principles of corporate governance—first developed by the Organisation for Economic Co-operation and Development (OECD) in 1999—have been updated several times, including most recently in 2015, after the global financial crisis, which highlighted lapses in the existing framework. The 2015 edition was developed with the goal of creating a legal and regulatory framework for effective and harmonized corporate governance standards across countries, and it is underpinned by six core principles. Specifically, these principles spell out the need to:

- **Ensure an effective corporate governance framework** that promotes transparent and efficient markets, is consistent with the rule of law, and clearly articulates the division of responsibilities among different supervisory, regulatory, and enforcement authorities.

- **Strengthen the rights of shareholders and key ownership functions**, specifically by facilitating the exercise of shareholders' rights. These rights include participating and voting in general shareholder meetings, electing and removing members of the board, sharing in the profits of the corporation,

2 These five local banks and financial institutions include UniBank, Royal Bank, Beige Bank, Sovereign Bank, and Construction Bank.

3 However, the challenges of corporate governance are not specific to these two countries. Several other African countries have gone through similar challenges in the last few decades, including Benin, Cameroon, Côte d'Ivoire, Ghana, Guinea, Kenya, Nigeria, Senegal, Tanzania, and Uganda. For more details on challenges facing the banking sector in Africa, see Daumont et al. (2004) and Fofack (2005).

obtaining relevant and material information on the corporation on a timely and regular basis, conveying and transferring shares, and securing methods of ownership registration.

- **Ensure equitable treatment of shareholders**, including minority and foreign shareholders who should all be able to obtain effective redress for violation of their rights.

- **Recognize the role of shareholders in corporate governance**. This includes recognizing the rights of shareholders established by law or mutual agreements and encouraging active cooperation between corporations and shareholders in creating wealth and ensuring the sustainability of financially sound enterprises.

- **Strengthen disclosure and transparency**, particularly by promoting the adoption of a corporate governance framework that ensures timely and accurate disclosure on all material matters regarding the corporation, including financial performance, ownership, and governance.

- **Entrench the responsibility of the board**, including adopting a corporate governance framework that ensures the board provides strategic guidance and effective monitoring and management, and is accountable to the company and shareholders.

This increasing emphasis on the promotion of good corporate governance seeks to create market confidence and business integrity. For instance, in the financial industry, existing empirical evidence has established a strong and positive correlation between good corporate governance and financial soundness, with the adoption of good corporate governance lowering non-performing asset ratios, increasing the profitability of banks, and lowering the cost of financing (Black et al., 2006). Good corporate governance is particularly important in a context in which an increasing number of companies are relying on equity capital for long-term investment (OECD, 2015; Fofack, 2017).

Even when investment and growth is financed from sources other than capital markets (banks, the government, and family), good corporate governance remains critical—not only for growth and balance sheet expansion—but also for overall welfare. Weak corporate governance systems have the prohibitively high cost of distorting the efficient allocation of resources and undermining opportunities to compete on a level playing field. For these reasons, and because a growing number of multinational companies are involved in cross-border transactions and investments, attempts have been made to globalize corporate governance standards (Fofack, 2017).[4]

At the same time, the adoption of good corporate governance standards promotes growth and sustains the expansion of corporate balance sheets, by fostering a culture of effective risk management and transparency. Likewise, this discipline tends to promote growth by nourishing a culture of independence and accountability at both the managerial and the board levels. In this challenging global environment, the transition from a passive board of directors to an active board of directors, brought about by a generalized culture of accountability, can make a huge difference in the survival and long-term growth of a corporation.

The growth of corporations also depends on incentive systems and management of conflicts involving different stakeholders. In a more inclusive and cooperative environment, a company can promote growth by fostering a culture of fairness and responsibility to incentivize staff. In some cases, corporate managers have gone as far as encouraging staff, and not just management, to own shares in the corporation. However, competing interests is a prevalent feature of corporations, and good corporate governance provides a framework that will systematically balance the overall interest

4 Corporate governance is so critical to growth and economic development that the last few decades have been dominated by increasing attempts to globalize corporate governance standards. Recent steps taken by the Institute of Chartered Secretaries and Administrators (ICSA) to create two qualifying programs, with one devoted to Chartered Governance Professionals, reflect the increasing importance of the subject.

of the company's many stakeholders, including shareholders, management, customers, suppliers, financiers, government, and the local community.

It has become axiomatic that striking the right balance between the interests of all stakeholders is growth-enhancing, and that doing so over time and in a sustainable manner is key for continued economic growth. Therefore, the quality and strength of corporate governance practices that seek to balance these competing interests is essential to the survival of corporations that contribute to aggregate output expansion and economic growth. In a weak corporate governance environment, the failure of large corporations not abiding by best governance standards can be fatal, highly consequential, and even systemic in a few strategic sectors—most notably the financial industry, which is prone to systemic risks.

3. Corporate Governance: The Zimbabwean Financial System

The potential implications of poor corporate governance for systemic risks in the financial sector are illustrated by the challenges that the Zimbabwean banking sector has faced in the last decade. Since the imposition of sanctions starting in 2001, the country's financial sector has endured the collapse of several banks.[5] The Trust Bank, regarded as the face of the local "Wall Street" and one of the largest and most trusted financial institutions in Zimbabwe, went under in 2004. This precipitated the collapse of several other local banks, including Barbican, Boka's Bank, Interfin, Kingdom, Renaissance, and Royal. The cascade of failures set the Zimbabwean economy on a path to sustained economic challenges, which unlike economic crises, tend to be long-lasting.

The cost of this has been significant—not just for the government, acting as the lender of last resort on behalf of all Zimbabwean taxpayers—but also for individuals and small depositors. The failed banks accessed billions of US dollars in liquidity support through the Government Troubled Bank Resolution Act. Under that act, the government attempted to rescue distressed banks

5 The sanctions were first imposed by the US in 2001 and EU followed in 2002. For more details see the following links: https://www.state.gov/r/pa/ei/bgn/5479.htm; and https://www.sanctionsmap.eu/#/main/details/40/?search= percent7B percent22value percent22: percent22 percent22, percent22searchType percent22: percent7B percent7D percent7D.

and financial institutions, including Trust Bank, by bundling three institutions (Trust, Barbican, and Royal) into the Zimbabwean Allied Bank Group.

At the individual level, it has been estimated that depositors in banks under probe have lost more than half a billion U.S. dollars. Even with the existence of the Deposit Protection Corporation of Zimbabwe which covers up to US$1000 per depositor per bank these failures have been net losses to poor households, most of which lost even more confidence in the banking system. At the same time, by reducing the purchasing power of these households, the banking system crisis reduced household consumption and economic growth, thereby creating a vicious cycle for the country. More recently, depositors have been unable to withdraw cash from banks on demand—even though most deposits have been in the form of demand deposits—which has exacerbated the deficit of trust in the Zimbabwean banking system.

While the deep economic crisis triggered by the imposition of sanctions is viewed as largely responsible for the myriad of challenges facing the banking sector in Zimbabwe, poor corporate governance has been singled out as another major factor (Dzingai & Kutuka, 2014; Shingirai, 2015). According to these authors, several lapses in corporate governance may have exacerbated the banking crisis: (a) widespread regulatory forbearance; (b) fraud and insider transactions; (c) lax regulatory oversight that allowed some banks to invest in highly speculative instruments; (d) the use of more lenient accounting rules in financial reporting; (e) increased investment in high-yield and risky instruments; (f) a high concentration of lending that relied on deposits with short maturities to be able to make riskier investments; (g) a lack of transparency and accountability; and (h) dereliction of duty on the part of boards of directors, which in some cases, were overruled by "shadow directors" —powerful shareholders whose personal gains and interests transcended the survival of the banks.[6]

6 The Reserve Bank of Zimbabwe reported that as of December 2013, insider loans in the banking sector totalled approximately U.S. $175 million, and of these, 67 percent were nonperforming loans. In one case, a bank lent 69 percent of its deposits to its own shareholders and related parties (RBZ, 2013).

Of course, lapses in corporate governance are not specific to Zimbabwe or Africa. The deficit of corporate governance has been pervasive in other regions of the world, including in advanced economies, where it took several forms in the run-up to the global financial crisis. Wall Street was the epicentre of this event, which brought the international financial system to a grinding halt after a cascade of high-profile failures that saw the nationalization of U.S.-based financial giants such as Freddie Mac, Fannie Mae, and American International Group (AIG), the distress sale of Bear Stearns to JPMorgan Chase, the collapse of Lehman Brothers, and in the United Kingdom, the effective nationalization of Northern Rock, HBOS and Royal Bank of Scotland.

Comprehensive reviews have attributed the global financial crisis to a worldwide deficit of governance, specifically regulatory weaknesses at the national and international levels, but also to poor corporate governance practices, as manifested in the weak risk-management standards that prevailed in many large financial institutions (United Nations Conference on Trade and Development [UNCTAD], 2010). In these institutions, poorly designed executive compensation packages shifted the incentives systems and led to excessive risk-taking, greatly exposing banks to liquidity risks. These risks were exacerbated by several other failures in the institutions, including inadequate stress-testing and scenario analysis, poor transmission of risk-related information up to the board level, weak board oversight, and a failure to observe the intent of relevant government regulations (UNCTAD, 2010; OECD, 2015).

4. Contours of a New Corporate Governance Framework

The Zimbabwean financial sector has been plagued by poor governance. Over time, the economic and social costs of that institutional failure have been significant, in part reflecting the fact that banks and financial institutions play a major role in the process of economic development, through financial intermediation (Muranda, 2006).[7] Therefore, strengthening and fostering a culture of good corporate governance is increasingly viewed as key for both risk mitigation and economic growth, not just in the financial industry, but also in other types of corporations and in government organizations. This section provides an overview of regulatory reforms to strengthen the governance framework of public and private corporations in Africa.

Although promoting and strengthening the culture of corporate governance reporting and disclosure has been recognized as central to good corporate governance in Zimbabwe, pushing the boundaries of corporate reporting has remained a challenge. But this pattern is not specific to Africa; rather, it is consistent in both developing and developed economies. Progress has been made in other dimensions of reporting, most notably in financial reporting, integrated reporting, corporate responsibility, and narrative reporting. However, attempts to disclose and ultimately stem the rise of executive remuneration in the United States and other leading economies, in a situation of stagnant wages in the middle class and rising wage inequality, have faced a lot of resistance.

In the Zimbabwean context, the deficit of disclosure is perhaps exacerbated by the absence of a common method for disclosing corporate governance issues in annual reports. Even in the absence of such a framework, the culture of good corporate governance should be fostered, especially for companies that

7 The link between corporate governance and economic performance and social stability is well documented in literature. Barth, Caprio, and Levine (2006) show that good corporate governance can reduce the risk of financial crisis, which can have devastating social and economic costs. Enobakhane (2010) also pointed out that good corporate governance could lead to better relationships with all stakeholders, which could lead to benefits such as improved labour relations and environmental protections.

are contemplating drawing on equity investment to sustain the expansion and growth of their balance sheets.

Perhaps the first step should be to revise the 2015 version of the Zimbabwean National Code on Corporate Governance, to provide specific guidance on corporate reporting and disclosure. Even then, it is not guaranteed that all corporate entities will step up and systemically abide by the new code. It is therefore imperative that Financial Regulators insist that banks comply with the code. However, this step will provide the framework for consistency and for monitoring progress toward reporting. Eventually, rewards in the form of access to finance for corporations abiding by the reporting requirements could act as incentives for other companies to follow suit.

Shareholder activism is another area in which Africa has been lagging vis-à-vis trends in the rest of the world. Many African companies have collapsed simply because of the passive nature and behaviour of shareholders who are not exercising their rights to systematically influence boards of directors and management to bring about social changes or shape major investment decisions by management.

The apathy among shareholders in Zimbabwe and most other countries in the region is at odds with developments in the rest of the world, especially in advanced economies, where activist shareholders are increasingly using their power as company owners to examine company financial reports, monitor executive remuneration, enforce good corporate governance, and push for increased sustainability and transparency.

Globally, the number of shareholder challenges has increased by more than 45%, rising from 520 episodes in 2013 to 758 in 2016. Around two-thirds of these challenges were successful, double the rate of just about a decade ago, suggesting that activist shareholders are indeed strengthening the culture of corporate governance. South Africa is one of the few African countries that seems to be in sync with global trends in shareholder activities, with KPMG recently emerging as the latest victim of shareholder activism there. Perhaps this development reflects the fact that more than 50% of the Johannesburg Stock Exchange's market capitalization is owned by foreigners.

In the short term, the culture of shareholder activism can be fostered through the implementation of several measures, including:

- **Education and training of shareholders**. This will help them transition from passive to active shareholders.

- **Strengthening the rights of all shareholders**. For example, the new Companies Act in South Africa, under which minority shareholders with as little as 10% of holdings can call an annual general meeting, has been a key driver of shareholder activism in that country.

- **Strengthening monitoring and accountability of directors**. South Africa's King Codes of corporate governance is entrenching the idea that boards of directors must act in the best interests of their company and that their responsibilities extend to shareholders and other stakeholders.

- **Fostering a culture of transparency**. Putting more information in the hands of shareholders and the public is likely to make board members more accountable and responsible.

Promoting a culture of good corporate governance in the banking sector is particularly important, to mitigate systemic risks and sustain long-term economic growth. This sector has seen important reforms in recent years in Zimbabwe and is one area where local reforms undertaken are in line with changes at the global level, with increasingly stringent regulatory and compliance measures adopted worldwide to combat money laundering and terrorism financing. A 2015 amendment of the Zimbabwean Banking Act to tackle corporate governance deficiencies and money laundering is illustrative. Specifically, the reforms instituted by the Reserve Bank of Zimbabwe aim to:

- tighten bank supervision, monitoring, and control;

- dilute controlling individual or bank-holding shareholder influence on banks;
- prohibit the acquisition of shares of a banking institution or controlling company; and
- limit the voting rights of members of a banking institution or controlling company to no more than 5% of total share capital or voting rights.

Although the cost of these reforms—most notably the ones associated with the conduct of customer due diligence and compliance with Know-Your-Customer (KYC)—have been significant for financial institutions, they are necessary and should be adopted by banks and financial institutions across Africa (Erbenova et al., 2016; Fofack, 2017). It is probably a step in the right direction, in a generalized environment of de-risking in which large multinational banks are either exiting the African financial landscape or withdrawing from correspondent banking relationships, to mitigate the marginal cost of compliance.

The reforms should go even further, especially in a context of increasing complexity of the banking sector, globalization of risk and speed of risk transfers, sanctions, as well as the systemic nature of risks associated with banking and financial crises. Nevertheless, the reformed act alone will not improve governance in the banking sector if it is not backed by concrete steps to ensure enforcement of prudential guidelines and requirements in the Banking Act as amended, in the context of Basel core principles and the emerging IFRS9,[8] and sanctions in case of violations.

Corporate governance is not exclusively a private sector concern, especially in a region where governments continue to account for a sizable share of the economy. In line with most African countries, it is estimated that the private sector in Zimbabwe accounts for 40 percent of the economy. This suggests that promoting good corporate governance exclusively in the Zimbabwean

8 IFRS 9 is an International Financial Reporting Standard promulgated by the International Accounting Standards Board.

private sector is not likely to result in sustainable economic development, if in a best-case scenario, only 40 percent of the economy are targeted. Perhaps the government, which is responsible for regulating banks, cannot be absolved from financial and banking crises when they materialize.

The debate between public and private sector can no longer be approached from an ideological standpoint, as done in the 1980s, during the implementation of structural adjustment programs. Public corporations are performing very well in both advanced and developing market economies. The challenges of weak governance, poor management, and corruption that plague African government entities are not necessarily because these entities are state-owned, but perhaps mostly because of weak corporate governance standards and weak accountability of management and governments in the absence of checks and balances, which has given rise to excessive centralized power.

Hence, perhaps the first step in reforming government entities and promoting the culture of good governance more generally is to make sure that accountability goes together with sanctions that could act as a deterrent. The second step is to make sure that government entities are run and managed as mandate-driven and/or profit-making and not as acceptable loss-making institutions, with management evaluated yearly against agreed performance targets. Private investors could also be invited to the shareholding structure, to forge a public-private partnership, with the goal of strengthening the culture of good corporate governance and emphasizing transparency, independence, and accountability.

5. The Corporate Governance and Economic Development Nexus

Is it really the case that countries must first build good institutions and establish a good and strong corporate governance culture to achieve economic growth and sustainable development? Which comes first in the process of economic development—good governance (address the corporate governance bottleneck first and growth will follow) or economic growth (engineer economic growth and governance will automatically improve over time)?

Empirical evidence points to a complex relationship between corporate governance and economic growth. Growth—even robust growth—has occurred in countries with relatively poor and weak corporate governance. At the same time, a strong and good culture of corporate governance does not necessary guarantee that government and corporate entities will remain on strong growth trajectories. Growth volatility and business cycles are part of the growth equation. More generally, irrespective of stage of economic development, countries that have succeeded in climbing the development ladder have somehow followed a different path. Whether one focuses on countries in Western Europe, in North America, or more recently, in Asia, none had to first establish the best institutions and models of corporate governance to engineer long-term growth and sustainable economic development (Fofack, 2017).

Instead, most countries in those regions with more developed and diversified economies followed a very interesting model: first, harnessing normatively "weak" institutions to kick-start markets and economic development; then, drawing on the power of emerging markets to stimulate strong institutions in the second phase of their development trajectory; and in the third and last phase, drawing on the strength of good institutions to preserve and regulate markets in support of economic growth and sustainable development.

At the same time, complacency can be fatal for corporate and government entities that have managed to establish a strong culture of good corporate governance and good institutions to drive economic growth and expand corporate balance sheets. If there is one lesson learned from the 2007-08 global financial crisis, during which the United States was the epicentre, it is that good corporate governance is neither a panacea for developed economies nor a given proposition. Cases and instances of poor corporate governance are not only found in developing countries at very early stage of structural transformation. Also, once a government or corporate entity is endowed with a culture of good corporate governance and good institutions, then these attributes become permanent features of its development or growth process. In other words, even in the most successful models, people and companies tend to adapt existing institutions to solve problems at hand and along the development path. Under that rather flexible model which has been a driver of success, at times, the modus operandi has been regulation, and at other times and perhaps even within the same country, the emphasis has shifted toward deregulation. Of course, deregulation has compliance-related costs and implications for systemic risks that have affected corporate balance sheets and economic growth, as witnessed during the 2007-08 global financial crisis.

In practice, the relationship between corporate governance and economic development has not been linear or unidirectional, systematically moving from good corporate governance to strong economic growth. While the correlation between good governance and economic growth is positive, the relationship between governance and economic performance is complex. Markets and the economic environment are also shaping the institution of governance and the corporate governance culture in most regions around the world, in both developed and developing countries.

The 2015 amendment of the Zimbabwean Banking Act was indeed a reflection of the changing global and African economic environment. Economic transformation tends to have disruptive effects on corporate and political governance, sometimes giving rise to strong interest groups that can eventually push for more accountable leaders and effective institutions. And, as countries move up the development ladder, more effective institutions become affordable (Acemoglu et al., 2005; Rodrik, 2006). It should not be expected that the relationship between these two important variables—corporate governance and economic development—will follow a different path or distribution in African countries. However, one should be mindful of that complexity in a drive to put African corporate and government entities on a robust growth trajectory.

6. Conclusion

This paper analyses the state of corporate governance in Africa and outlines the contours and a framework to strengthen the culture of corporate governance within the region, considering recent steps to reform the Zimbabwean financial sector. While good corporate governance is a necessary but certainly not a sufficient condition for the expansion of corporate balance sheets and economic development, evidence from this review of the Zimbabwean financial sector suggests that the 2004 collapse of the sector caused by poor corporate governance structures had devastating effects on the Zimbabwean economy. That said, the impact of poor corporate governance was overshadowed by the impact of economic sanctions imposed on the country by the European Union and the United States during the same period. Going forward, like steps taken by other countries in the region, Zimbabwe's Reserve Bank has instituted some financial sector reforms that have already brought stability and confidence to the financial system and that could mitigate the recurrence of systemic risks in the future.

References

Acemoglu, D., Johnson, S., & and Robinson, J.A. (2005). Institutions as the Fundamental Cause of Long-Run Growth. In P. Aghion & S. Durlauf (Eds.), *Handbook of Economic Growth.*

Basel Committee on Banking Supervision (BCBS) (2006, 2010, 2015). *Principles for Enhancing Corporate Governance for Banks*. BIS publications.

Barth, J. R., Caprio, G., Jr., & Levine, R. (2006). *Rethinking Bank Regulation: Till Angels Govern*. New York: Cambridge University Press.

Black, B.S., De Carvalho, A.G. & Gorga, E (2010). *Corporate governance in Brazil.* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1152454

Bank of Ghana. (2018). *Statement on the closure of five banks*. Bank of Ghana.

Cheffins, B. R. (2009). Did corporate governance 'fail' during the 2008 stock market meltdown? The case of the S&P 500. ECGI *Working Paper Series in Law*. Retrieved from http://ssrn.com/abstract=1396126

Daumont, R., Gall, F. L., & Leroux, F. (2004). *Banking in Sub-Saharan Africa: What Went Wrong?* (IMF Working Paper WP/04/55).

Dzingirai, C., & Kutuka, B. (2014). Determinants of Bank Failures in Multiple Currency Regimes In Zimbabwe. *International Journal of Economics and Finance*, 6(8).

Enobakhare, A. (2010). Corporate governance and bank performance in Nigeria (Doctoral dissertation). University of Stellenbosch.

Erbenova, M., Liu, Y., Kyriakos-Saad, N., Lopes-Mejia, A., Gasha, G., Mathia, E., Norat, M., Fernando, F., & Almeida, Y. (2016). *The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action* (IMF Staff Discussion Note). Washington, DC: International Monetary Fund.

Fofack, H. (2017). The Globalization of Corporate Governance and Implications for African Corporates in a Changing Regulatory Landscape. *World Economics* 18(4).

Fofack, H. (2005). *Nonperforming loans in Sub-Saharan Africa: Causal analysis and macroeconomic implications* (World Bank Policy Research Working Paper Series No. 3769). The World Bank.

Hussein, T. (2011). The Role of Corporate Governance in the Events Leading up to the Global Financial Crisis: Analysis of Aggressive Risk-Taking. *Global Journal of Business Research* 5(4).

Muranda, Z. (2006). Financial distress and corporate governance in Zimbabwean banks. *The international journal of business in society* 6(5), 643-654.

OECD (2015). G20/OECD Principles of Corporate Governance (OECD Report to G20 Finance Ministers and Central Bank Governors). Paris: OECD.

Reserve Bank of Zimbabwe. (2013). *Zimbabwe: Monetary Policy Statement*.

Rodrik, D. (2006). Goodbye Washington Consensus, Hello Washington Confusion? *Journal of Economic Literature* 44(4), 973-87.

Shingirai, K. (2015). *The Root Causes of Bank Failures in Zimbabwe Since the Year 2008 to 2015*.

Sun, W., Stewart, J., & Pollard, D. (2011). *Corporate Governance and the Global Financial Crisis: International Perspectives*. Cambridge University Press.

United Nations Conference on Trade and Development. (2010). *Corporate Governance in the Wake of the Financial Crisis: Selected International Views*. New York and Geneva: United Nations.

THE AfCFTA: OPPORTUNITIES FOR INDUSTRIALIZATION IN THE DIGITAL AGE

David Luke and Lily Sommer [1]

Abstract: The African Continental Free Trade Area (AfCFTA) offers a long-awaited platform for accelerating progress on Africa's industrialization agenda. Implementation of the AfCFTA agreement will occur in a new digital age where the Fourth Industrial Revolution is rapidly altering the traditional labor-intensive path to industrialization. In this context, African governments should fast-track AfCFTA implementation before the full impact of these technological changes is felt. To fully harness the industrialization potential of the AfCFTA, African policymakers and businesses will need to adapt to the new digital climate and innovate in this space. This paper discusses how the remaining phases of the AfCFTA can be shaped to ensure that this continental project serves as a tool for digitalization and industrial catch-up in Africa.

Keywords: Africa, digital, policy, skills, trade

1. Introduction

For decades, industrialization has been a core objective of Africa's development agenda. The Action Plan for the Accelerated Industrial Development of Africa (AIDA), adopted at the 2008 African Union Summit on The Industrialization of Africa, is the main framework for the continent's industrialization. Other important initiatives to promote industrialization considered in the past include the Lagos Plan of Action for Economic Development of Africa (1980-2000), the African Alternative Framework to Structural Adjustment Programmes for

1 David Luke is the Coordinator of the African Trade Policy Centre (ATPC) of the United Nations Economic Commission for Africa (ECA). Lily Sommer is a Trade Policy Expert at the ATPC of the ECA.

Socioeconomic Recovery and Transformation (AAF-SAP), developed in 1989, and the New Partnership for African Development (NEPAD), launched in 2001 (Adedeji, 2002; Fofack, 2014).

The continent's emphasis on industrialization reflects the clear benefits it can bring. Manufactured goods, which are much less vulnerable to fluctuating global prices than extractive goods, can provide a more sustainable tax base. They are also more frequently produced by micro, small and medium-sized enterprises (MSMEs), which comprise about 80 percent of all enterprises in Africa. Manufacturing processes are typically labor-intensive and therefore crucial to creating jobs for Africa's expanding youth population. Industrialization is also essential for transforming the agriculture sector, which accounts for about half of Africa's workforce. The development of agro-processing industries is a fundamental requirement for facilitating the release of labor into the more productive activity of manufacturing, where output per worker is estimated to be six times that of agriculture (Newman et al., 2016).

With these potential advances in sight, it is disappointing that Africa has de-industrialized over the past few decades. In 2016, manufacturing contributed just 9.6 percent on average to Africa's GDP, almost a quarter lower than in 1990. Manufacturing exports as a share of Africa's total exports have similarly declined. Africa's exports predominantly consist of primary commodities and raw materials, with fuels alone accounting for over one-third of exports in 2016. However, manufacturing in Africa is on the rise in absolute terms. Manufacturing value-added grew at an average of 3.7 percent in 2016. The value of African manufacturing exports is also increasing. The manufacturing sector now contributes approximately one-fifth to Africa's inward FDI stock (UNCTAD, 2016).

The African Continental Free Trade Area (AfCFTA) provides a long-awaited game changer for the continent. The AfCFTA will create a single African economic space of potentially 55-member states comprising more than 1.2 billion people and with a total GDP of more than US$2.5 trillion. This promises to enable economies of scale, drive competitiveness, and attract significant investment in Africa. The agreement commits members to progressively eliminate tariffs on imports covering 90 percent of tariff lines and to address a range of non-tariff barriers. ECA projects that full liberalization will boost intra-African trade by about 52 percent over the 20 years preceding 2040, with estimated increases highest for industrial products, reflecting the more diversified and industrialized nature of African export markets (ECA, forthcoming).[2]

Implementation of the AfCFTA agreement will take place in a global environment very different than the one that existed at the time of AIDA's adoption. The Fourth Industrial Revolution (IR 4.0) is rapidly evolving and transforming the traditional labor-intensive path to industrialization. While the digital economy is becoming more prevalent across the continent, there remains a substantial digital divide between African countries and the rest of the world. In this context, it is important that African governments fast-track AfCFTA implementation before the full impact of these technological changes is felt. To fully harness the industrialization potential of the AfCFTA, African policymakers and businesses will need to adapt to the new digital climate and innovate in this space.

This article discusses how the remaining phases of the AfCFTA can be shaped to ensure that this continental project serves as a tool for Africa's industrial catch-up in the digital age. Following this introductory section, Section 2 demonstrates the important role that the AfCFTA can play in supporting Africa's industrialization. Section 3 provides an overview of IR 4.0, specifically how it is disrupting the traditional labor-intensive pathway to industrialization. Section 4 identifies the implications of this disruption for African policymakers and businesses and recommends actions to harness the AfCFTA's industrialization potential in the digital age. Section 5 concludes.

2. The AfCFTA: A Game Changer for Africa's Industrialization

On March 21, 2018, in Kigali, Rwanda, 44 AU member states signed the agreement establishing the AfCFTA. This landmark agreement offers significant

2 In 2014, manufactured goods accounted for 41.9 percent of intra-African exports compared to only 14.8 percent of Africa's exports outside the continent (ECA and ODI, 2017).

promise for the continent's industrialization. Although substantial progress has been made to drive integration and industrialization within regional economic communities, enhanced continental cooperation is required to enable the levels of economies of scale, scope, and investment necessary to develop regional value chains and to support truly transformational industrialization. To this end, the AfCFTA was specifically designed to drive industrialization. The agreement:

- Targets an ambitious liberalization agenda for trade in goods;
- Permits the use of anti-dumping, countervailing, and safeguard measures as remedial actions against imports that are causing material injury to a domestic industry;
- Covers trade in goods and services, investment, intellectual property rights, and competition policy; and
- Addresses other key challenges to improving Africa's business environment, including non-tariff barriers, standards harmonization, customs cooperation, and trade facilitation;

The AfCTFA will be implemented alongside its sister initiative, the Boosting Intra-African Trade (BIAT) Action Plan, which provides the overarching framework for addressing challenges to intra-African trade and industrialization under seven clusters: trade policy, trade facilitation, productive capacity, trade-related infrastructure, trade finance, trade information, and factor market integration.

3. The Digital Economy: Altering the Traditional Pathway to Industrialization

The rapidly evolving digital economy is setting a new path for industrialization. IR 4.0 has emerged as a concept to describe the digital transformation of industrial production and distribution. In practice, IR 4.0 will digitalize all elements of industrial activities to achieve a highly flexible, distributed production and services network. Through advanced digital technologies such as artificial intelligence (AI), 3D printing, advanced automation and robotics, big data, and the Internet of things (IoT), a tighter integration of digital and physical elements is anticipated to facilitate machine-to-machine interactions and a mode of operation that provides more efficient production (World Bank Group, 2018). Figure 1 below represents the main shifts in manufacturing opportunities and patterns of specialization enabled by key technological developments characterizing the four industrial revolutions.

Figure 1: Industrial Revolutions and Shifts in Manufacturing Specialization

Industry 1.0 (18th century)
Mechanizaton, steam power, and weaving loom ▸ shift from cottage industry to mechanical production

Industry 2.0 (19th century)
Electrical energy ▸ assembly line and mass production

Industry 3.0 (20th century)
Electronics and ICTs ▸ automated and networked production

Industry 4.0 (21st century - today)
AI, advanced automation and robotics, 3D printing, big data, and IOT ▸ Intelligent, flexible, and distributed production

Source: Authors' adaptation from World Bank Group (2018).

The digital economy is transforming value chains, skills development, production, and trade globally. Although the impact of IR 4.0 may not yet be fully visible in Africa, these changes will have major implications for ongoing efforts to accelerate the process of industrialization in Africa.

On the one hand, digitalization offers new opportunities for trade and industrial leapfrogging. The digital economy can lower barriers to entry and help connect MSMEs with global markets and value chains by providing the supportive services necessary to facilitate their exports, such as simplified payments and logistics. Digital applications are already being leveraged to promote innovation and entrepreneurship, including the empowerment of women as traders, and mobile and digital solutions are helping to fill credit gaps. The digital economy also offers new possibilities for productive job creation for youth, who are typically quicker at adapting to new technologies and developing new digital solutions. Finally, digital trade can serve as a tool for boosting intra-African trade that is more diversified and industrialized than Africa's trade with the rest of the world.[3]

These industrialization gains are, however, not automatic. The digital divide also presents immense challenges for the continent. Due to the concentration of digital technologies in advanced and leading emerging market economies, and the skills-biased nature of digitalization, the main beneficiaries of the digital economy are currently skewed towards these countries. The digital divide risks reducing Africa's ability to resolve its unemployment problem and constrain it to take the traditional low-wage, low-skilled, labor-intensive route to industrialization. There are also concerns that digital trade embodies network effects that can lead to market concentration and anti-competition issues.[4] Moreover, digital trade may induce international companies to further distort their taxable income through transfer pricing, further reducing the already scarce domestic resources available to fund African countries' industrialization.

The digital economy presents tremendous opportunities for improving manufacturing processes, relocating production, and boosting innovation in Africa.

3 A perfect example is MercadoLibre, the largest online marketplace in Latin America, which has helped to foster intra-regional trade by connecting buyers and sellers in this region and providing online payment services for regional businesses that do not have bank accounts.

4 For instance, large e-commerce platforms such as Amazon—which accounts for half of all online expenditure in the United States—collect vast amounts of valuable data on their customers. These data can be used to outcompete smaller rivals which lack access to it.

In the early 1900s, large-scale, dedicated production machinery facilitated low-cost mass production and decreased labor hours per unit. Since tooling tends to be product-specific and expensive, full automation has typically been too costly for all but the most high-volume industries. However, recent digital developments remove the need for tooling entirely. Additive manufacturing equipment such as 3D printers can produce complex parts by printing solid objects from digital design files (UNCTAD, 2017).

As IR 4.0 evolves and manufacturing technologies mature, mass customization, characterized by large-scale production with greater variety, will follow. Productivity gains brought about by automation will reduce the need for labor per unit of production and exert downward pressure on wages for labor to remain competitive. Over the last few decades, many African countries have adopted labor-intensive manufacturing to absorb workers released from subsistence farming and other low-skilled activities and to kick-start new and modern industries, increasingly enhanced by advanced automation.

It should be recognized, however, that while technological advances may remove some routes to traditional manufacturing employment, new jobs are being created in agro-processing and in trade-related sectors such as branding, marketing, logistics, transportation, and distribution. Services now account for over 50 percent of Africa's GDP. The digital economy is offering new ways to add value in this sector and deliver services across national borders.

Rising labor costs in advanced and leading emerging market economies offer opportunities for labor-abundant Africa to diversify into the export of low-value manufactures and services and integrate into global value chains (GVCs). In many industries, decisions on where to locate manufacturing activities still reflect a compromise between time-to-market and production costs. Advances in robotics and 3D printing could provide a way for lead firms to address this compromise through more automated local production. As the cost of automated technologies falls relative to labor in African countries, advanced economies may find it increasingly attractive and cost-efficient to re-shore manufacturing activities closer to the home market. This would also provide the additional benefits of reduced transport costs, lower carbon emissions, and fewer inventory requirements.[5]

Recent estimates for the United States in the period 2010–2016 suggest that for every company that re-shores production, 126 African jobs are lost. Until now, reshoring has occurred only on a small scale, but it has been more than offset by new offshoring activities.[6] Some leading firms such as Adidas, Phillips, Fort, and Caterpillar have, however, begun to re-shore traditionally labor-intensive manufacturing closer to the home market, and incentives to re-shore are expected to increase as the cost of automation falls. This may potentially exclude African countries from participating in GVCs, constraining their options for productive employment, learning and skills development, technology transfer, and industrial upgrading.

Although African countries still have time to adapt to the digital future, they have a window of opportunity to expand production in activities where digital technology innovation and/or installation has been slow. The digital economy offers significant opportunities for MSMEs in Africa to innovate. It offers new options for accessing finance, labor, inputs and production services, customer service, sales channels, and marketing locally and at low cost. Multinational companies typically locate their research and development centers in advanced economies and adapt innovations to developing country contexts. Digital innovation tools such as AI, crowdsourcing, big data analytics, digital design tools, and technology and e-commerce platforms, however, will make local innovation and the tailoring of products and services to local markets easier, quicker, and cheaper. This type of local innovation offers an opportunity for the development of new industries in Africa tailored to the demands of the African market.

5 As an illustrative example, the cost of operating robots and 3D printers in furniture manufacturing in the United States is predicted to be cheaper than paying Kenyan workers in 2033. Thus, low labor costs in Africa may be less of a determinant of competitiveness in the future (ODI, 2018).

6 Between 2010 and 2012, only 2 percent of all German manufacturing companies and only 4 percent of firms in Austria, Denmark, France, Germany, Hungary, Portugal, the Netherlands, Slovenia, Spain, Sweden, and Switzerland re-shored their production. For every company that has re-shored production, more than three companies continue to offshore it (De Backer et al., 2016).

4. Implications for African Policymakers and Businesses

The transformative potential of the digital economy for Africa's industrialization process is significant. It has important implications for African policymakers and businesses driving the AfCFTA. For the project to deliver on its industrialization goal, African economies will need to adapt to the new digital climate and innovate in this space. If the AfCFTA is to fulfill its potential to boost African manufacturing, it must come up with a clear digital strategy to overcome the challenge of market fragmentation and enhance the long-term development of e-commerce enterprises.

Expanding the scope of the AfCFTA Phase II negotiations to explicitly include e-commerce could provide a platform for African governments to establish institutional arrangements for cooperation on the digital economy, and provisions to support digital capacities and industrialization and connect African businesses. Because the digital economy is closely intertwined with the other Phase II issues, it would make sense to negotiate e-commerce concurrently. However, if e-commerce is not included in Phase II of the negotiations, it could be addressed in the negotiations on trade in services, particularly since the development of e-commerce relies on the development of certain service sectors such as computer and related services, communication services, and e-financial services.

The African Union Commission is already taking steps towards a continental approach to e-commerce. The Commission, with the technical support of ECA, organized the first ever African e-commerce conference in Nairobi in July 2018. This conference brought together policymakers, researchers, the private sector, and civil society representatives to discuss the requirements for an African e-commerce strategy. There is a common understanding that an African e-commerce strategy must also encompass issues related to the wider digital economy.

A continental digital strategy would also provide a framework for developing a common African position on e-commerce. As a united regional grouping, African countries will stand on a more even footing when it comes to e-commerce capabilities than when they stand by the full spectrum of WTO members (Macleod, 2018). The AfCFTA offers a platform for coordination and benchmarking on digital trade, including e-commerce, and an opportunity to develop African e-commerce priorities, ascertain the potential benefits and costs of adopting e-commerce rules, and create sufficient policy space for Africa to deliver on its industrialization agenda.

To ensure ownership, effective implementation, and tailoring of a continental digital strategy, African countries would need to establish the necessary and appropriate institutional, legal, and regulatory governance, taxation, and financing structures.[7] The development of national digital strategies and policies should also be a priority. For example, Côte d'Ivoire, with the support of the International Trade Centre, has developed a national e-strategy targeted at harnessing the industrialization opportunities offered by the digital economy. Similarly, Senegal has developed Digital Senegal 2016-2025, which includes plans to update legal frameworks, set up interoperability conditions among electronic financial services platforms, and launch a program to support the creation of e-commerce sites with a focus on local products and e-payments.

Due to the cross-sectoral breadth of the digital economy, which now extends significantly beyond information and communication technology (ICT), horizontal integration and coordination across government and with the private sector is key. One option would be to establish a dedicated department to coordinate the digital industrialization process, housed within a relevant ministry such as trade, industry, or ICT. For example, South Africa recently established the Future Industrial Production Unit at its Department for Trade and Industry. The unit has been tasked to carry out research on the potential impacts of IR 4.0 on existing value chains and the country's employment landscape, and to develop policies, strategies, and programs to address the competitiveness issues of South African manufacturing companies, as well as the gap in technical skills required for advanced manufacturing. Senegal has established a national consultative framework to bring together e-commerce players from the public and private sectors and civil society (Sarr, 2018).

7 In 2017, the share of African economies with laws on e-transactions, consumer protection, privacy and data protection and cybersecurity was only 51.9, 33.3, 38.9 and 50.0 percent, respectively (UNCTAD, 2017b).

Building capacities to take advantage of the opportunities and interventions identified under national, regional, and continental digital strategies will also be key. This should include both infrastructural and skills capacities. There is a need to replace outdated curricula and strengthen the focus of educational institutions on science, technology, engineering, and mathematics subjects. More broadly, African countries can learn from South Africa, which has started to forecast skills needs in priority areas impacted by digitalization. The private sector can play an important role in identifying the types of skills that will be required in the digital age and can collaborate with governments in the delivery of technical and vocational education and training programs. The digital skills most vitally needed are in the areas of data analytics, artificial intelligence, and other intelligent data extraction tools. These skills will be key for African firms to be able to compete in higher value-added industries with larger incumbent rivals, since the economic value of data is realized through the ability to conduct data analysis.

Finally, it is the responsibility of national governments to ensure that national, regional, and continental digital strategies result in inclusive outcomes and do not replace an external digital divide with an internal one. This will require policies that are responsive to the constraints and needs of MSMEs as well as supportive government schemes and innovation funds for start-ups and the scaling of digital firms. Creating linkages between larger, more established firms and smaller businesses can also help to support cross-fertilization and sharing of technologies, skills, and ideas. Opportunities for digital skills development should be accessible to youth, women, and other vulnerable groups.

African countries have begun to develop clear plans to benefit from the AfCFTA Agreement. National implementation strategies will need to identify comparative advantages, areas of specialization, and other niches based on the evolving and anticipated digital environment. For example, it would make sense for countries to prioritize the development of industries that to date have experienced minimal automation and those that are expected to create new jobs to facilitate the application of mechanized technologies. At the same time, policies could be targeted at leveraging local digital technologies and resources, such as mobile technologies, to harness comparative advantages and promote inclusive development.

ECA will support member states in developing national strategies for AfCFTA implementation. The overarching objective of the approach is to inform the crafting of AfCFTA strategies that complement the broader trade policy of each State party and identify key trade opportunities, current constraints, and steps required for each country to take full advantage of national, regional, and global markets in the AfCFTA context. The resulting strategies, organized around the key pillars outlined in Table 1 below, will consider a range of cross-cutting issues, including digital technologies.

Table 1: Key Pillars of the AfCFTA National Implementation Strategy

Pillars		Cross-cutting issues
Situation analysis: production and trade review	- Thorough review of the current production and trade profile for goods and services in the target country. - Deep analysis to understand the country's intra-African and global trade performance in the context of existing policy frameworks.	Gender equality / environmental and climate change / digital technologies
Identification and prioritization of opportunities for value-chain development	- Identification of market opportunities and prioritization of sectors for value addition, trade, and regional value-chain development under the AfCFTA through statistical analysis. - Systematic screening to identify promising export markets. The methodology will include an assessment of economic risks and market size, comparative advantages, trade facilitation measures and costs, and degree of market concentration and specialization.	
Constraints to overcome	- Thorough analysis of constraints, including non-tariff barriers faced by businesses, that undermine competitiveness and inhibit options to access regional and continental markets for priority sectors identified under the AfCFTA.	
Strategic actions to boost identified priority sectors	- Identification of strategic actions required to boost sectors with the greatest potential under the AfCFTA. - These actions may include solutions to overcome identified constraints, approaches to attract and increase sectoral investments, and development of infrastructure quality systems, among others.	

AfCFTA-related risks and mitigation actions	- Identification of potential short- and long-term risks associated with AfCFTA implementation. - Identification of appropriate measures to mitigate the impact of these risks. - These measures may include the identification of actions to address any adverse fiscal impacts resulting from the agreement and the use of trade remedies, safeguards, and other exceptions within the AfCFTA framework.	Gender equality / environmental and climate change / digital technologies
Monitoring and Evaluation (M&E) framework	- Development of an M&E framework to track progress on implementation of the National AfCFTA Implementation Strategy.	
Financing	- Identification of potential sources of funding (domestic and international) to implement the strategy.	

Source: ECA.

The next phase of AfCFTA negotiations, which will focus on investment, competition policy, and intellectual property rights, should address digital technology. Competition in digital markets is more complex than in traditional markets, since the sector typically includes platform-based business models, multi-sided markets, network effects, and significant economies of scale. Digital markets are also characterized by relatively higher rates of investment and innovation, which lead to rapid technological progress and disruptive innovation. African authorities concerned with competitiveness should strengthen their expertise in intellectual property-intensive and high-tech industries. Although the digital economy creates global markets for content and rights holders, it also creates a threat of increased piracy. A framework that protects intellectual property rights will need to be designed to protect African-grown innovations, while also building in sufficient flexibility to facilitate the transfer of digital technologies from outside the continent.

5. Conclusion

Constraints such as inadequate infrastructure, scant productive capacity, and the lack of affordable intermediate inputs have hampered the ability of African economies to industrialize. The AfCFTA is a long-awaited platform for accelerating progress toward delivering on Africa's main agenda for industrialization, AIDA. For the AfCFTA to achieve this goal, African policymakers and businesses will need to adjust their strategies in line with recent digital developments underpinning IR 4.0.

The digital economy is altering production patterns, industrial organization, and GVCs. These changes mean that the traditional labor-intensive pathway to industrialization is no longer applicable in a context of increasingly advanced automation. African countries must explore and develop alternative routes to industrialization by building the relevant skills sets and capacities to actively participate in and benefit from the digital revolution. The AfCFTA implementation phase offers a perfect opportunity for African governments to develop strategies to harness intra-African trade gains through the digitalization-industrialization nexus. Developing a dedicated e-commerce strategy could also be considered in Phase II of the AfCFTA negotiations to accelerate the process of industrialization.

The African continent is at a critical juncture that positions it perfectly to fully take advantage of IR 4.0 and use the digital economy as a tool for industrial leapfrogging. The continent is prioritizing coherent strategies for regional integration, industrialization, and development. Digital technologies, which have a much higher diffusion rate than the manufacturing shifts that characterized previous industrial revolutions, offer tremendous opportunities for economic transformation in Africa. What is required is a fast-adapting system of governance that both tackles the challenges associated with the digital economy and capitalizes on the opportunities it creates.

References

Adedeji, A. (2002). *From the Lagos Plan of Action to the New Partnership for African Development and from the Final Act of Lagos to the Constitutive Act: Whiter Africa?* Keynote Address Prepared for Presentation at the African Forum for Envisioning Africa, Nairobi, Kenya.

De Backer, K., et al. (2016). Reshoring: myth or reality? OECD Science, Technology and Industry Policy Papers No. 27. Paris: OECD Publishing. Available at: http://dx.doi.org/10.1787/5jm56frbm38s-en

United Nations Economic Commission for Africa (ECA) (2018). *African Continental Free Trade Area: towards the finalization of modalities on goods—Toolkit*. Addis Ababa: ECA.

ECA. (forthcoming). *A technical assessment of the AfCFTA modalities*. Addis Ababa: ECA.

ECA and Overseas Development Institute (ODI) (2017). *Transforming African economies through smart trade and industrial policy*. London: African Trade Policy Centre and ODI.

Fofack, H. (2014). *The idea of economic development: views from Africa*. WIDER Working Paper 2014/093. Helsinki: World Institute for Development Economics Research.

Macleod, J. (2018). Using digital trade for development in Africa. *Bridges Africa* 7(2), March 14. International Centre for Trade and Sustainable Development. Available at: https://www.ictsd.org/bridges-news/bridges-africa/news/using-digital-trade-for-development-in-africa

Newman C., et al. (2016). Made in Africa: Learning to compete in industry. Washington, DC: Brookings Institution Press.

ODI. (2018). *Digitalisation and the future of manufacturing in Africa*. London: ODI.

Sarr, A. (2018). Talking e-commerce with Alioune Sarr, Senegal's Trade Minister. *Bridges Africa* 7(2), March 14. International Centre for Trade and Sustainable Development. Available at: https://www.ictsd.org/bridges-news/bridges-africa/news/talking-e-commerce-with-alioune-sarr-senegal%E2%80%99s-trade-minister

United Nations Conference on Trade and Development (UNCTAD). (2016). *World Investment Report 2016—Investor nationality: policy challenges*. Geneva: UNCTAD.

UNCTAD. (2017a). *The 'new' digital economy and development*. UNCTAD Technical Notes on ICT for Development. No.8. October 2017. Geneva: UNCTAD.

UNCTAD. (2017b). Information Economy Report 2017 - *Digitalization, trade and development*. Geneva: UNCTAD.

World Bank Group. (2018). Trouble in the Making? The Future of Manufacturing-led Development. Washington D.C.: World Bank.

Contemporary Issues in African Trade and Trade Finance

CIAT

THE END OF THE WHEAT COMMODITY SUPER-CYCLE AND EGYPT'S BONANZA

Abah Ofon

Abstract: As a net importer of food, the dynamics in the world's market for wheat has been felt on balance of payments and fiscal accounts of most countries across Africa. Egypt, the world's largest wheat importer, has been particularly exposed to price movements. This paper reviews policy options considered by the government of Egypt to balance its growing demand for wheat with price cycles in commodity markets.

Key Words*:* Africa, Commodities, Wheat, Egypt

1. Introduction

The world price for grains fell sharply during the period in the run-up to the 2007/08 global financial crisis. The Standard & Poor's Grains index traded at an average of 335 in 2018, down around 50% from its peak in 2008. In the midst of this generalized decrease in grain prices, wheat prices have gone through one of the sharpest declines, falling by more than 60% from their highs in 2008. The period of high grain prices that preceded the financial crisis came to be known as the world food crisis, in part reflecting the wide-ranging effects of exceptional increases in food prices, which included not only inflationary pressures and macroeconomic instability, but also threats to political and social stability, especially across the developing world (World Bank, 2008).

More than any other region, Africa is highly vulnerable to high food prices, given its dependence on food commodity imports for staple diets. For instance, the continent imports around 65% of its domestic consumption of wheat and around 45% of its domestic consumption of rice (US Department of Agriculture [USDA], 2018). In this context it is not surprising that the substantial price increases preceding the financial crisis was associated with a deterioration in a number of macroeconomic indicators across the region, especially in the most vulnerable import-dependent countries, which witnessed rising inflationary pressures and a deterioration in their fiscal account and balance of payments.

Conversely, the collapse in agricultural commodity prices, associated with the end of the commodity super-cycle, had a positive impact on trade and balance of payments in African countries that are highly dependent on food imports. Lower prices provided financial respite for these countries, and particularly for wheat importers, in a region where wheat consumption has increased rapidly in the last decades and is set to increase even more, because of population growth. This disproportionate increase was largely driven by a few countries, especially Egypt, which is the region's largest importer of wheat, accounting for 6.7% of Africa's total wheat imports[1].

While the fiscal and macroeconomic implications associated with the end of the commodity super-cycle have been broad, affecting both commodity importers and exporters, the focus in Africa has been on the latter. Yet, as net importers of food, some African countries were affected positively by the collapse in commodity prices. This paper reviews the macroeconomic implications of falling agricultural commodity prices for macroeconomic management in Africa, with a focus on Egypt, as one of the world's leading importers of wheat.

After this introduction, section 2 revisits the commodity super-cycle, contrasting its dynamics with the oil and wheat markets; section 3 reviews

1 The era of low food prices also has helped in limiting headline inflation, as energy prices have trended higher, following the recovery in oil prices.

the importance of the dynamics of wheat markets for African economies; and section 4 assesses the implications of that market for macroeconomic management in Egypt. Section 5 concludes.

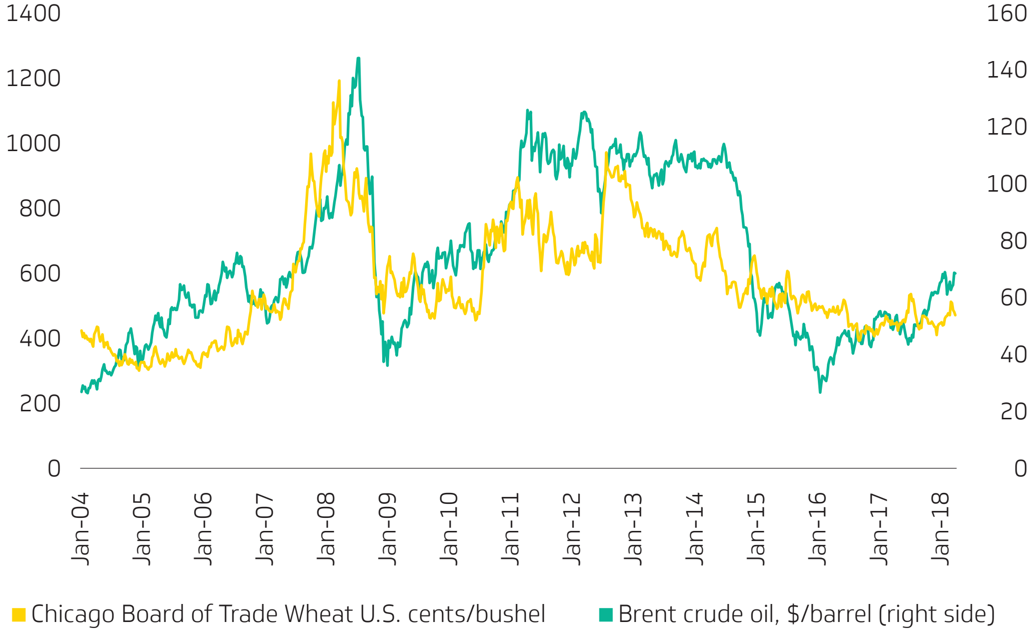
2. The Commodity Supercycle: A Juxtaposition of Crude Oil and Wheat Markets

Much of the contribution to the discussion on the sharp fall in global commodity prices that occurred in 2014—the end of the commodity supercycle—has been dominated by developments in energy markets, and crude oil in particular. In Africa, this is perhaps explained by the dominance of fuel exports in the region's merchandise exports.[2] The sharp decline in oil prices, which began in June 2014 and only troughed in January 2016, had tangible repercussions on the region's merchandise trade receipts, which fell to U.S.$316.3 billion in 2016, from U.S.$517.6 billion in 2013 (International Monetary Fund, 2018).

However, apart from developments in crude oil markets, momentous changes were also underway in other commodity markets. As Africa's crude oil exporters benefitted from the dividends of high oil prices between 2004 and 2008, prices of agricultural commodities for the world's most consumed grains—wheat, rice, and corn—were also inflating, with important consequences for African trade, especially for leading importers of grains, such as Egypt, Algeria, and Nigeria. Between 2004 and 2008, wheat prices rose from a low of U.S. cents 284 per bushel (bu) to peak at U.S. cents 1,280/bu in February 2008 (350%), the highest price on record. In the same period, rough rice prices rose by 295%, corn by more than 300%, and soybeans by about 226%.

2 According to World Bank data, fuel accounted for around 50% on average of the value of merchandise exports in Africa in 2014. The contribution of oil export revenues is even higher in highly oil-dependent countries, such as Nigeria and Angola.

Figure 1. The End of the Commodity Supercycle: Wheat Prices Decline Preceded Oil Prices Decline



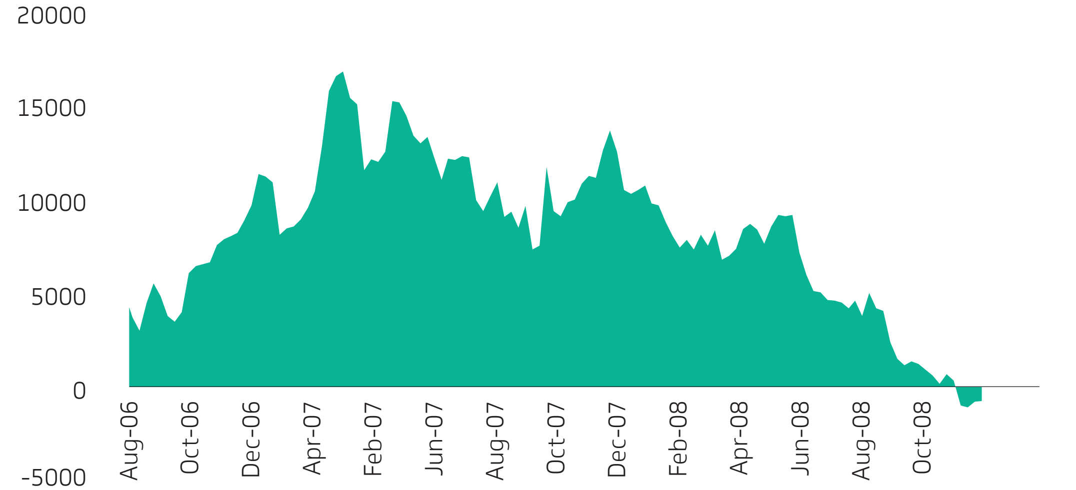
Sources: Bloomberg, Afreximbank Research.

The dramatic increase in the price of wheat was due to both cyclical and structural factors. Cyclically, grain harvests were relatively poor for a number of years prior to the crisis, when adverse weather conditions led to a tightening of stock levels. The situation was exacerbated by an acceleration in demand from the biofuel sector, which boosted demand for agricultural commodities such as corn, which is partially substitutable for wheat in the feed sector. Critically, the rise of wheat prices was also driven by higher energy prices, via the costs of fertilizer and transportation. Moreover, growing interest from investors in commodity markets sustained and subsequently added to upward pressure on asset prices (figure 2).

Policy responses to the increased commodity prices, while relieving local pressures, in some cases added to the lack of exportable supply and drove internationally traded commodity prices even higher. The dynamic of financial markets played an equally important role in the movements of commodity prices. Abundant liquidity and investor interest in commodity markets supported higher commodity prices, while a weaker US dollar contributed to elevating prices for dollar-denominated commodities (Henton, et al., 2009).

Structurally, cheap food prices squeezed producer margins, undermining additional investment in the sector, with the consequence of further depleting global grain stocks. The tipping point came with poor planting weather in the United States, the leading grain exporter at the time, and subsequent protectionist policies imposed by some of the world's other major grain exporters, such as India, Ukraine, and Vietnam, which for security reasons imposed bans on exports to meet domestic demand, reduce inflationary pressures, and limit the risk of social unrest.

Figure 2. Speculative Demand Helped Boost Wheat Prices, Managed Money Contracts in wheat



Sources: Bloomberg, Afreximbank Research.

Since 2009, divergent fundamentals have led to a decoupling of crude oil and agricultural commodity prices. Both markets plummeted in the second half of 2008, partly because of the liquidity crunch associated with the global financial crisis and contraction in global demand. In the aftermath, oil markets recovered and price levels increased into 2014—mainly due to ongoing supply concerns and a subsequent recovery in global demand. In contrast, while wheat prices enjoyed bouts of strength, ongoing expansion in output and benign weather conditions led to a sustained structural downtrend in prices that started in June 2012.[3] Consequently, wheat prices traded at an average of US cents 500/bu, down around 45% from US cents 910/bu in July 2012.

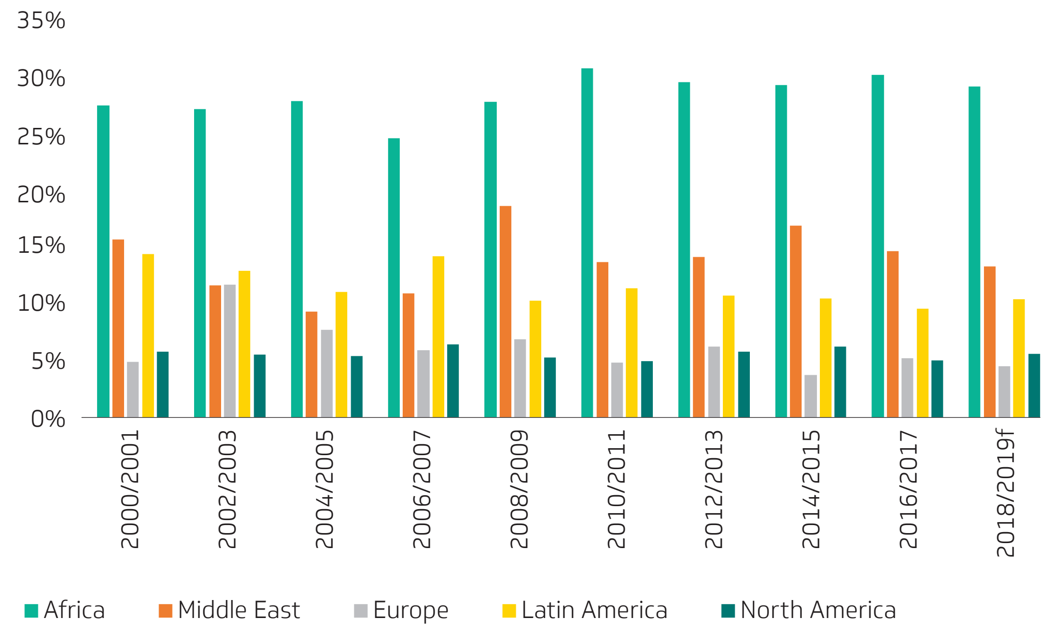
3. The Importance of Global Wheat Markets to Africa

The impact of a sustained decline in global wheat markets beginning in 2012 has been felt across world food markets. Approximately 21% of the world's food supply depends on annual wheat crop harvests. Wheat is a dynamic grain that is typically milled into flour and used to make a wide range of foods, including bread, noodles, pasta, biscuits, cakes, pastries, cereal, and snacks. Global wheat markets are particularly important to Africa, which imported an estimated US$12 billion of wheat during the 2017/18 season.[4] However, despite the importance of wheat to the region's diets, Africa accounts for only 3.3% of global wheat production (25.3 million metric tons) and relies on imports to meet growing domestic demand. The continent is importing more than 30% of global seaborne wheat volumes (53.4 million metric tons) and accounts for 10% of global consumption (76.4 million metric tons) (USDA, 2018). Therefore, the price cyclicity for wheat has a sizeable impact on trade and consumer price inflation in Africa.

3 The wheat supply market has grown tremendously over the last decade, and output is dominated by a few large players, The major players, measured by global output share in 2017, include the European Union with 20%, China (17%), India (13%), Russia (11%), the United States (6%), Canada (4%), and Ukraine (4%). Global demand for wheat has also been increasing consistently, at an average rate of 1.7% per year since 2007.

4 Afreximbank estimation using the active wheat contract on the Chicago Board of Trade.

Figure 3. Regional Share of Global Wheat Imports (%)



Sources: USDA Production, Supply, and Distribution data, 2018; Afreximbank Research.

Africa's wheat import needs have remained high in the last decade, with the region consistently emerging as the leading importer of wheat globally (figure 3). Its sustained demand for and import of wheat is largely driven by Nigeria and Egypt, two of the continent's largest countries, both demographically and economically. Together, these two account for around 10% of total wheat imports by all African countries, representing about US$1.2 billion of wheat imports in the 2017/18 season.[5] The sharp decline in global commodity prices—specifically wheat prices—was therefore a bonanza for these two countries.

The dynamics of world wheat prices have also affected the balance of payments of other African countries, although not to the same degree. These countries include Algeria, Morocco, Ethiopia, Kenya, South Africa, and Sudan, which together account for 38% of total African wheat imports. Although

5 Algeria and Morocco are also large wheat importers and together accounted for around 7% of total wheat imports by all African countries in the 2017/18 season.

these countries, along with Nigeria, have a high potential for expanding wheat imports and consumption, Egypt has emerged as the largest destination for wheat in Africa—and perhaps the largest in the world, ahead of other major economies such as Japan, Korea, and Turkey.

An important consideration in the wheat trade is the level of protein present in different classes of wheat.[6] Higher protein varieties fetch premium prices on the market. The relatively high level of protein in wheat compared with grains such as rice and corn makes it a more versatile grain, and also an important source of food for people (milling wheat) and animals (feed wheat). While the protein content of wheat primarily determines its level of demand, it is also an important consideration for African wheat importers. Additionally, during periods of price volatility, buyers commonly choose between price and protein content. This phenomenon has increasingly come to define trading patterns for some wheat importers in the region, such as Egypt.

4. The Wheat Supercycle and Egypt's Bonanza

Egypt has consistently been a major player in the global wheat market, importing an average of 10-12 million metric tons of wheat every year for the last decade, or an average of 7% of global seaborne volumes. In the decade ending with the 2016/17 season, Egypt imported a total of 85.7 million metric tons of wheat, making it the world's top wheat importer during that period. Recent USDA estimates suggest that Indonesia could overtake Egypt as the largest importer, with 12.5 million metric tons imported for Indonesia compared with 12 million metric tons for Egypt in the 2017/18 season (USDA Production, Supply, and Distribution data, 2018). Still, Egypt is forecast to rank as Africa's top wheat importer this season, ahead of Algeria (7.7 million metric tons), Nigeria (5.2 million metric tons), and Morocco (4.8 million metric tons). These four African countries are among the world's top ten wheat importers.

While global wheat consumption grew by 21% between 2006 and 2017, this was outstripped by increases of 26% in Egypt and 47.8% in Africa during the same period. The reasons for the increase in wheat demand in particular, and food demand in general, are the same for Egypt and the rest of Africa: population growth, rising incomes, and increasing urbanization (FAO, 2017).

There are important differences between the domestic markets of Egypt and of other wheat importers on the continent. Despite being a top wheat importer, Egypt is also a relatively substantial producer of the grain, with 8.1 million metric tons of annual output estimated in the current season (41% of total domestic consumption). This compares with 2.6 million metric tons produced in Algeria (23% of consumption) and very nominal production in Nigeria (around 1% of consumption). However, with a population estimated at 97.7 million and growing at 2.5% annually, and per-capita wheat consumption of 200 kilograms, domestic wheat production is insufficient to meet demand (Egypt's Central Agency for Public Mobilization and Statistics, 2018). Egypt also maintains a stock-to-use ratio of around 20%, compared with around 4% for Nigeria.

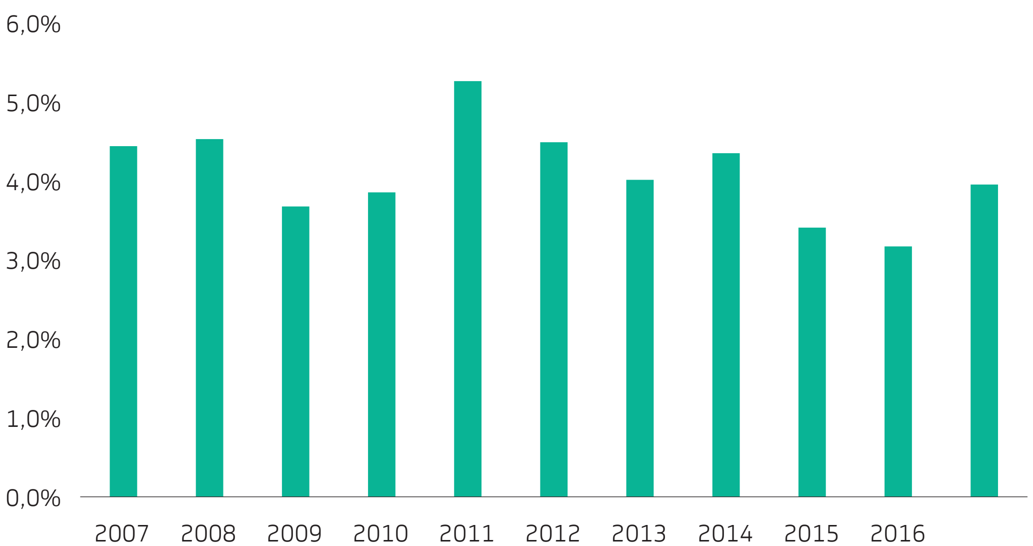
Moreover, the General Authority for Supply Commodities, Egypt's state grain buyer, typically maintains a three-to-four-month supply of grain stocks (including wheat) in the import pipeline, while an additional one-month supply of wheat transits to Egypt. These buffers hedge against unanticipated drawdowns in stocks and mitigate against emergency purchases, explaining to some degree Egypt's robust demand for the grain. Alongside growth in population and income and increasing urbanization, dietary changes are boosting demand for wheat in Egypt, as there has been a shift toward higher value, higher protein foods such as edible oils and meat protein. Since diets rich in meats require feed grains and meals, they demand more cereal than diets based on direct cereal consumption. While demand for food wheat in Egypt is the primary motivation for imports, the demand for feed wheat is evident in the composition of wheat use, with around 6.6% of consumption allocated to feed, higher than the African average of 3.8%.

6 There are six main classes of wheat: (1) hard red winter and (2) hard red spring which contain the highest percentages of protein and are most often used to make breads and rolls. (3) Hard white and (4) soft white contain the lowest percentages of protein and are best suited for baked goods such as cakes, cookies, crackers, pastries, and muffins. (5) Soft red winter is often used in brown crackers and flat breads and (6) durum is mainly used to make pastas and noodles (Crump, 2013).

Impact of Wheat Prices on Egypt's Trade and Fiscal Accounts

Data from the Central Bank of Egypt indicate that at U.S.$2.18 billion, wheat is the second-highest import item by value on Egypt's merchandise trade balance after crude oil imports (U.S.$9.64 billion, Central Bank of Egypt, 2017). This is supported by data from Egypt's Central Agency for Public Mobilization and Statistics, which suggests that in the last decade, wheat imports have accounted for an average of 4% to 5% of the country's import bill, with adverse implications for balance of payments. The value of wheat imports rose above this average in 2011, principally because of a spike in procurement prices and an increase in the volume of imported wheat in the aftermath of the 2007 food crisis (figure 4).

Figure 4. Value of Egypt's Wheat Imports as a Share of Total Imports (%)



Source: Egypt's Central Agency for Public Mobilization and Statistics, 2018.

The implications of sustained imports of wheat are also felt on the country's national accounts, through fiscal outlays. As an important ingredient in the Egyptian diet, used to make *baladi* bread, wheat is highly subsidized by the government and has created a sizeable dent in the fiscal balance (figure 5). The World Bank has previously attributed the rising cost of Egyptian food subsidies to increased international commodity prices, mainly wheat (World Bank, 2010). In this context, the relative decline in the price of wheat, particularly in an environment of rising wheat demand in the last three years, has eased pressure both on Egypt's trade account balance and on public finances.

Figure 5. Egypt's Fiscal Budget Cost of Food Subsidies (% of gross domestic product)

Source: Various World Bank reports.

However, Egypt's savings achieved by favorable world prices for wheat are diminished by sustained increases in its domestic demand, in line with demographic changes.[7] The cost considerations associated with that growing demand has led to changes in the government's subsidy program and also in its bilateral trade relationships. While prices for key agricultural commodities such as wheat have enjoyed a long period of below-trend prices, the sustained

7 According to our estimates, the reduction in wheat prices compared with the average in 2011 has resulted in savings of around U.S.$700 million a year for Egypt since the 2012/13 season, equivalent to around 2% of annual tax revenue.

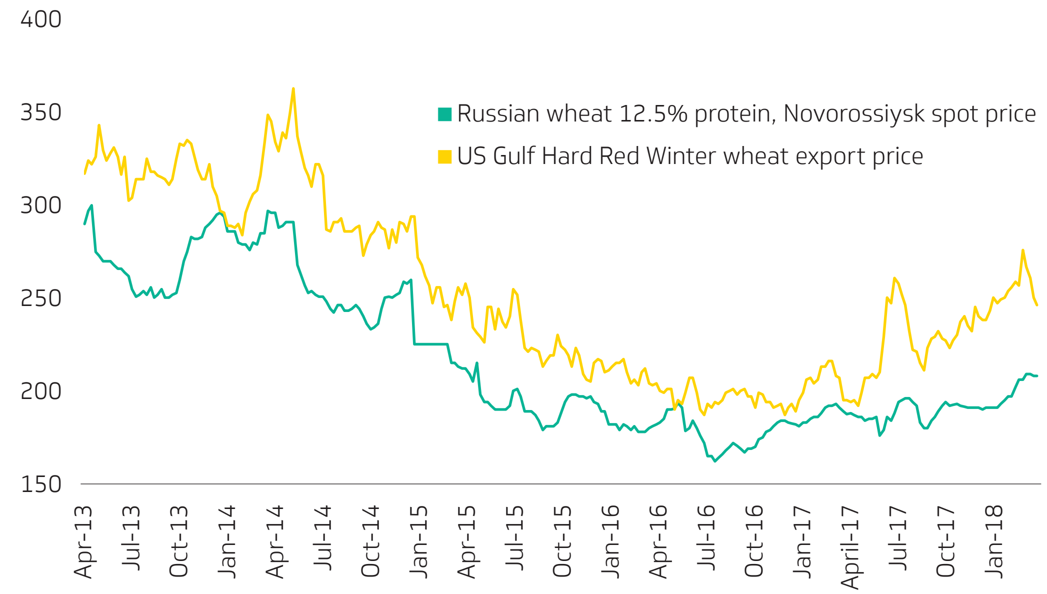
increase in demand coupled with the probability of sporadic supply shocks makes it imperative for the government to consider measures to address its wheat trade deficit.

In response, Egypt is reforming the way wheat is bought, sold, and distributed. In particular, the Egyptian government has implemented reforms to its food subsidy program, eliminating subsidies on flour used by bakeries and replacing these with subsidies on actual bread purchased by consumers. The objectives of this new policy are to remove the incentive for smuggling flour and to reduce waste by eliminating leakages in the subsidy program. The policy seems to be working, and has saved up to 10% on Egypt's 2017/18 food subsidy bill, which is forecast to reach around U.S.$4.7 billion (around 2% of gross domestic product, or 7.3% of the budget).[8] The government also expects that the lower flour consumption will translate directly into reduced imports, with a direct impact on its trade balance and public expenditures.

In addition, Egypt is altering its traditional trade relationships and exploring other trade partners besides the United States, as a way of dealing with pressures on its wheat import bill. In the 2007/08 season, the United States accounted for around 36% of all wheat imports to Egypt, but this dwindled to less than 1% in the 2016/17 season. In that season, more competitively priced Black Sea wheat accounted for around 70% of Egyptian wheat imports. Black Sea varieties are not only more competitively priced but also enjoy freight cost advantages when shipped to Egypt, compared with wheat grown in Europe and the United States (figure 6). In the 2016/17 marketing year, the three largest suppliers to Egypt were Russia (4.47 million metric tons, around 40% of total imports), Romania (1.26 million metric tons, around 12% of the total), and Ukraine (560 thousand metric tons; around 5% of the total). Meanwhile, the average price paid by Egypt's General Authority for Supply Commodities during the last two tenders of marketing year 2016/17, including freight, was roughly U.S.$205 per metric ton (USDA Global Agricultural Information Network, 2017) compared with an estimated US$250 per metric ton for US wheat.

8 More generally, African governments are looking at ways of stemming the continent's dependence on imported wheat through the use of substitutable products. In Nigeria—Africa's third largest wheat importer, which uses around 70% of its wheat for bread—cassava flour must be 5% of locally milled bread flour ingredients. Although the success of this policy has been measured, flour millers are making significant investments in trying other more protein-rich sources, such as sorghum flour.

Figure 6. US vs. Black Sea Wheat Prices (US$/metric ton)



Source: Bloomberg

Egypt's diversification of sources of wheat imports in search of better prices is also shaping the geopolitics of wheat exports. The decline in its imports from the United States has created opportunities for other potential suppliers, and while Russia has been the main beneficiary, other suitors—such as the United Kingdom, which does not currently supply any wheat to Egypt—have been making overtures to Egyptian wheat buyers in the post-Brexit era. According to the head of the United Kingdom's Agricultural and Horticultural Development Board, "Egypt is a significant opportunity for British agriculture, which typically produces a surplus of wheat." The Agricultural and Horticultural Development Board was part of a trade delegation to Egypt in September 2017, to showcase UK flour for baked products.

5. Conclusion

Wheat prices have fallen dramatically from the levels at the height of the world food crisis in 2008 and have remained sluggish since 2013. This decline, along with subsequent drops in energy and metal markets globally, have signalled the end of the commodity super-cycle. For many African wheat importers, the decline in wheat prices provided a welcome boost to their fiscal and trade account balances, given that the grain accounts for a large proportion of staple diets in the region. Egypt, one of the world's largest importers of wheat and the largest in Africa, has realized substantial dollar savings from the globally favorable environment of falling wheat prices in the last decade, particularly given that wheat is a highly subsidized commodity in the country.

But while the fall in global wheat prices has eased pressure on Egypt's national accounts and external trade balance, Egyptian policymakers are implementing fiscal and trade reforms to pre-empt the adverse impact of ongoing robust wheat demand and potentially higher wheat prices. The reforms have included changes in subsidy programs to reduce leakages and a diversification to more competitively priced wheat imports, given a context of a growing population and increasing domestic demand.

References

Alderman, H., Ugo, G., & Ruslan, Y. (2018). *The 1.5 Billion People Question: Food, Vouchers, or Cash Transfers?* Washington, DC: World Bank.

Alexandratos, N., & Bruinsma, J. (2012). *World agriculture towards 2030/2050: the 2012 revision* (ESA Working Paper No. 12-03). Rome: UN Food and Agriculture Organization (FAO).

Central Bank of Egypt. (2006-2017). Annual reports. Retrieved from www.cbe.org.eg/en

Crumbs, T. (2013). *Different types of wheat and what they are used for*. Retrieved from www.dontwastethecrumbs.com

Enghiad, A., Ufer, D., Countryman, A.M., & Thilmany, D.D. (2017). An Overview of Global Wheat Market Fundamentals in an Era of Climate Concerns. *International Journal of Agronomy 2017*(19).

FAO. (2017). *The Future of Food and Agriculture—Trends and Challenges*. Rome: FAO.

Henton, H., Ofon, A., Barrett, A., Lopes, V., Sienart, A., & Chan, R. (2009). The Food Report—The End of Cheap Food. London. Standard Chartered Bank.

International Monetary Fund (IMF). (March 2018). *Direction of Trade Statistics*. Washington, DC: IMF.

U.S. Department of Agriculture. (2018). Production, Supply, and Distribution online database.

U.S. Department of Agriculture Global Agricultural Information Network (USDA GAIN). (April 2016). *Grain and Feed Annual*. Nigeria.

USDA GAIN. (July 2017). *Nuggets*. Egypt.

USDA GAIN. (September 2017). *Grain and Feed Update*. Egypt.

USDA GAIN. (November 2017). *Egypt's New Guidelines for Wheat Imports—CAPQ Directive No. 48*. Egypt.

World Bank. (2010). *Egypt's food subsidies: Benefit incidence and leakages*. Washington, DC: World Bank.

Contemporary Issues in African Trade and Trade Finance

CIAT

COMMODITIES AS SOURCES OF DOMESTIC RESOURCE MOBILIZATION IN AFRICA

Raymond Kouadio Boumbouya

Abstract: In an increasingly challenging global economic environment of declining finance from traditional international development partners, the option to raise more domestic resources has become paramount. Drawing on successful experiences, this paper shows that Africa's abundant natural resources offer tremendous opportunities for the region to sustainably increase domestic resources for endogenous growth.

Keywords: Domestic resource mobilization, natural resources, primary commodities

1. Introduction

Access to financing is essential for economic growth, development, and wealth creation. Over the past decades, the remarkable growth of many African economies has been supported largely by external financing, most notably by inflows of foreign aid in the form of official development assistance and other official flows. That aid, while important, has been characterized by repeated irregularities caused by uncertainty, volatility and other risks associated with the global economic environment. As a result, it has often been difficult for developed countries to honor their commitments, including the ones underpinning the Monterrey Consensus.[1] This volatility of foreign aid has raised

1 From March 18-22, 2002, the United Nations hosted a conference on Financing for Development in Monterrey, Mexico, which gave birth to the "Monterrey Consensus." Key components of the consensus include: (i) identification of mechanisms to ensure availability of financing for attainment of the Millennium Development Goals, (ii) achieving sustainable growth and poverty reduction by mobilizing domestic saving, and (iii) mobilization of domestic and international financial resources for development. Developed countries were urged to contribute towards resolving the development financing challenges facing poor nations by providing them with financial assistance in the form of official development assistance equivalent of 0.7% of their gross national product.

awareness of the importance of mobilizing resources domestically to sustain both structural transformation and economic growth.

Increasing reliance on domestic resource mobilization in Africa is consistent with experiences of other regions of the developing world. The most recent examples derive from the role domestic resource mobilization has played in the transformation of Asian emerging and developing market economies, particularly China and South Korea. During the 1980s-decades of exceptional growth and economic transformation in the two countries' domestic savings averaged 35% of gross domestic product (GDP) in China and 33% in South Korea. However, the relevance of domestic resource mobilization for growth is not specific to developing countries. Domestic financing also played a key role in the economic transformation of advanced economies, including natural resource-rich countries such as Norway. Revenues from oil, for example, have been used not just for consumption, but as a central component in the financing of industries including those related to oil. In Botswana, the process of value addition along the diamond value chains and strong governance system have set the country on a path of fiscal sustainability and long-term economic growth.

Against this backdrop, this paper attempts to make the case that Africa's abundant natural resources offer great opportunities for the region to sustainably increase domestic resources in order to engineer economic development less vulnerable to global volatility. Section 2 discusses the need for the continent to mobilize resources domestically. Section 3 reviews the potential for mobilizing domestic resources from Africa's excess natural resources. Section 4 provides recommendations and best practices for mobilizing domestic resources from resource-rich countries. The last section draws conclusions.

2. The Case for Raising More Domestic Resources in Africa

Historically, external sources have provided the bulk of development financing for Africa, most often through the mechanism of official development assistance. Of the more than US$3.5 trillion in official development assistance

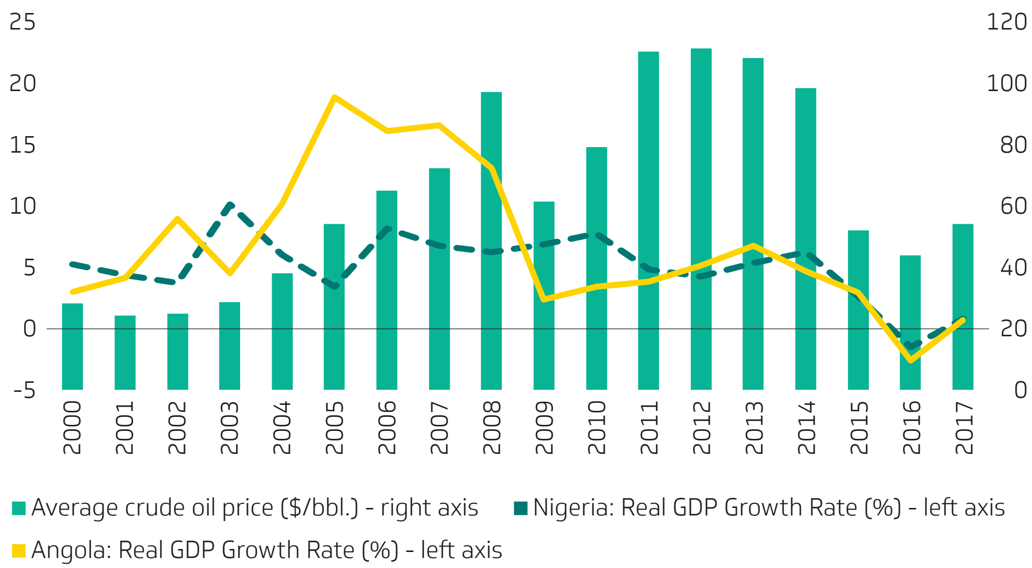
disbursed to developing countries around the globe between 1960 and 2016, African countries received about US$1 trillion, or 28.6%. However, these funds still fall short of the region's needs. For instance, according to the World Bank's 2012 Africa Infrastructure Diagnostics Survey, closing Africa's development infrastructure financing gap alone would require about US$93 billion per year for 10 years. Between 1960 and 2016, the largest flow of official development assistance to the continent was US$56.7 billion in 2013, leaving an infrastructure financing gap of more than US$36.3 billion. Financing gaps in other areas, most notably trade finance and education are also significant.

Not only has official development assistance to Africa been inadequate, it has also been associated with significant volatility. A number of development partners, especially members of the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD), have consistently failed to honor their commitments to provide official development assistance equivalent of 0.7% of their gross national product to low-income countries as stipulated by the Monterrey Consensus. These developments have generally arisen from challenges emanating from the global economic environment which have, in most cases, compelled some countries to resort to rigid economic adjustment measures.

Volatility in commodity prices also continues to create uncertainty on export receipts to sustainably support national growth and the development agenda of African economies. Most recently, this challenge has been illustrated by the end of the commodity super-cycle which led to economic contraction in major natural resources and commodity-dependent economies, resulting in widening current account deficits. Africa's merchandise trade contracted by more than 11.9% in 2016 for the third consecutive year, as a result of a dramatic fall in the continent's total merchandise exports- 27% in 2015 and 13.2% in 2016. These developments also triggered sharp declines in the level of the continent's foreign reserve, which dropped from US$553.66 billion in 2013 to US$396.63 billion in 2016, exacerbating exchange rate volatility. Oil-rich countries Angola and Nigeria were among the hardest hit, with the Nigerian economy slipping into a recession with growth contracting by 1.5% in 2016 and the Angolan economy contracting by 2.6% the same year (see figure).

Beyond building resilience against the volatility of external financing, greater reliance on domestic sources for development financing reduces overdependence on foreign aid, which often imposes stringent conditions not always aligned with a recipient country's development priorities. At the same time, poverty has persisted and even increased in several aid-dependent countries, raising concerns about the efficiency and impact of foreign aid. Increasingly, it is believed that the transition from excessive reliance on external financing to domestic resources in commodity-dependent economies may translate into stronger ownership of public policy and greater development outcomes (Culpeper and Bhushan, 2010).

Figure 1: Trends in Oil Prices and Real GDP Growth



Source: World Bank, World Development Indicators; Commodity prices data, the Pink Sheet, 2018.

3. Potential for Mobilizing Domestic Revenues from Commodities and Natural Resources

For decades, Africa has been referred to as a continent of great potentials, both in terms of growth prospects and wealth. That positive outlook reflected the continent's ample endowments of both human and natural resources. Indeed, the Democratic Republic of Congo alone has an estimated US$24 trillion in untapped mineral deposits, including the world's largest reserve of coltan and significant quantities of the world's cobalt. At the continental level, the region enjoys both significant renewable and non-renewable resources. In the non-renewable resource space, including oil, gas and minerals, the region accounts for about 30% of all global mineral resources. Its proven oil reserves constitute 8% of the world's stock, and those of natural gas represent 7%. Likewise, in the renewable space, the continent's total value-added of fishing and aquaculture sector alone is estimated at US$24 billion. Its potential for the development of renewable energy technologies is also significant, with space for hydropower, wind, solar or geothermal energy.

In addition to driving the process of economic growth and balance sheet expansion in the private sector, natural resources offer tremendous opportunities to boost public revenues and thus drive the development of infrastructure required for structural transformation and cross-border trade.

Tax revenue has increased markedly across Africa since the early 1990s, boosted by favorable commodity terms of trade. Expressed as a percentage of GDP, tax revenue grew from 22% in 1990 to a peak of 28.1% in 2008, before dropping to 24.8% in 2014, following the end of the commodity super-cycle and the collapse of oil prices. In a region where most countries rely on natural resources for export earnings and fiscal revenues, favorable commodity terms of trade were the main driver of domestic revenue mobilization during the period of exceptional boom in commodity prices. For instance, over the long rally in commodity markets and global demand which started at the turn of the new millennium, public revenue from resource taxes jumped from US$45 billion in 2002 to US$230 billion in 2008 – then rose to a new height of US$561.5 billion in 2012 before falling by 22% to $437 billion in 2015 (UNECA, 2018).

Nearly half of natural resource-rich African countries rely on extractive industries for more than a quarter of their government revenue. In a few countries the contribution of extractive industries to government revenues is even higher. These include Nigeria, where oil revenues account for over 75% of government revenue, and the Democratic Republic of Congo, where mineral revenues account for over 80% of total government revenue.

Despite the increase in the contribution of extractive industries to public domestic revenue across Africa, most countries are still operating below their potential and could raise even more revenues from their natural resource endowment. Nigeria, for example, failed to upgrade its oil refining capacity when oil prices were high and instead exported most of its oil in crude form, losing significant revenue potential in the process.

In Zambia, the government reaped only about US$10 million in royalties from the extraction of copper in 2005/2006, even as the price of the metal more than quadrupled. But foreign firms operating in the sector grew their profits by more than fourfold, from US$52.7 million in 2014 to $206.3 million in 2008. In Tanzania, the profits of foreign mining companies have also failed to translate into commensurate government revenue, erupting most recently in a dispute between the government and Acacia Mining—majority owned by Barrick Gold—the biggest gold producer in the world. Although Acacia Mining posted US$444 million in dividends between 2010 and 2015, making significant profit from extractive operations in Tanzania, it paid no corporate income tax to Tanzania over that period (UNECA, 2018).

The poor performance of resource-rich African countries on domestic resource mobilization is highlighted by the Natural Resource Governance Index (NRGI), which assesses the quality of natural resources governance in most national resource-rich countries against benchmarks such as tax and revenue collection. Most African countries achieve a relatively low score. Of all countries surveyed in 2017, only Ghana and Botswana scored above 60 on a scale of zero to 100. Most countries below the satisfactory threshold score have a very weak natural resource governance framework. Either elements necessary to ensure that the country benefits are missing from the National Resource Governance

framework or in the worst-case, countries simply do not have a governance framework to ensure resource extraction benefits society (NRGI, 2017).[2]

The relatively poor fiscal incidence in natural resource-rich African countries is partly the consequence of terms underpinning revenue-sharing agreements. Although fiscal regimes around the world offer governments, on average, about half of the rents generated by mining, and two-thirds or more from petroleum, actual collections have been significantly lower in Africa. For instance, in the Republic of Congo, an oil-rich country, the top corporate tax rate is 30%, compared with 35-47% in the United States. Zambia, a leading copper producer, collects 6% in royalties from mining firms, compared with Indonesia's 15 to 20% and Chile's 30%.

Throughout Africa, multinational companies operating in resource sectors have used loopholes and inefficiencies to take advantage of gaps in legal and regulatory frameworks. These companies are diverting tax revenues by engaging in a set of activities, including transfer pricing, base erosion profit shifting and illicit activities (UNECA, 2018). Over time, these activities have contributed to the erosion of the tax base in many countries with major implications for domestic revenue mobilization. The costs have been significant. Most recent available data show the continent loses about US$50-65 billion a year to illicit financial flows, with oil, precious metals and minerals representing the bulk between 2000 and 2010.

The scale of illicit financial outflows carried out by firms operating in the extractive sector is a clear indication of the tremendous potential for domestic resources mobilization from commodities and natural resources. Closing the resource gap between actual and potential requires improving efficiency and

2 African countries falling under this latter category include: Eritrea, Libya, Sudan, Equatorial Guinea and Democratic Republic of Congo. (For details, see the 2017 Natural Resource Governance Index).

effectiveness in implementation of various instruments used by governments to extract resource rents, including competitive bidding, royalties, explicit rent taxes, and state participation through national resource companies.

4. Recommendations

While challenges, most notably poor governance and the excessive reliance on exports of primary commodities and natural resources as raw materials, have constrained prospects for inward mobilization of domestic revenues in Africa, the success achieved by countries such as Norway and Botswana shows that natural resource endowments can indeed provide the path to domestic resource mobilization. Drawing on emerging best practices, this section outlines a set of recommendations to improve domestic resource mobilization in natural resource-rich African countries.

- Strengthening the administration of taxes to enable governments to effectively draw on existing fiscal instruments, including income tax, profit tax, and royalties is perhaps the first step to improve domestic revenue mobilization. Norway's Petroleum Taxation Act, which enabled the government to impose a 50% profit tax on the petroleum sector and a standard 28% profit tax to all firms, has allowed the government to collect a total profit tax of 78% in the sector.

- Establishing state-owned mining firms and strengthening government ownership rights with foreign companies operating in extractive industries would boost government's leverage to monitor production levels and expatriation of resources by foreign firms. At the same time, increasing government involvement would strengthen control and oversight of production costs and volume. Ultimately such measures would reduce the transfer pricing, profit shifting and illicit capital flows which have constrained the prospects for domestic resource mobilization. For instance, the joint-venture between the government of Botswana and London-based diamond giant De Beers has enabled Botswana to raise more domestic resources by moving up the diamond value chain, domesticating activities such as cutting and polishing (IGF, 2018).

- Establishing a legal and regulatory framework on use of revenues collected from natural resources would compel governments to direct funds to specific sectors to bring about sustainable growth and development. In Norway, the government established the Petroleum Fund (now Pension Fund) as a financial buffer governed by a law which stipulates that the wealth from the oil sector should be invested in foreign assets in order to generate more revenue in hard currency (Holden, 2013). Many Gulf states, including Kuwait and Qatar, have invested a portion of oil revenues in Sovereign wealth funds as financial buffers. This is particularly important for non-renewable resources and would ensure inter-generational transfer of natural resources wealth.

- Establishing an overall strong governance framework in line with global best practice to facilitate the collection and management of revenues from natural resources. For instance, as part of efforts to ensure optimal revenue collection from the oil sector, the government of Norway has implemented the Extractive Industries Transparency Initiative standard to ensure a transparent tax system and revenue collection through improved governance and accountability.

- Strengthening and building the capacity of the tax administration to support revenue collection. This approach is critical to ensure proper tracking and valuation of natural resource production to increase domestic revenue mobilization. One illustrative example is the step taken by the government of Botswana to seek assistance from the African Tax Administration Forum and Tax Inspectors Without Borders to build local tax expertise in transfer pricing and to help better understand the diamond industry.

- Prioritizing value-addition in the resource sector to deepen integration into global value chains and raise more revenue from natural resources. In the cocoa sector, for example, producers of raw cocoa capture less than 10% of total value generated globally along the cocoa value chain, as more resources is generated at higher level of value chains. The distribution of revenues follows a similar path for oil and minerals and could be rebalanced by moving up the natural resource value chains where primary commodities and natural resources are found. The African Export-Import Bank has developed the Africa Cocoa Initiative (AFRICOIN) to (among other things), promote and finance increased processing of cocoa beans into industrial raw materials (cocoa liquor, cocoa powder and cocoa butter) in efforts to deepen the integration of the African cocoa economy into the global cocoa value chain.

5. Conclusion

Although the level of revenue mobilization from natural resource-rich countries in Africa remains very low, even by the standards of most developing countries, recent successes achieved by a growing number of countries both in the developed and developing world suggest that natural resource endowment can increase domestic revenue mobilization and support economic transformation. This paper outlines a set of recommendations to leverage more revenues from natural resources in support of economic transformation in Africa. In particular, it argues for good natural resources governance, and capacity for natural resource management to strengthen ownership and lead the process of value addition for increased revenue retention.

References

Culpeper, R. & Bhushan, A. (2010). Why Enhance Domestic Resource Mobilisation in Africa? *Trade Negotiations Insights, Volume 9*(6).

Holden, S. (2013). Avoiding the Resource Curse: The Case of Norway. *Energy Policy, Volume 63* (C).

IGF. (2017). Case Study. Botswana: Downstream Leakages–Leveraging the Negotiating Position. Geneva: Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development. *International Institute for Sustainable Development*.

NRGI. (2018). "2017 Resource Governance Index." *Natural Resource Governance Institute*, 19 Sept. 2017, resourcegovernance.org/analysis-tools/publications/2017-resource-governance-

UNECA. (2018). "Natural Resource Governance and Domestic Revenue Mobilization for Structural Transformation." *African Governance Report V. United Nations Economic Commission for Africa, UNECA, Addis Ababa, Ethiopia*.

Contemporary
Issues in
African Trade and
Trade Finance

CIAT

Volume 4 • Number 1 • December 2018

ISSN 2409-3688
ISBN 978-92-95097-15-5