Africa in Fact

The Journal of Good Governance Africa

Facets of value

Treading a new path

Manufacturing consent

Profit in paradox

Can Africa make it?

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Africa, industrialise!

Manufacturing contributed less than 10% to sub-Saharan Africa's GDP in 2012, according to the World Bank. Not a single manufactured product is found among the top three exports of any African country, according to the UN Comtrade database. Instead, raw materials and agricultural products head the lists—iron and gold, coal and oil, fish and hides.

Some manufacturing takes place across the continent, but the goods are too expensive or unattractive to find large markets in other countries. This is because most African economies are small and do not warrant the large investment needed to build local manufacturing, which could then be used as a springboard for supplying exports. At the same time, poor or non-existent infrastructure and trade barriers between African countries stand in the way of setting up larger, more viable regional markets.

Another obstacle to industrialisation is poor-quality education. Generally, moving an economy from a predominantly agricultural orientation to a large industrial base and from there to an advanced services economy requires better-educated workers at each stage of development. Sub-par education in many African countries means industrialisation relies on foreign investors, NGOs or international organisations rather than local initiative.

But does this matter? Why should African countries stop doing what they currently do best: digging holes in the ground to extract oil and minerals? After all, the world's appetite for these commodities shows no signs of shrinking.

It does matter because industrialisation is the principal route to developed-nation status. Relying on mining, oil extraction and small-scale agriculture is undesirable for three reasons.

First, it is not sustainable indefinitely. Once it is no longer commercially viable to extract more, there is no fall-back—unless the revenues have been invested into education, infrastructure and economic diversification.

Second, some raw materials offer low profit margins and high volatility in response to world prices. Diverse goods with higher margins offer higher resistance to fluctuations in demand. Greater product variety requires more specialisation and leads to better opportunities to supply niche markets.

Third, African populations are young and growing rapidly. Too many young people are unemployed. Industrialisation offers the best chance for generating jobs and income. It creates a middle class, improves individual lives and increases political stability.

African governments have benefited from high commodities prices over the past decade, but this may not last. To keep growing their economies, they must boost manufacturing and industry by promoting business-friendly policies and investing in education and infrastructure.

John Endres
CEO of Good Governance Africa

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Why manufacturing is key to creating jobs and building diversified economies

Can the continent make it?

by Ronak Gopaldas

Côte d'Ivoire and Ghana produce 53% of the world's cocoa. But the supermarket shelves in Abidjan and Accra, their respective capitals, are stacked with chocolates imported from Switzerland and the UK, countries that do not farm cocoa.

This scenario is repeated throughout the continent in different contexts. For example Nigeria, the world's sixth-largest producer of crude oil, exports more than 80% of its oil but cannot refine enough for local consumption. In 2013 it spent about $6 billion subsidising fuel imports, estimated Finance Minister Ngozi Okonjo-Iweala late last year.

In such apparently baffling scenarios lies one of Africa's greatest challenges—and opportunities. The continent possesses 12% of the world's oil reserves, 40% of its gold and between 80% and 90% of its chromium and platinum, according to a 2013 report from the UN Conference on Trade and Development (UNCTAD). It is also home to 60% of the world's underutilised arable land and has vast timber resources. Yet together, African countries account for just 1% of global manufacturing, according to the report.

This dismal state of affairs creates a cycle of perpetual dependency, leaving African countries reliant on the export of raw products and exposed to exogenous shocks, such as falling European demand. Without strong industries in Africa to add value to raw materials, foreign buyers can dictate and manipulate the prices of these materials to the great disadvantage of Africa's economies and people.

"Industrialisation cannot be considered a luxury, but a necessity for the continent's development," said South Africa's Nkosazana Dlamini-Zuma shortly after she became chair of the African Union in 2013.

This economic transformation can happen by addressing certain priority areas across the continent.

First, African governments, individually and collectively, must develop supportive policy and investment guidelines. Clearly-defined rules and regulations in the legal and tax domains, contract transparency, sound communication, predictable policy environments, and currency and macroeconomic stability are essential to attract long-term investors.

Moreover, incentives—such as tax rebates to multinational companies that provide skills training alongside their commercial investments—will help local economies grow and diversify. In addition, each industrial policy should be tailored to maximise a country's comparative sector-specific advantages.

Mauritius, one of Africa's most prosperous and stable countries, provides important lessons for other African countries.

In 1961 this Indian Ocean island nation was reliant on a single crop, sugar, which was subject to weather and price fluctuations. Few job opportunities and yawning income inequality divided the nation. This led to conflict between the Creole and Indian communities, which clashed often at election time, when the rising fortunes of the latter became most apparent.

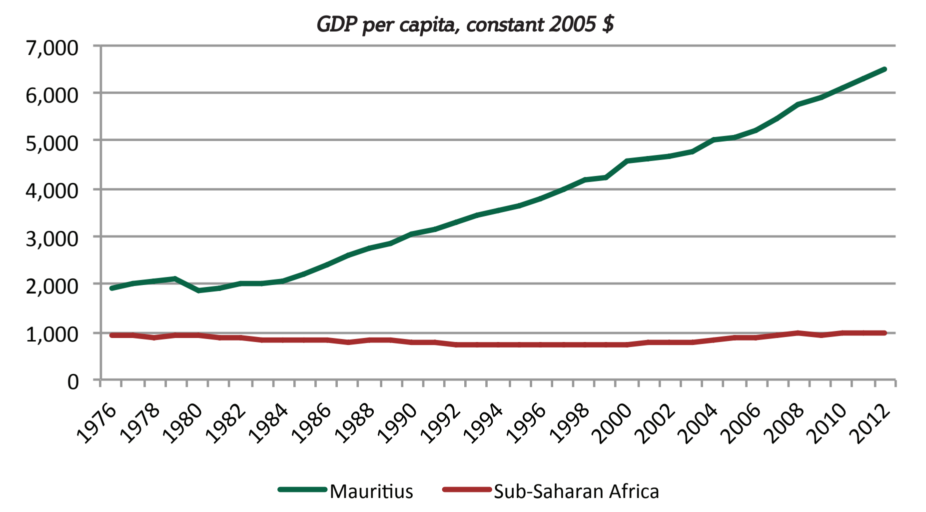
Then from 1979 on the Mauritian government took practical steps to invest in its people. Realising that it was not blessed with a diversity of natural resources, it prioritised education. Schooling became the critical factor in raising skills and smoothing the lingering religious, ethnic and political fractures remaining since independence from Britain in 1968. Strong governance, a sound legal system, low levels of bureaucracy and regulation, and investor-friendly policies reinforced the country's institutions.

Under a series of coalition governments, the nation moved from agriculture to manufacturing. It implemented trade policies that boosted exports. When outside shocks hit—such as loss of trade preferences in 2005, and overwhelming competition from Chinese textiles in the last 15 years—it was able to adapt with business-friendly policies.

From being a mono-economy reliant on sugar, the island nation is now diversified through tourism, textiles, financial services and high-end technology, averaging growth rates in excess of 5% per year for three decades. Its per capita income also rose from $1,920 to $6,496 between 1976 and 2012, according to the World Bank.

While much responsibility lies with African governments, the continent's private sectors must play their part in improving co-ordination between farmers, growers, processors and exporters to increase competitiveness in the value chain and ensure the price, quality and standards that world markets demand.

Mauritius marches ahead



Source: World Bank

Tony Elumelu, chairman of Nigerian-based investment company Heirs Holdings, and Carlos Lopes, the executive secretary of the United Nations Economic Commission for Africa, advocate what they call "Africapitalism", a private sector-led partnership focused on the continent's development. "Private-sector business leaders must also do more to tackle poverty and drive social progress by ensuring that long-term value addition—as well as short-term gain—is built into their business model," they wrote in a joint article for CNN in November 2013.

Next, African countries must pursue beneficial economic strategies with their neighbours. Regional integration would help reduce the regulatory burden facing African industries by harmonising policies and restraining unfavourable domestic programmes. It would boost inter- and intra-African trade and accelerate industrialisation.

The right recipe for regional integration requires countries to concentrate on commodities in which they have a competitive advantage. For example, Benin and Egypt could concentrate on cotton, Togo on cocoa, Zambia on sugar—each country trading in bigger regional markets.

Agriculture, which employs over 65% of the continent's population, according to the World Bank, could become a springboard towards industrialisation. It can provide raw materials for other industries, as well as promote what economists call backward integration, in which a company connects with a supplier further back in the process, such as a food manufacturer merging with a farm.

This is already under way in Nigeria. The diversified BUA Group "will process 10m tonnes of cane to produce 1m tonnes of refined sugar annually", according to Chimaobi Madukwe, the company's chief operating officer.

Sustained investment and improvements in infrastructure are also needed throughout the continent. Countries everywhere, not just in Africa, cannot establish

Behind Africapitalism

Africapitalism looks to the market to improve living conditions by creating jobs and alleviating poverty.

It recognises that while a strong resource sector will boost GDP, this growth rarely translates into gains for broader society. Africa's manufacturing sectors are vastly underdeveloped and control of many businesses on the continent lies in foreign hands.

Businesses and governments need to start long-term thinking about African markets. Educating citizens and building roads help to foster a more stable and inclusive environment.

A growing number of businesses seem to be doing this. Mr Elumelu's Heirs Holdings has a controlling stake in a fruit concentrate processing plant, the first of its kind in Nigeria. Aliko Dangote has backed the development of an oil refinery in Nigeria (see page 19). Recently, the Dangote group announced that it was considering buying oil fields from international energy companies who find it increasingly difficult to navigate the tempestuous political climate in the Niger Delta region. The Dangote group believes that it can provide an approach that is more sensitive to the region's developmental needs. It hopes to reduce restlessness and create a more productive environment with new jobs and infrastructure.

Africapitalism recognises that social stability is needed for the broad business community to flourish, and that the private sector must be involved in creating and sustaining that environment. Africapitalism is a bet that this continent can use the profit-seeking drive to hone better societies.

competitive industrial sectors and promote stronger trade ties if saddled with substandard, damaged or non-existent infrastructure.

"Developing industries require sustained electricity supply, smooth transportation and other very basic infrastructure facilities, which at present are still not enough to ensure operations," said Xue Xiaoming, vice-chairman of the Nigerian Chinese Chamber of Commerce and Industry.

Africa's poor roads, railways and other transport networks, faulty communications, and unreliable and insufficient energy result in high production and transaction costs. It takes 28 days to move a 40-foot container from the port of Shanghai, China to Mombasa, Kenya at a cost of $600, while it takes 40 days for the same container to reach Bujumbura, Burundi, from Mombasa at a cost of $8,000, explained Rosemary Mburu, a consultant at the Institute of Trade Development in Nairobi. "This represents double the time at 13 times the cost," she said.

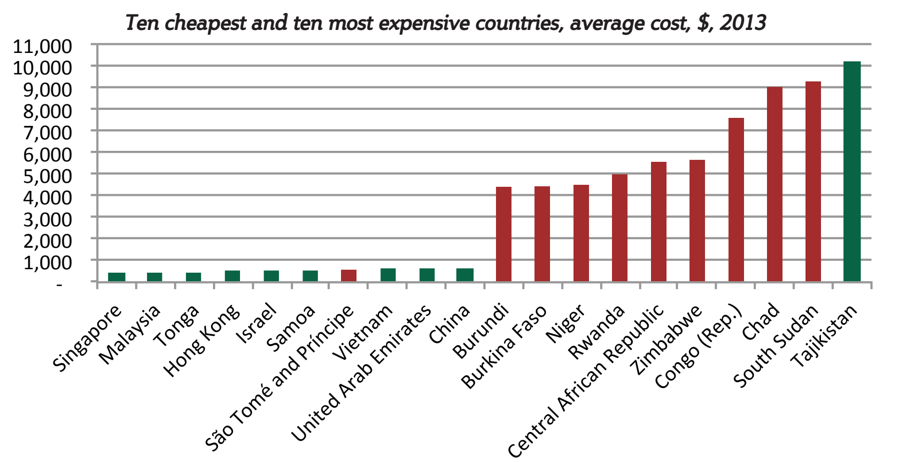
Public-private partnerships (PPPs) should be developed to stimulate massive investments in infrastructure, which could have a multiplier effect on economic growth.

Finally, without education the continent cannot succeed in its drive towards industrialisation. PPPs should be pursued in this arena too, because governments often lack the skills and finances to carry out technical training. Private sector companies would benefit from a skilled and competent workforce. The country would benefit from a stronger economy blessed with less unemployment and higher incomes.

Historically, countries have succeeded by focusing on education in science and technology and promoting research. For example, in the 1960s and 1970s South Korea —like Singapore, Taiwan and Hong Kong—reformed its education system and made elementary and high school compulsory.

From an adult literacy rate of less than 30% in the late 1930s, South Korea now boasts a literacy rate of nearly 100% and has one of the highest levels of education anywhere in the world, according to UNESCO, the UN's education agency. Its highly-

How much to bring in a container?



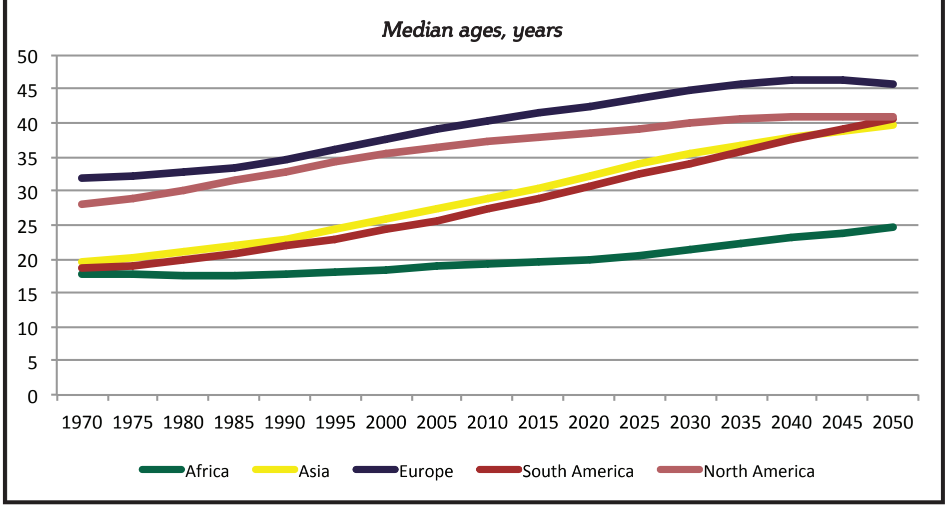
Source: World Bank

skilled population has helped South Korea to become one of the world's foremost exporters of high-tech goods.

Africa, the world's youngest continent, is currently undergoing a powerful demographic transition. Its working-age population, which is currently 54% of the continent's total, will climb to 62% by 2050. In contrast, Europe's 15-64 year-olds will shrink from 63% in 2010 to 58%. During this time, Africa's labour force will surpass China's and will potentially play a huge role in global consumption and production. Unlike other regions, Africa will neither face a shortage in domestic labour nor worry about the economic burden of an increasingly ageing population for most of the 21st century.

This "demographic dividend" can be cashed in to stimulate industrial production. An influx of new workers from rural areas into the cities, if harnessed correctly and complemented with the appropriate educational and institutional structures and reforms, could lead to a major productivity boom. This would then increase savings and investment rates, spike per capita GDP, and prompt skills transfers. Reduced dependency levels would then free up resources for economic development and investment.

Africa Jr.



Source: World Bank

Without effective policies, however, African countries risk high youth unemployment, which may spark rising crime rates, riots and political instability. Rather than stimulating a virtuous cycle of growth, the continent could remain trapped in a vicious circle of violence and poverty.

The continent's youth represent a huge potential comparative advantage and a chance to enjoy sustained catch-up growth. Or they could remain shackled in joblessness and become a major liability.

Africa is ripe for industrialisation. A strong and positive growth trajectory, rapid urbanisation, stable and improving economic and political environments have opened a window of opportunity for Africa to achieve economic transformation.

A giant Chinese shoe manufacturer is lacing up for the long run. Will others follow in its footsteps?

Treading a new path

by Elissa Jobson

At 6.45am the first bus halts outside the main gates of the Eastern Industry Zone. The doors clang open. Bleary-eyed young men and women begin to emerge and brace against the chill morning air. A second, then a third and fourth bus arrives from the nearby dormitories, disgorging more and more workers dressed in the turquoise polo shirts that employees are required to wear on the shop floor at Huajian, one of China's largest footwear manufacturers.

Each member of staff pauses briefly at the factory door and presses an identity tag against the electronic sensor that records their clocking-in time. Minutes later small groups of employees begin to assemble inside and outside the main buildings. Lines are formed, calisthenic drills executed and chants recited before workers march briskly to their stations and begin their duties.

These scenes, played out in thousands of factories across China each day, seem more than a little incongruous here in Dukem, about 40km south of Addis Ababa, Ethiopia's capital. But they could become an increasingly familiar sight if, as the Ethiopian government hopes, Chinese companies move more light manufacturing operations to this booming east African country.

Sole providers

"With the fast growth of its economy, Ethiopia will become a promising land full of trade and investment opportunities," wrote Ethiopian Prime Minister Hailemariam Desalegn at the first Africa-China Commodities, Technology and Service Expo, held in Addis Ababa in December 2013. "More Chinese enterprises will be attracted to Ethiopia with technology and investment, which will achieve win-win cooperation."

Chinese manufacturers, facing rising costs at home, are well aware of Ethiopia's advantages: cheap labour and land leases; low-cost and reliable electricity in Addis Ababa, where most manufacturing is sited (with more to come soon as a series of hydro-electric dams turns the country into an exporter of electricity); easy access to cotton, leather, and other agricultural products; and proximity to key markets in Europe and America.

This explains why Addis Ababa was chosen as the location for this fair, the first of its kind to be held on the continent to showcase Chinese companies and generate business. "We selected Ethiopia as the destination of this expo because we think Ethiopia is a place many Chinese industries would like to relocate to," said Gao Hucheng, China's minister of commerce.

Pairing up for the future

Huajian, which produces shoes for Guess, Tommy Hilfiger, Naturalizer, and other Western brands at its Dukem factory, is keen to take full advantage of the opportunities Ethiopia affords. "We are not coming all the way here just to reduce by 10%-20% our costs," insists Helen Hai, former vice-president of Huajian Group, who is now advising the Ethiopian government on how to attract Chinese investors. "Huajian's aim here is in ten years' time to have a new cluster of shoemaking. We want to build a whole supply chain," she adds.

The company's vision is bold. Huajian began producing shoes in Ethiopia in January 2012 and the company now employs 2,500 people in the country, 90% of whom are local. Huajian currently exports more than $1m worth of shoes from Ethiopia to Europe and the US each month. But within a decade, Huajian hopes Ethiopia will become a global footwear industry hub, providing jobs to more than 100,000 local workers, 30,000 of whom will be directly employed by Huajian.

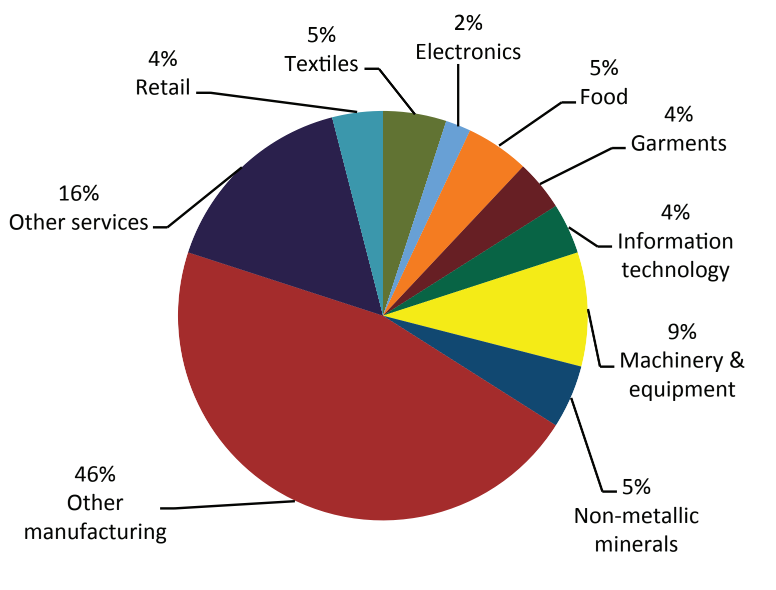
Together with the China-Africa Development Fund, a private-equity facility, Huajian has committed to invest $2 billion over the next ten years to create a "shoe city" that will provide accommodation for as many as 200,000 people, as well as factory space for other footwear, handbags, accessories and components producers.

Ms Hai is convinced Ethiopia will become "the future manufacturing floor of the world". She believes it should follow China's path and begin with labour-intensive industries such as footwear and garment production. "The labour cost in shoemaking in China is about 22% of the overall cost portfolio," she explains. "In China today the cost of each labourer is $500 [a month]. In Ethiopia it is only $50. So the question comes down to the efficiency." If one Ethiopian worker can produce the same number of shoes as one Chinese worker then labour costs could be reduced from 22% to 2.7% of the new total cost.

People argue that African efficiency is low, Ms Hai says, but she maintains that with one year's training Ethiopian workers could achieve "70% of the efficiency" of workers in China.

The profit motive for relocation to Ethiopia is clear. But other factors—excise breaks, tax holidays and cheap land rental offered to investors in certain preferred sectors—make Ethiopia attractive too, Ms Hai claims. For example, Ethiopia is eligible for schemes like the US's African Growth and Opportunity Act (AGOA) and the EU's Everything but Arms (EBA) treaty, which allows exporters from many African countries duty- and quota-free access to America and Europe.

Getting down to business



Source: World Bank
Manufacturing and services sub-sectors of Chinese firms in Ethiopia, excluding construction companies

What is in it for Ethiopia? While the Chinese are taking advantage of Ethiopia's cheap labour, "they bring technology, know-how and training", Ms Hai says. "This will help the country create jobs and bring exports. That is truly the root of industrialisation."

Grand plans like Huajian's, however, are few and far between. Annual levels of Chinese investment in Ethiopia are low, totalling about $200m in 2013, according to the Chinese Chamber of Commerce in Addis Ababa. This marks a substantial increase from virtually nothing in 2004 and $58.5m in 2010. But just $50m of the current investments are in manufacturing, mainly in small and medium enterprises producing steel, cement, glass, PVC, paper, furniture, mattresses, blankets, shoes and other products. Instead, Chinese economic activity in Ethiopia tends to be focused on major infrastructure programmes—roads, railways, telecommunications and electricity transmission—which the Ethiopian government pays for with financial backing from Chinese institutions.

"This is substantial activity, at least in terms of the value of these projects," explains Jan Mikkelsen, IMF resident representative in Ethiopia. Last December's China-Africa Expo reflected this pattern with few of the more than 130 Chinese companies exhibiting looking to open factories in Ethiopia or elsewhere on the continent. Instead, many, like China Machinery Engineering Corporation (CMEC), with their large, prominent stand, were hoping to secure lucrative government contracts.

Unlike many Western countries, China has a policy of non-interference in domestic affairs, which has been appealing to African countries. Ethiopia's adherence to China's developmental state model shows that the two countries share a strong affinity.

"Ethiopia is a very big potential market," says Jin Chunsheng, CMEC vice president. "There is the five year [Growth and] Transformation Plan and we expect to see a lot of power and infrastructure business which is related to the work of our company." CMEC is currently negotiating to build fertiliser plants with Metals and Engineering Corporation, a major state-owned Ethiopian enterprise, Mr Jin adds.

Although manufacturing in Ethiopia is beginning to rise, it accounted for only 12% of GDP in 2012-13, compared to 43% for agriculture and 45% for services, according to government figures. The sector's annual growth, however, was 18.5%, as opposed to 7.1% and 9.9% respectively for agriculture and services.

Yangfan Motors, a subsidiary of Chinese automobile manufacturer Lifan, was one of a small number of exhibitors currently operating in Ethiopia. The company opened a car assembly plant in Addis Ababa in 2009. "We chose Ethiopia because it is secure and stable," says Liu Jiang, Yangfan's general manager. "Furthermore the two governments [Ethiopia's and China's] have a good relationship and we think that this is a very important point too."

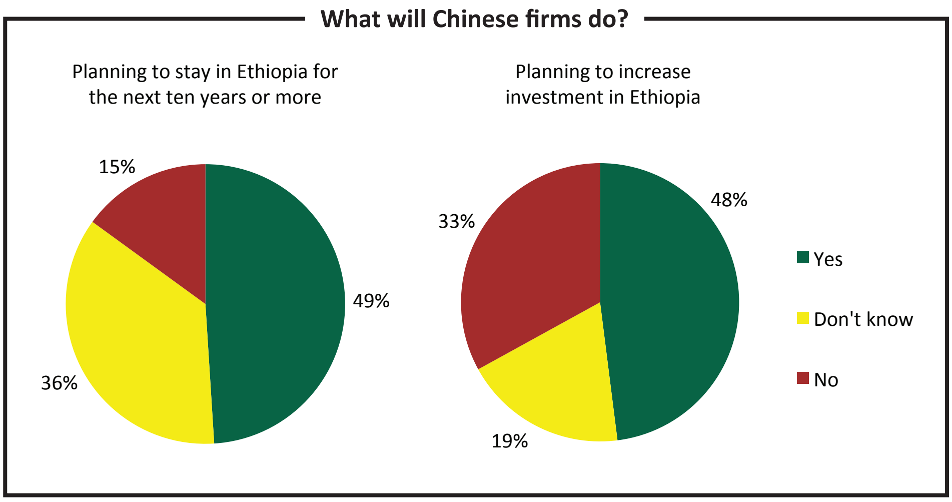
Unlike many Western countries, China has a policy of non-interference in domestic affairs, which has been appealing to African countries. Ethiopia's adherence to China's developmental state model shows that the two countries share a strong affinity.

Not surprisingly, business has been difficult for Yangfan. More than 83% of Ethiopia's population live off subsistence farming in rural areas, according to the World Bank, and 90% of all car sales are used models. The company currently manufactures around 3,000 vehicles annually but only manages to sell one-third to the local market. Lifan had hoped to use its Ethiopian base as a regional hub, but so far has been unable to distribute abroad because Ethiopia is a landlocked country with high taxes and transport costs, Mr Liu says. "To transport one container from China to Ethiopia is almost triple the cost of sending a container from China to Brazil," Mr Liu adds.

A container from Shanghai, China, travels 12,400km to the port of Djibouti, at a cost of about $4,000, and is then transported overland 865km to Addis Ababa, for another $4,000, Ms Hai says.

A 2012 World Bank study on Chinese foreign direct investment showed that investors cited customs and trade regulations and tax administration as major constraints on their business. An underdeveloped financial sector and a dysfunctional foreign exchange market are other business impediments, Mr Mikkelsen says. In the bank's 2014 "Doing Business" report, Ethiopia slipped down one place to 125th and dropped from 162nd to 166th in terms of ease of starting a business.

Companies seeking short-term profits may not take the risk or feel that the inconveniences are worth staying the distance, says Lars Moller, lead economist at the World Bank's Addis Ababa office.



Source: World Bank

Yangfan, however, is committed to the long haul, Mr Liu says. Later this year, the company will move to a bigger factory in the same industrial complex as Huajian. Government environmental policies will begin to favour newer, less-polluting vehicles and the ongoing road and railway construction will significantly reduce transportation costs, he adds. "In 2014 we are planning to bring two new models, one of which is especially designed for the Ethiopian market."

Ethiopia clearly has a long way to go on its path to an industrial economy that offers jobs to its people and sensible opportunities to foreign and regional investors. Much shoe leather will be worn out before that destination is reached. Ventures such as Huajian's and Yangfan's offer tentative hope. GGA

Botswana's diamonds

The World Bank says that adding value to precious stones is a dead-end street

Facets of value

by Roman Grynberg

Should African countries be condemned to digging holes in the ground and exporting unprocessed oil, gold, iron and other natural resources?

For the better part of a decade, the international community has advised African countries not to add value to their raw minerals, a process better known as beneficiation. But most African policymakers have refused to accept that this development model is sustainable.

The World Bank has put considerable resources and research into trying to convince Botswana not to beneficiate its diamonds, Zambia its copper or South Africa its gold, chromium, platinum and other minerals. Along with the OECD, an intergovernmental think-tank based in Paris, and other opponents of beneficiation in Africa, the World Bank offers two main alternatives.

Their first and favoured proposal is to forego forging forward linkages with the mining sector through the beneficiation of unprocessed minerals. Instead, African countries should emulate Australia and Canada, mining-intensive economies that have developed strong backward linkages with engineering, services and higher education.

Backward linkages are channels through which a company or an entire sector connects with its suppliers and creates economic interdependence. Forward linkages, by contrast, are distribution channels that connect a producer with its customers.

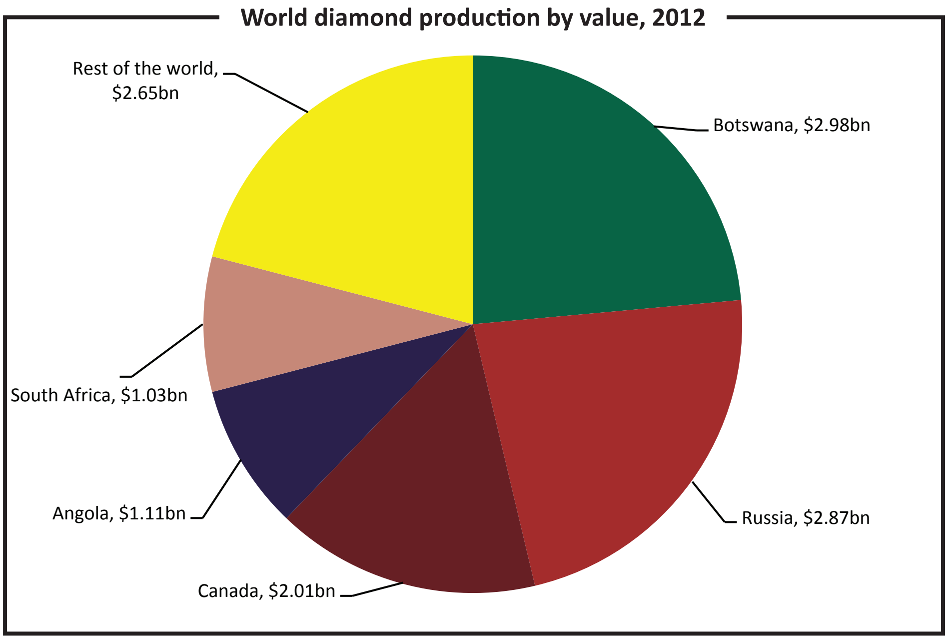
The backward-linkages alternative has one serious flaw, however. Most smaller African countries do not possess the resources or the economies of scale to cultivate the networks found in those mining titans.

The second alternative is that countries should diversify their economic base through sovereign wealth funds and earn high returns on their investments.

Neither forward nor backward linkages will work, according to this argument. Small African economies will never compete with mining giants when it comes to developing backward linkages, nor with processing behemoths, such as China, when it comes to beneficiation. Globalisation has eliminated any possibility of these mineral-based economies undergoing a traditional transformation.

Faced with these constraints, where do most African countries go? Unfortunately the answer is neither backwards nor forwards nor outwards, but downwards. African countries are currently making ever-deeper holes in the ground, with the extracted minerals and their monetary fruits being used more or less prudently depending on a country's internal political management.

Botswana, the world's largest producer of diamonds by value, has in the past several years moved on two fronts to reap the precious stone's economic benefits. In a 2011 marketing agreement, Botswana's government and De Beers—the world's leading diamond company, of which Botswana is 15% owner—agreed on two ways to add value to the gems.



Source: Kimberley Process Certification Scheme

The first was for De Beers to move its supply and sale of diamonds from its offices in London to Gaborone, Botswana's capital, a transfer that was completed in December 2013. As a result, about 160 positions have relocated to Botswana, industry insiders estimate. Half of the new jobs have gone to locals.

The second part of the 2011 agreement called for Botswana to supply some $500m worth of rough diamonds a year to local cutters and polishers, with the explicitly written expectation that this would grow to some $800m by 2014.

About 3,400 people worked in Botswana's cutting and polishing industry in 2012, according to President Ian Khama's state-of-the-nation address last year. These workers polished some 257,000 carats, according to Botswana's Central Statistics Office, or a little more than 1% of Botswana's estimated 2012 production of 23m carats, according to the Kimberley Process website.

Still, the value of the exports was some $600m, making diamond cutting by far the country's largest industrial sector. For a small country of 2m people, such a new and non-traditional export can be considered an overall success. Challenging questions remain, though. The first concerns the sector's sustainability.

Botswana's cutting and polishing industry exists in large measure because the government has permitted the import of high-value rough diamonds to supplement local supply. With new, capital-intensive cutting and processing techniques, Botswana can now cut and polish higher-value diamonds despite its high production costs.

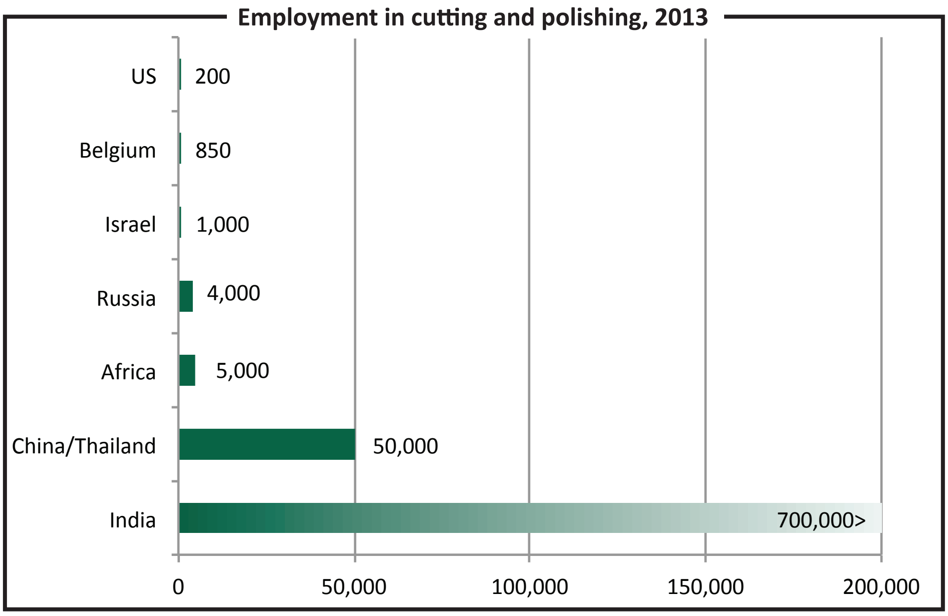
India, the world leader in the cutting and polishing of diamonds, uses traditional, labour-intensive techniques. If Botswana used these methods, its industry would collapse. The country cannot compete with India, where pay levels are lower and productivity is higher. Although wage levels in the diamond industry are notoriously difficult to ascertain the world over, industry insiders estimate that in Botswana a cutter earns between $300 and $400 per month, significantly more than cutters in Surat and Mumbai.

But is Botswana's diamond-cutting industry viable in the longer term? The answer may lie in looking at the history of India's cutting and polishing industry.

Until the early 1970s most diamonds were cut in Amsterdam, Antwerp, New York and Tel Aviv. Even in the 16th century, when India was the world's only source of diamonds, most of its diamonds were cut in Europe to European tastes.

Soon after India's independence from Britain in 1947, European cutters began training Indians in modern cutting and polishing techniques. In the 1970s India, much as Japan and Korea did in manufacturing, kick-started its cutting and polishing industry by emphasising that its labour costs were lower than those in Europe or Israel. In addition, the subcontinent developed expertise in cutting poor-quality diamonds traditionally rejected because they were too costly to cut.

It was not long before the comparative advantage India gained from low wages extended to higher-value diamonds. It is now globally dominant. In 2012 India processed 80-90% of the world's diamonds, according to a 2013 report from India's Ministry of Commerce and Industry. Diamonds were responsible for 14% of total exports, or $43 billion in the 2011-12 financial year, according to the report. Diamond production is one of India's leading growth sectors, providing an estimated 1m jobs in

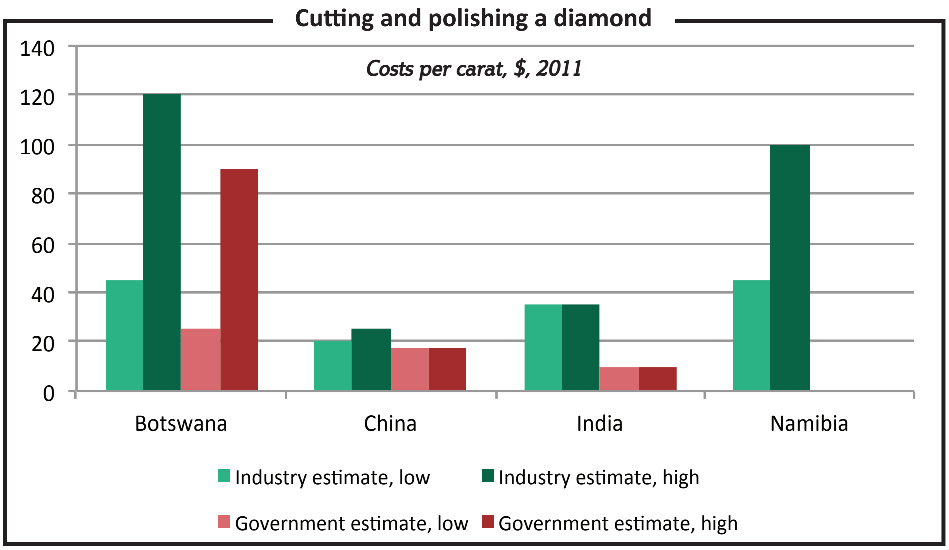


Source: Bain Global Diamond Report 2013

Surat and Mumbai alone.

The lessons Botswana can learn from this are complex. While India had diamond mines and was able to develop a cutting industry, this process evolved over centuries. By the time India became a dominant player in diamond cutting, it had long ceased to have a significant mining industry.

India's historical entry point in adding value to diamonds—low-cost workers and materials—is not commercially viable in Botswana.



Source: L. Mbayi, 2011

But a crucial lesson, often forgotten, is that comparative advantage can be acquired. If Botswana's government works closely with the private sector it can locate productivity bottlenecks and target cost-raising inefficiencies, a move which it needs to make urgently.

Nevertheless, even if Botswana does not succeed in competing with India, this still does not mean the World Bank's and the OECD's blanket criticism of beneficiation is justified.

Botswana is likely to continue mining diamonds into the 2040s. The country can use the next two decades to refine its cutting and polishing industry through training and developing talent, entrepreneurial know-how and linkages in both directions of the value chain. When diamonds run out, these skills and capacities can be transferred to other sectors.

However, without concrete policies to capitalise on the benefits the industry could create, beneficiation in Botswana will indeed fail. The government needs to assist local entrepreneurs to develop connections with suppliers, and assist skilled workers without imposing ever-higher costs on the industry.

Will beneficiation succeed in Botswana? The answer is a conclusive maybe. Its realisation lies in the hands of policymakers. GGA

Nigeria's $9 billion oil refinery

Africa's largest producer of crude oil is the continent's second-biggest importer of petroleum

Profit in paradox

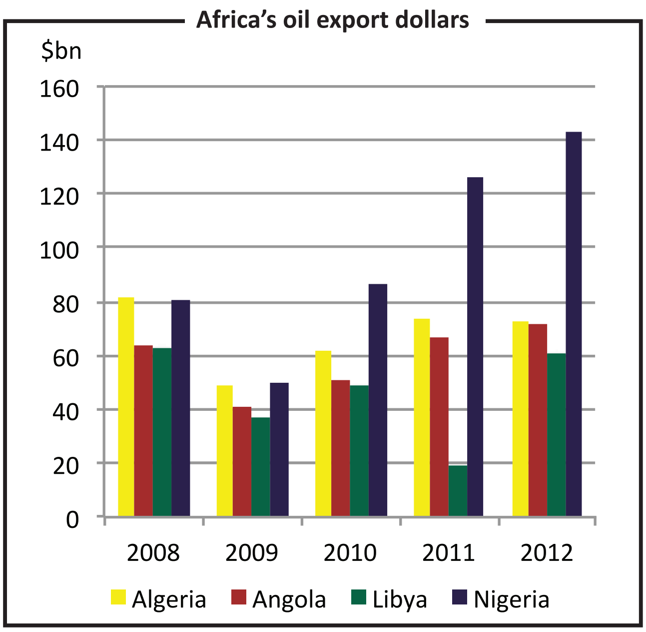
by Simon Allison

Nigeria's oil paradox is one familiar to many African countries, where an abundance of resources often swamps the ability to use these natural gifts effectively. Nations may have massive supplies of oil, iron or gold, but lack the infrastructure and industrial know-how to process or refine these resources. Out go the raw and rough commodities, loaded onto tankers, trucks and planes and exported to far-away shores; in come the refined and finished products—petrol, automobiles and jewellery—imported at a hefty premium.

In Nigeria, Africa's largest oil producer, this paradox is especially pronounced. Nigeria has copious amounts of crude oil. According to the latest available data from OPEC, it produced 1.95m barrels a day (b/d) in 2012, far less than Saudi Arabia, the world's largest producer, which pumps out 11.7m b/d. Angola is Africa's second-largest producer, with 1.5m b/d.

Despite the overflowing crude, Nigeria is also the second-largest importer of refined petroleum products in Africa, behind only South Africa, which has little oil or natural gas of its own. Every day on average 350,700 barrels of gasoline, diesel and related products are shipped in to Nigeria, according to OPEC figures.

This is an expensive paradox. By the time transport and external refinery costs are counted, the Nigerian government spends hundreds of billions of naira in subsidies to keep prices at the pumps reasonable. It was 888 billion naira ($5.5 billion) in 2012. This year the federal government has budgeted 971 billion naira ($6 billion).



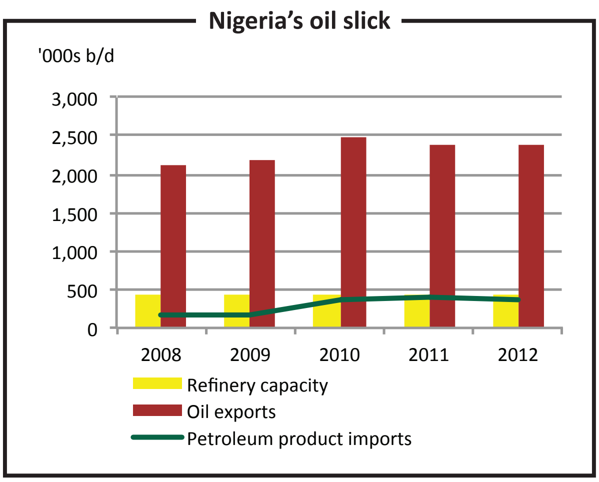
Source: OPEC

Concerned that this kind of spending is

unsustainable, the government has occasionally flirted with decreasing the subsidy or removing it entirely. These plans, however, remain enormously unpopular among Nigerians, who see relatively cheap petrol as the major benefit of living in an oil-producing country. Who can blame them? There is little else to show for all that oil wealth. After the subsidy was suspended in January 2013, mass protests around Nigeria forced the government to reinstate it.

The obvious solution is for Nigeria to refine its own crude oil. Stripped of transport costs and import duties, the petrol price would surely decrease, allowing government to eventually remove the subsidy altogether.

The Nigerian government has tried this solution too. It failed, miserably. With all systems go, the three refineries owned and operated by the state in southern Nigeria's Port Harcourt and Warri, and Kaduna in the north-west, could be refining 445,000 b/d, which is more than enough to cover Nigeria's daily needs. It would even allow the country to enter the lucrative business of exporting refined petroleum.



Source: OPEC

This capacity, however, exists only on paper. In practice, a nasty combination of corruption, bureaucracy, inefficiency and chronic disrepair has left the various state-owned refineries operating at just 18% capacity—hence the shortfall that must be made up by imports.

Fortunately for Nigeria, this absurd situation could be about to change, thanks to Africa's richest man, 56-year-old Nigerian businessman Aliko Dangote. With his sprawling concrete and construction empire, Mr Dangote knows better than most that there is profit to be found in paradox. Moreover, he holds the skills, assets and reputation to make it happen.

Mr Dangote announced plans in April 2013 to build a new oil refinery in the Olokola Liquefied Natural Gas Free Trade Zone on the Gulf of Guinea coast near Lagos. The refinery, which Mr Dangote hopes to complete by 2016, will cost an estimated $9 billion and produce around 400,000 b/d of petroleum products, comfortably meeting Nigeria's total demand. At the same time, it will "change the economic and industrial landscape of Nigeria", according to Doyin Okupe, a special assistant to Nigerian President Goodluck Jonathan.

This $9 billion price tag is a huge amount of money for anybody, but Mr Dangote can afford it. The latest Forbes Africa Rich List values his estate at a tidy $20.8 billion, nearly three times larger than that of South African luxury goods mogul Johann

Rupert, who is second on the list. Mr Dangote has already pledged $3.5 billion of his Dangote Group equity to the project. Of course, he will not pay the entire sum: his company has already announced a $3.3 billion financing agreement with a syndicate of Nigerian and international banks, led by the UK's Standard Chartered and Nigeria's Guaranty Trust. The remainder will be raised later.

Aliko Dangote: from cement czar to oil oligarch?

This loan is significant beyond its monetary value. Giant industrial projects in Africa struggle to attract funding, with foreign investors historically shy of uncertain political climates and unconvinced by Africa's potential for profit. That international banks are prepared to invest billions of dollars in a complex, long-term project is a positive change and a strong symbol of confidence in the continent's future and Nigeria's in particular.

In addition, this confidence has the potential to be self-fulfilling. By eventually lowering fuel costs, Mr Dangote's new refinery will make it cheaper to do business in Nigeria and free up government funds for other development and infrastructure projects. It will also create 85,000 direct and indirect jobs for Nigerians, Mr Dangote claimed in an interview last September.

Given Mr Dangote's track record, any profit the plant makes is likely to be reinvested in Nigeria. This should speed up Nigeria's economic expansion, which continues to be impressive despite the army's ongoing and violent confrontation with Islamist militant group Boko Haram in the north. As Africa's second-largest economy (expected to become its largest in early 2014 when the National Bureau of Statistics releases rebased GDP figures), Nigeria's economic growth will fuel the continent's progress.

The refining process will yield further tangible and lucrative benefits useful for making other sellable goods. The industrial complex housing the refinery will include plants to produce agricultural fertilisers and polypropylene, used to make plastics.

Fertiliser will be a major money maker for Mr Dangote and Nigeria. His project is expected to produce 2.75m metric tonnes of urea and ammonia for the agriculture sector every year. "We'll also see Nigeria for the first time exporting fertiliser rather than using hard-earned foreign exchange to import fertiliser," Mr Dangote said.

In the early stages of production, massive start-up costs will prevent the new refinery's petrol from being significantly cheaper than imports. It may be even more expensive.

Despite these ringing expectations, a few notes of caution remain.

First, refining oil is a notoriously difficult process. Crude oil has to be heated to extreme temperatures until it vaporises and loses its chemical structure, turning into various hydrocarbon gases. These gases are pumped through a special tower. As they rise to the top, they start cooling. As they cool, each condenses at a different temperature corresponding to a specific height. The liquid is then collected and siphoned off. Some of these liquids will be ready for public consumption. Others need to go through additional, even more complex procedures before they become useful.

Plenty of room for error resides in all this complexity. Mr Dangote's refinery will not be immune to the problems that have plagued Nigeria's existing refineries. It will probably be many years before it is operating at full capacity.

The pricing issue is another potential problem. In the early stages of production, massive start-up costs will prevent the new refinery's petrol from being significantly cheaper than imports. It may even be more expensive. Reports are emerging that Mr Dangote is looking for government subsidies to make sure his final product is competitive initially.

Given his close ties to the ruling People's Democratic Party (PDP), and President Jonathan in particular, Mr Dangote will probably get whatever he needs. Some argue that his proximity to government is an essential ingredient of his business success. So far Mr Jonathan's administration has been effusive in its praise for the refinery project.

Voters, however, are expected to elect a new president in 2015. Thanks to a new opposition coalition, the PDP faces a genuine challenge to its rule for the first time since multiparty democracy resumed in 1999. Will a new administration, if there is one, be as supportive when it comes to financial incentives and in granting the all-important operating permits, without which the refinery would lie dormant?

Mr Dangote has already made his bet and placed his money on the table. It is a gamble without much risk. Even Nigerian politicians, not always known for their foresight, would have a hard time arguing against this particular project for one simple reason: everyone—Mr Dangote through immense profits, the Nigerian government through reduced subsidies, and the Nigerian people through eventually cheaper petrol and fertiliser—stands to benefit. GG

To revive its manufacturing sector, Africa's largest economy needs to bridge the gap between labour, industry and government

Manufacturing consent

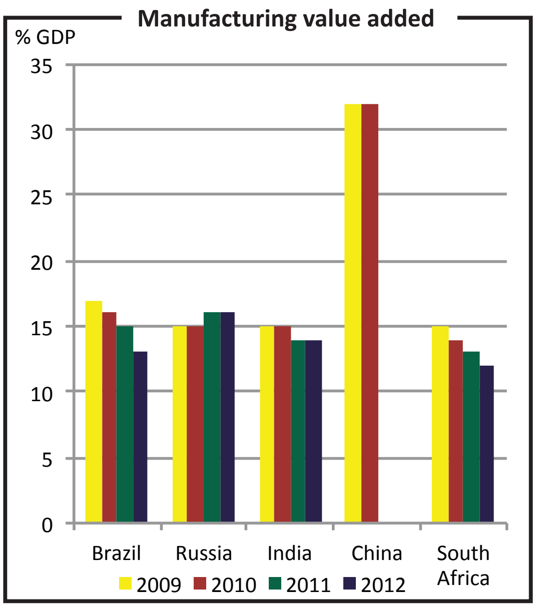
by Richard Poplak

Africa, so the story goes, makes nothing except holes in the ground. And while extractive industries drive economies across the continent, they do not produce the sort of employment figures that make for sustainable growth.

In South Africa, the continent's largest and most diversified economy, a yawning lacuna between industry, labour and government is not just curbing manufacturing but promises to swallow the entire nation.

This chasm was plainly in evidence during a forum held last November by Johannesburg-based consultancy outfit Frontier Advisory, operated by Martyn Davies, a leading analyst and former Stellenbosch University academic. Held about once a month, these forums often involve people who would not ordinarily find themselves in the same room. This was certainly the case with "The Future of Manufacturing in South Africa". The irony is that there is no future for manufacturing in South Africa if representatives from industry, labour and government are not in the same physical space as often as possible.

The preamble printed on the programme did not offer much solace: "Despite having the strongest manufacturing base in the region and strong demand for manufactured goods in African economies, South Africa's manufacturing sector continues to underperform. Recent strife between labour and investors in the country's manufacturing sector… has only served to highlight how divergent the future vision for manufacturing is in South Africa. According to the World Bank, South Africa's manufacturing value add as a percentage is now down to 12% of GDP—the lowest amongst all the BRICS countries. What is to be done to fix manufacturing in South Africa? What are the views of industry, government and labour and how can these be reconciled?"



Source: World Bank

During his introduction,

Mr Davies made his views plain: manufacturing in South Africa is in free fall. In 1994, the sector contributed between 23% and 24% of GDP, a number which has now plunged by half, according to Mr Davies. "Hence," he noted drily, "the enormous unemployment figures in this country."

Martyn Davies

Alongside Mr Davies sat Mike Whitfield, the managing director of Nissan South Africa. To his left sat Karthi Pillay, director of IT, Risk and Control at Deloitte, followed by Patrick Craven, national spokesman for the Congress of South African Trade Unions (Cosatu). Coenraad Bezuidenhout, of the industry lobbying group Manufacturing Circle, and Bill Scurr, executive director of the Southern African Stainless Steel Development Association, rounded out the panel.

This coterie were all ostensibly invested in stemming the fall and spurring the rise of local manufacturing. But as you might imagine, they drink different flavours of the economy wonk's Kool-Aid. How to stop the plunge? While each member of the panel had a subtly different outlook, some views overlapped.

For his part, Nissan's Mr Whitfield wanted us to remember that nowhere in the world do car manufacturers work without co-operation and incentives from government, such as tariff protection, tax breaks and subsidies for building factories. With African plants in Egypt, Morocco, South Africa and, shortly, Nigeria, Nissan's modus operandi is always based on receiving a helping hand. Mr Whitfield made the point that the size of the incentives guide where and when a car manufacturer sets up shop. "It now costs 20% more in South Africa than it does in, say, Thailand," he said.

Warily, he noted that the 20% uptick had much to do with labour costs. Seven car manufacturers operate in South Africa, and all seven had just been slammed by almost eight weeks of industrial action led by the National Union of Metalworkers of South Africa (NUMSA). The strikes led to an agreement that saw workers granted a 10% wage increase in 2013, and 8% in 2014 and 2015. This led BMW to pull the plug on plans for an expansion of its manufacturing programme in South Africa. In total the strike cost the sector almost 20 billion rand ($1.8 billion).

Such carnage resonates across the entire sector. Mr Pillay directed our attention to the just-published Deloitte 2013 Global Manufacturing Competitiveness Index, a yearly survey to determine how hundreds of leading international CEOs view the competitiveness of the manufacturing industry in 38 countries around the world.

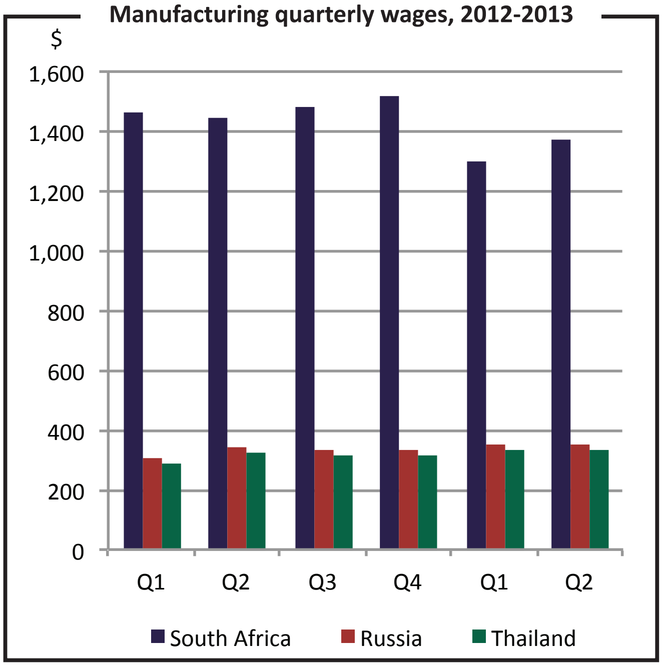
Unsurprisingly, China ranked number one. Another four emerging economies were included in the top ten: India (4), Taiwan (6), Brazil (8) and Singapore (9). Five years from now, according to the survey, emerging economies will surge to the top three places, with India and Brazil following fast on China's heels. South Africa? A gruesome 24 out of 38, followed by sundry crisis-hit European states, Saudi Arabia and the UAE. That is not company South Africa can afford to keep.

"This country employs 1.5m people in the manufacturing sector," Mr Pillay said, by way of explanation. "And manufacturers struggle with a high-wage to low-productivity ratio." Worker productivity is usually calculated by dividing total output by the number of workers or the number of hours worked. Labour yield has fallen from 7,297 rand ($675) to 4,924 rand ($456) a year since 1967, a decline of 32.5%. From a peak in 1993, labour productivity has plummeted by 41.2%, according to a 2013 report from Adcorp, a Johannesburg Stock Exchange-listed human capital management group.

Industry complaints about productivity generally focus on unions' high wage demands and an abject lack of skilled or educated workers. However, productivity is not just a worker issue, but a management issue, argued Cosatu's Mr Craven. "If your productivity is low, don't the managers need to be held accountable?" he asked.

Mr Craven is not troubled by high wages. He pointed to Brazil's vaunted "Lula moment" during the 2000s, when then-President Luiz Inácio Lula da Silva raised basic wages, social grants and provided subsidies for small businesses. The Brazilian economy exploded, growing 7.5% in 2010, according to the World Bank. "And not," said the union stalwart, "by underpaying workers."

Manufacturing quarterly wages, 2012-2013



Sources: Statistics South Africa; National Statistical Office of Thailand; Ministry for Economic Development, Russia

The state has a role to play in bridging gaps between industry and labour, Mr Craven said, but perhaps not the same role that the industry representatives on the panel had in mind. "We need a developmental approach," he added. "Market forces alone are not going to fix this."

Most of those gathered agreed that a weak rand—usually hyped as a salve for manufacturing—was not a silver bullet. Lowering the value of the currency, while helpful in the short term, was not going to fix the desultory structural issues that were destroying the economy and shedding jobs like so much dandruff.

The issue, Mr Davies suggested, was not that there were no ideas, but that those ideas were not being communicated between industry, labour and government. Mr Davies recalled post-unification Germany as an example of a country that successfully bridged these gaps.

"Similar to South Africa," he said, "in 1990 Germany was [a] newly united country, with its population living in…different stages of development. But the Germans were able to significantly integrate the East into the developed economy, drive employment figures up, and keep industry manufacturing high-end goods with skilled and educated employees earning a living wage...and while Europe dies around it, Germany thrives. Never mind the Lula moment, what about the Merkel moment?" he asked, referring to Angela Merkel, Germany's long-term chancellor.

According to a 2001 study from the Brookings Institution, a think-tank based in Washington, DC, "from 1989 to 1992, GDP in the former German Democratic Republic (GDR) declined by roughly 30%, value added in industry by more than 60%, and employment by 35%. During the same period, unemployment rose from officially zero to more than 15%." In short, Germany's east was a backwater in 1992.

But by 2000 the former GDR's GDP per capita had risen to 65.3% of the former West Germany's, thanks to a comprehensive programme of wealth transfers and industry-government collaboration. Berlin did everything in its power to ensure factories did not leave Germany; development was not an economic drain, but an economic engine. As the writers of the study argue, "The ultimate measure of the economic success of German reunification is no longer the introduction of a market economy, but rather the attainment of an efficient production pattern made possible by the union of the two regions."

While Germany's manufacturers can rely on an endless stream of highly educated, highly skilled workers entering the work force every year, South Africa's cannot. As Mr Craven has noted, "Our education system is in a crisis and it sidelines 400,000 young people who do not proceed with their studies after writing exams every year. Today, 95% of the people who are unemployed have no tertiary education, 60% of the unemployed have no secondary education. As a result of this crisis, 68% of the unemployed have been unemployed for the past five years or have not worked in their lives."

What can South Africa learn from the Germans? First, it can buck up employment by ensuring that the education system provides the jobs market with highly skilled, highly productive workers. Next, it can support industry at the research and development level. It can encourage factories to stay on shore with aggressive tariffs and foster an environment of innovation, where industry builds for an international market with an appetite for excellence. Last—and perhaps most important—it needs to create a culture of co-operation, where a win for labour is a win for industry is a win for government. GG

Transforming raw materials into manufactured goods

African countries can turn their natural resources from a bane into a boon

Ending the resource curse
by Kopo Mapila

Africa, blessed with many minerals and other natural resources, has often fallen prey to the resource curse. This disease comes in two forms: revenues from natural resources push up a country's currency exchange rate and depress other sectors, particularly manufacturing; and/or governing politicians become "rent-seekers", seizing control of these assets and using the income to stifle opposition to their rule.

Despite Africa's wealth in oil, gold, chromium, platinum and other minerals, very little manufacturing takes place on the continent. Rent-seeking and corruption have created powerful elites that block diversification and inclusive growth. Too many leaders and their cronies use resource income for personal enrichment at the expense of development. For example, about 80% of Nigeria's oil wealth accrues to 1% of the population while the percentage of people living on less than a dollar a day has increased from just over 27% in 1970 to about 75%, wrote Greg Mills in his 2010 book called "Why Africa is Poor".

Resource rents, however, can be harnessed to drive industrialisation in Africa, in four steps.

First, create a mutually advantageous environment for governments and private firms for mineral discovery, investments and extraction. Too often governments lack the expertise to extract the resources and the political will to share the income equitably with their citizens. On the other hand, mining companies, like most businesses, are interested in maximising profits.

These divergent interests can be tamed to meet the needs of both in the interest of the country. Transparency in public tendering and competitive bidding would go a long way in providing governments with better financial and other returns. In auctioning off contracts, governments can choose firms that offer the best terms, particularly in creating jobs or programmes that benefit communities. Policymakers can also adopt and enforce strict regulations that discourage opportunistic speculators from buying and selling exploration licences. Governments must give mineral rights only to firms that will invest and develop the mineral plots.

Second, tailor a tax regime to make adjustments for costs and profits. Paul Collier and Tony Venables, Oxford University economists and authors of "Plundered Nations", compared the cost of copper mining in Zambia and Chile. According to their analysis, Zambia, as the higher-cost producer, is best served by a flexible tax regime that can be adjusted against copper price fluctuations. This would protect Zambian copper from becoming too expensive and thus safeguard its global exports.

The ideal tax regime encourages long-term exploration beyond an initial contract. Botswana, for instance, has succeeded in increasing private-sector investment through its 19.5% income tax on profit, which is significantly lower than the average sub-Saharan rate of 68%, according to the 2012 African Economic Outlook, a report produced by the UN, the African Development Bank and the OECD, an intergovernmental think-tank based in Paris.

Benefits to the state must also be maximised during an asset's limited life span, particularly at its early stages when it is still highly profitable. In the past, companies paid taxes only after they had recouped their investment, usually when extraction and profits were low. The 1980s structural adjustment programmes gave private investors very lenient terms that saw "the burden of tax [structured] in such a way that little tax was paid until the invested capital was recovered", according to a 2011 report by the UN Economic Commission for Africa.

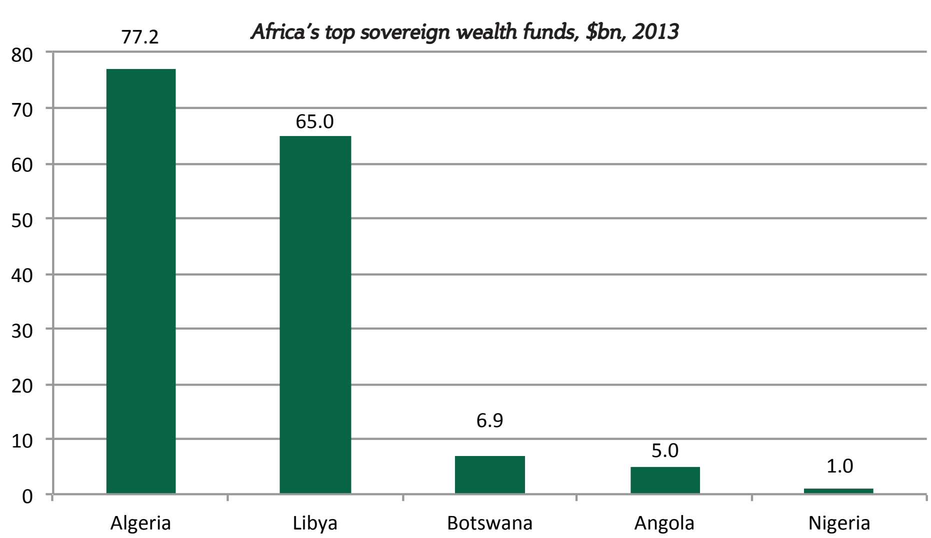
This meant that the state collected significantly lower taxes because the profits were lower. Governments could have collected more had the agreements been structured to collect taxes when the mines were most profitable, usually when extraction was at its highest in the early stages. Ghana, for instance, has succeeded in receiving early revenue from its oil and gas royalty taxes.

A tax regime can also ring-fence projects and limit the extent to which private firms can receive tax deductions from one activity against another, according to a report written by Nana Adjoa Hackman, an oil and gas expert, for the Danquah Institute, a Ghanaian research centre.

Third, adopt strategic savings and investment plans in infrastructure and technology, both crucial for industrialisation and growth.

Resource-rich countries often pool their profits from oil, gas or minerals into sovereign wealth funds (SWFs), government or state-run accounts. Africa has nine

For a rainy day



Source: Sovereign Wealth Fund Institute

SWFs, according to the Sovereign Wealth Fund Institute, a US-based think-tank. Of the largest five, four are based on oil and gas, while Botswana's is based on diamonds and other resources.

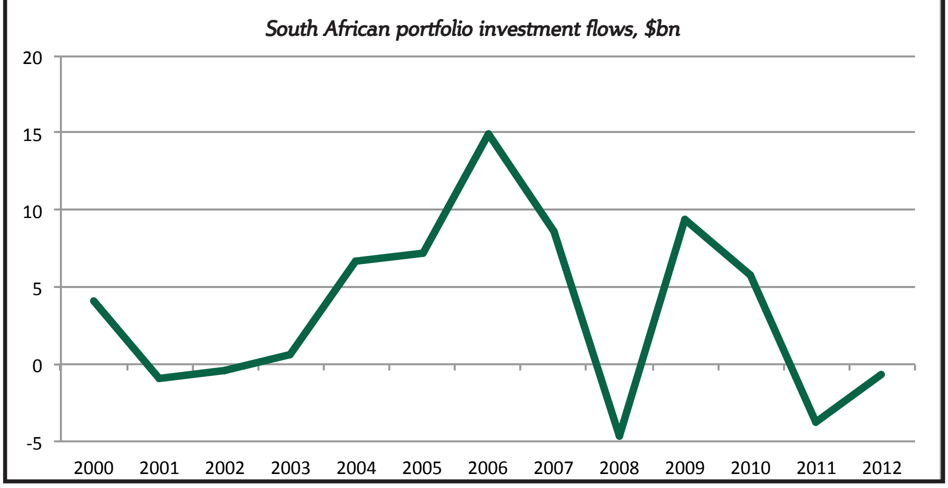
SWF benefits are short- and long-term. In the short term, countries use these state accounts to smooth expenditure when commodity prices are bumpy, which could negatively affect expenditure planning. In the long term, SWFs can safeguard declining revenues as resources run out. SWF proceeds can also be spent on investing in sectors that spur diversification.

SWFs can ring-fence revenues from political interference through adherence to international conventions such as the Santiago Principles, a set of 24 accounting and investment guidelines emphasising transparency that was adopted by 26 SWFs around the world in October 2008.

SWFs can also curb risky overreliance on foreign capital. Stops or reversals in capital flows have been frequent in South Africa since the 2008 recession and have crippled the country's job-creating potential, according to this author's analysis. Capital flows affect the currency's stability, which also affects export prices. In the manufacturing sector, when the price of tradable goods is volatile, few jobs will be created as companies are unlikely to take on additional costs in the face of uncertain profits.

South Africa's 2009 fourth-quarter decline in GDP of 6.4% was a direct result of capital flow reversals experienced by the Johannesburg Stock Exchange six months before, according to a 2012 report by University of the Witwatersrand economists Rex McKenzie and Nicolas Pons-Vignon.

Cash flow problems



Source: World Bank

The fourth step towards resource-led development is through diversification. This requires creating strong links between core commodity sectors and the rest of the economy. A country's industrial base can be strengthened through backward linkages such as manufacturing and purchasing mining equipment to extract the resource;

and forward links through mineral beneficiation and value addition, such as creating jewellery, after the commodity has surfaced.

De Beers and Debswana, Botswana's state-owned diamond company, renegotiated a contract in 2011 that called for moving the Diamond Trading Centre (DTC) from London to Gaborone, Botswana's capital. The DTC move will see the value of Botswana's diamond sales increase from roughly $500m to about $5.5 billion, said Varda Shine, De Beers diamond trading global head, in a 2012 article in *Mining Weekly*.

The DTC has also created about 160 new specialised jobs and is expected to create many more over the next three to five years, according to industry insiders. The DTC is a major step forward in creating a regional diamond-trading hub and diversifying Botswana's economy. It is an example of a forward linkage that will yield long-term returns as it develops local workers' skills and technical expertise.

Debswana's headquarters in Gaborone

Other African countries need to follow Botswana's example, and renegotiate or create new agreements with foreign investors to secure terms more favourable to their own economies and people.

Many African countries today are in an excellent position to reduce poverty, inequality and unemployment. With the dramatic decline in diseases associated with malnutrition and recent positive developments in combating HIV/AIDS and malaria, African populations are healthier today than ever. Through broad democratisation, political accountability on the continent is at its highest. In addition, the continent boasts unparalleled economic growth rates. Finally, the global community seems to have an insatiable appetite for Africa's commodities.

Dynamic policies that define a new industrial landscape could lead Africa into a new era of inclusive growth and prosperity. This requires transforming the commodity boom from a curse into a blessing. GG

The east African country has failed to kick-start its manufacturing sector, but not for lack of trying

Maps, missteps and missed opportunities

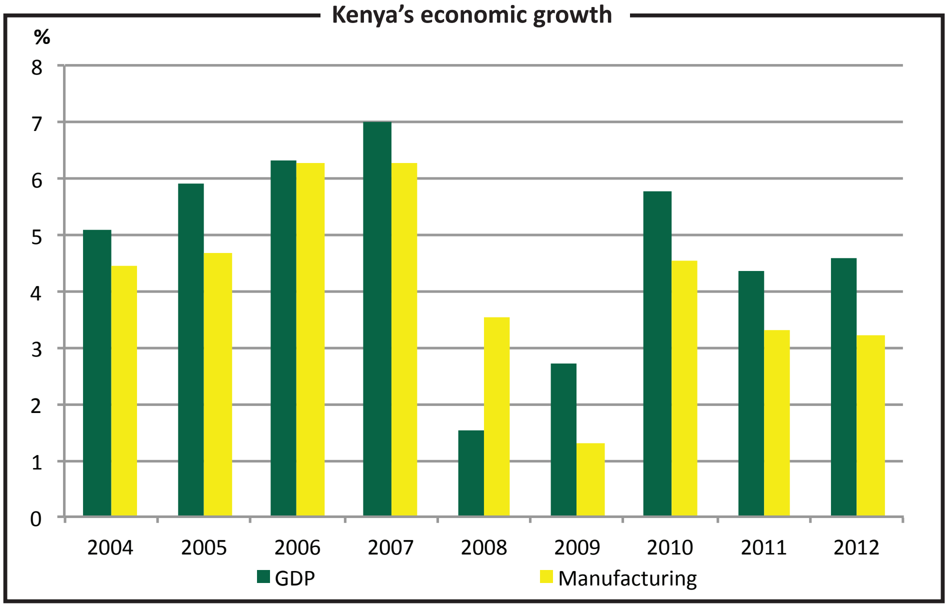
by Joel Macharia

Nairobi's industrial district is well laid out—or at least looks that way on a map. The district's main thoroughfare, Enterprise Road, starts just outside the city's Central Business District and runs for almost 15km. Alphabetically named roads branch off at regular intervals. Each of these ends in a broad cul-de-sac designed to allow lorries to turn easily. The main railway has branch lines terminating at every warehouse to expedite the off-loading of goods.

Off the map and on the ground, a very different picture emerges. The roads are choked with traffic, the sidewalks covered in litter. The railway tracks are overgrown with weeds, and car mechanics and metal forgers have taken over the cul-de-sacs.

This wide gap—between the efficiency imagined on the map and the cluttered chaos on the ground—is analogous to the gap that separates Kenya's manufacturing plans from its actual progress towards becoming an industrialised country.

With a two-year hiccup provoked by election violence in 2008 and the global financial crisis, Kenya's GDP has grown on average 5% annually since 2004, according to the World Bank. Industrial production, however, still languishes at 15% of GDP, with agriculture accounting for 24% and services for 61%, according to the Kenyan National Bureau of Statistics (KNBS).



Source: World Bank

A historical perspective helps to understand why industry lags. When Kenya gained independence from Britain in 1963 it inherited an industrial policy that aimed at substituting imports for locally manufactured products. Continuing this policy, the newly independent government under Jomo Kenyatta invited foreign manufacturers of locally-consumed products to set up in the country and to make these goods using locally-sourced raw materials.

Kenya did not participate actively in export, focusing instead on supplying domestic and regional markets, which traded in relatively weak local currencies.

The government protected these infant industries from competition through quantitative restrictions, import licensing, foreign exchange controls, high tariffs on competing imports and overvalued exchange rates that made imports uncompetitive. The East African Community (EAC), an intergovernmental body Kenya set up with Uganda and Tanzania to create a common market, customs tariffs and other shared public services, also attracted foreign investors.

This policy of import-substitution worked, for the most part. In the five years following independence, manufacturing value added increased 44%, led by the textiles, food, beverages and tobacco sectors. Annual growth in manufacturing peaked between 1971 and 1973 at over 25%, according to the World Bank.

The downside, however, was that the protective policies were so effective that established foreign companies—such as chemical manufacturer Union Carbide and rubber producer Firestone—enjoyed near monopolies; and parastatals took over traditional spheres such as utilities but also many aspects of manufacturing and distribution.

These private and government-owned monopolies did not permit the development of a competitive business model and contributed to massive inefficiencies in domestic industries. By 1980 this import-substitution strategy had run its course. Imports of consumer goods had declined and new industries could not be established to produce local substitutes. In addition, the collapse of the EAC in 1977 reduced the regional market for Kenyan manufacturers.

Kenya did not participate actively in export, focusing instead on supplying domestic and regional markets, which traded in relatively weak local currencies. The country ran into repeated foreign exchange shortages and found it increasingly difficult to pay for crucial imports, such as petroleum.

Faced with these constraints, in 1980 Kenya became the second country—after Turkey—to sign a structural adjustment agreement with the World Bank. A $55m loan from the bank was conditional on the Kenyan government adopting more liberal trade and interest rate regimes, as well as a more outward-oriented industrial policy.

From 1982 into the 1990s, under pressure from donors, particularly the World Bank, Kenya began shifting import restrictions from quotas to tariffs, and decreasing tariff levels. In 1987, 40% of all importable items had quantitative quotas, but by July

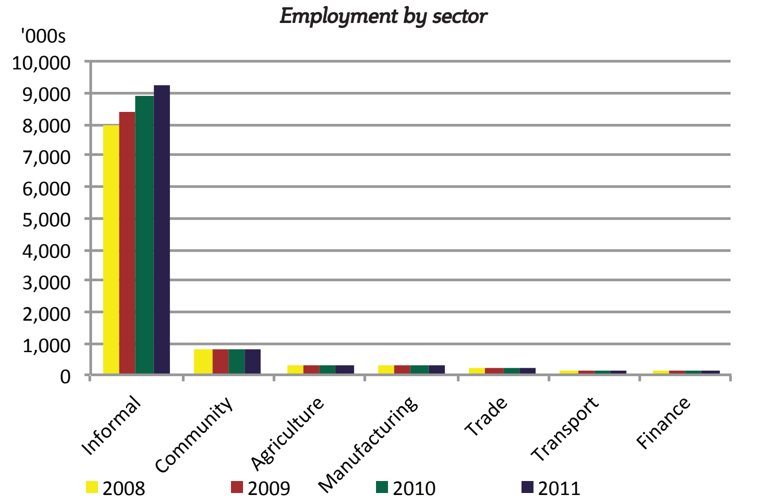
1991, import licences were only used for health or security reasons.

In addition to opening up imports, Kenya introduced several programmes through the 1980s and 1990s designed to promote exports, such as the manufacturing-under-bond scheme in 1988, which allowed manufacturers producing for export to import equipment duty-free, as well as the creation in 1990 of manufacturer-friendly export processing zones.

Kenyan industry experienced a major shake-up during the structural adjustment period, particularly as a result of competition from cheaper imports. Many companies collapsed, including Kisumu Cotton Mills, the Pan Paper Mills, and other state-owned firms that had previously operated as monopolies.

The liberalisation of the market saw an influx of very cheap clothes imported mainly from the US and Europe, which led to the downfall of the local textile industry in the early 1990s. In the 1980s the textile industry was Kenya's leading manufacturing activity, employing about 30% of the labour force in the manufacturing sector.

Few factory jobs



Source: World Bank

Such collapses hindered investment in those industries, with dramatic results. Between 1991 and 1992, for example, the real annual growth rate of the manufacturing sector fell from 3.8% to a mere 1.2%, according to the World Bank.

New hope for Kenyan industry emerged in 2003, when Mwai Kibaki took over from Daniel arap Moi, who had been Kenya's president for 24 years. Mr Kibaki soon unveiled the Economic Recovery Strategy for Wealth Creation and Employment (ERS). He hoped the plan would provide an environment for private enterprise to drive industrialisation. The ERS sought to improve infrastructure by increasing financial investment in roads, privatising railway operations and re-implementing infrastructure development plans that had been dropped under the previous government. It aimed to ensure that the rule of law was enforced.

While Kenya's annual economic growth has since jumped from 0.5% in 2002 to an average of more than 5%, it is the burgeoning communications, financial services and retail sectors that have contributed to growth, not industry, according to the KNBS.

Two main reasons for this latest failure to stimulate industrial growth were also partly responsible for the failure of the export-promotion policies in the 1990s. First, policies have often been contradictory. For instance, in the early 1990s monetary strategy sidelined new export promotion programmes by targeting inflation and allowing extremely high interest rates on treasury bills. This made credit unaffordable to the private sector and manufacturing businesses—particularly small and medium-sized—struggled to expand.

The second main reason for the failure has been high-level corruption and mismanagement. In 2005 the Centre for Governance and Development, a Nairobi-based non-profit research and policy firm, found that between 1992 and 2003, state-owned corporations—including the Kenya Ports Authority, the Kenya Railways Corporation and the Agricultural Finance Corporation—had "lost" more than $630m.

The post-Moi governments, for all their rhetoric about stamping out corruption, have not been sleaze-free. In 2003 several key ministers in Mr Kibaki's government were implicated in the notorious Anglo Leasing tender scandal in which state contracts worth hundreds of millions of dollars were awarded to non-existent firms. In 2005 John Githongo, a journalist given a government post specifically to fight corruption, resigned, citing frustration with carrying out his job. Mr Githongo later accused several top-level ministers of fraud.

Mwai Kibaki broke his promise to clean up corruption

On the flipside, however, several moribund parastatals, such as the Kenya Meat Commission and the New Kenya Co-operative Creameries, have not only recovered, but have turned profitable.

Kenya is taking steps to remove these barriers to industrial growth. The country's new constitution limits the number of ministries and defines their roles. In addition, the country is privatising state-owned corporations and has merged regulatory bodies to increase efficiency and reduce corruption.

Back in Nairobi's industrial zone, a 250m-long strip of pitch-black tarmac stands out from the surrounding roads. Chogoria Road, once so badly potholed that it resembled the surface of Mars, now glints smoothly in the blazing Nairobi sun. Aside from fixing the road, the Nairobi City Council has also moved the car mechanics into lots off the road and set up kiosks for entrepreneurs to peddle spare parts.

Chogoria Road shows that it is possible for the industrial zone on the ground to match its promise on the map. Sustained political will and gritty efforts like this one need to be applied on a national level to make sure that industrial plans take root and grow, and do not remain good intentions neatly bound in policy documents. GG

Tunisia: how to kick-start a divided economy

The north African country should link its coast and interior by creating quality jobs for its well-educated youth

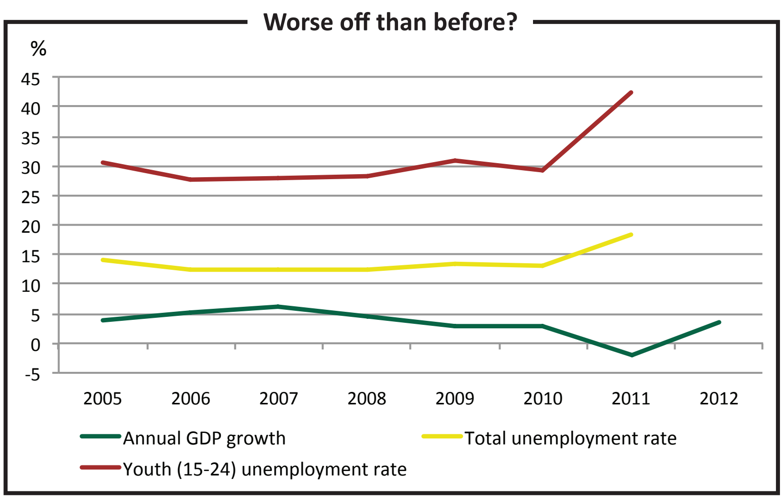
Too smart to fail

by Duncan Pickard

Tunisia's economic history is a tale of two territories: its coastal cities export mostly to Europe across the Mediterranean Sea; its farms on the dry central plains grow food for the local market.

This split narrative led to the birth of the Arab spring in December 2010. A street vendor, 26-year-old Mohammed Bouazizi, set himself on fire in Tunisia's central Sidi Bouzid governorate. His act was meant to draw attention to the interior's high unemployment, especially among youth and college graduates who have few connections to the coastal cities. It also sparked a wave of protests that swept across North Africa.

Tunisia's economy today, however, provides fewer jobs than it did before the revolution. Although GDP growth has recovered slightly from its shock in 2011, unemployment is markedly higher, rising to 18.3% in 2011, according to the latest World Bank figures. But not all is bleak: former President Zine al-Abidine Ben Ali's era of corruption and cronyism is over. Tunisia's well-educated and youthful population brightens the prospects for building a strong and inclusive economy.



Source: World Bank

For decades before the revolution, the Tunisian government practised central economic planning as part of its state-sponsored industrialisation policy. It dictated private-sector growth, largely to strengthen political control and corruption. The regime favoured the lucrative export-oriented, Europe-facing firms based in Tunisia's coastal cities, especially manufacturing firms such as the Tunisian Compagnie des Phosphates de Gafsa and the Austrian oil and gas giant OMV.

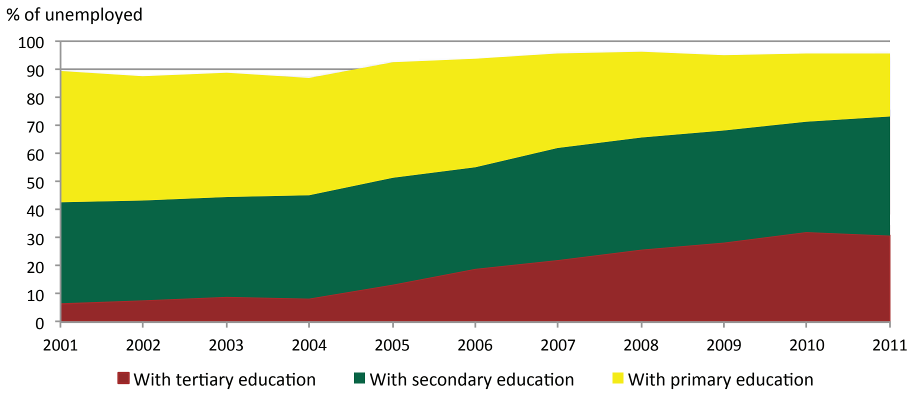
Simultaneously, the government kept a lid on social unrest by subsidising staple products such as food and fuel. These subsidies, however, made business extremely difficult for domestic producers, particularly of olives, grains, tomatoes and canned goods, based mostly in the interior. Despite their significantly lower costs, local growers could barely compete with heavily-subsidised imported bread, tuna fish, produce and other foodstuffs. The regime's industrial and social policies boosted the exporting coastal cities at the expense of the domestic-producing interior.

Despite its many shortcomings, the former government invested more equitably in higher education. Since the early 1990s schooling has skyrocketed, especially in the interior. The proportion of Tunisians without any formal education is over 50% among people over 60, but less than 18% for those under 40, according to a 2010 employment survey by the Tunisian Institute of Statistics (INS).

Tunisia is at the peak of its demographic window of opportunity. In 2012 its dependency ratio (under-14s and over-65s as a percentage of working-age 15-64s) was 43%, according to the World Bank. A majority of Tunisia's roughly 10m people are under 35.

Tunisia's young population, however, is struggling with high unemployment, which has been hovering above 30% for the last decade, according to the INS. Among certain tertiary-educated groups, especially in the interior, unemployment is a staggering 60%.

Educated but unemployed



Source: World Bank

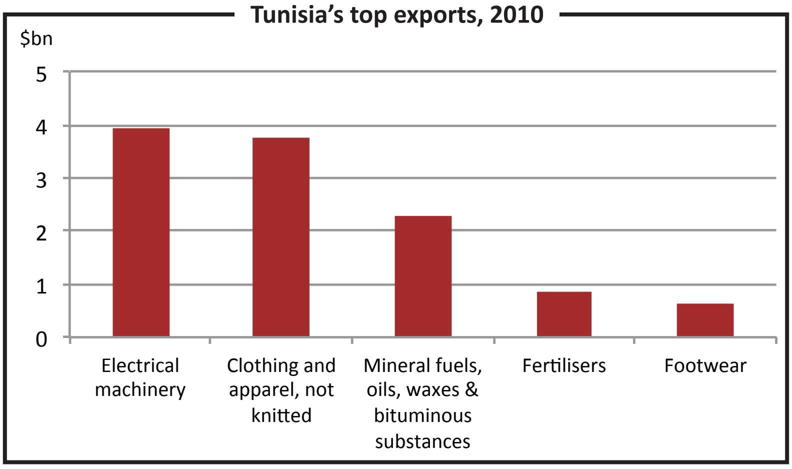
Tunisia needs a growth strategy that incorporates both halves of the country and leverages its economic assets, particularly its good infrastructure and well-educated population. It should link the interior's natural resources and demographic opportunity with the coast's export markets and create more skilled manufacturing jobs for its well-trained workforce. But what would such a strategy look like at the policy level?

In March 2011 the International Labour Organisation (ILO) published a report to promote inclusive growth in Tunisia. It called for creating more jobs for women, young college graduates and less-educated workers in Tunisia's interior. The ILO study also recommended diversifying and expanding manufacturing, but did not shed much light on which industries to finance.

"The Atlas of Economic Complexity", a book and online project of Harvard

University and the Massachusetts Institute of Technology (MIT), does, however. It attempts to measure economic complexity across two variables: diversity, or the number of products a country makes; and ubiquity, the number of countries that make the same product. Strong economies have high diversity and low ubiquity, meaning that they can compete in the global economy with a wide range of products that not many other countries make.

According to this measure, Tunisia's economy is remarkably strong considering its small size. It is as diverse as Egypt's despite having one-sixth the population. Tunisia exports manufactured goods such as consumer electronics (especially televisions), pharmaceuticals and car parts. This export basket also has the lowest ubiquity in the Maghreb, which gives Tunisia an advantage against its regional competitors.



Source: The Atlas of Economic Complexity

Despite these regional advantages, Tunisia's economic complexity is still below average when compared to countries with a similar GDP per capita. Tunisia's GDP per capita of $9,795, adjusted for purchasing power parity, is just above China's, according to the World Bank. But where China is ranked 29th in economic complexity, Tunisia is ranked 47th, according to the latest figures from the Harvard-MIT project.

Paradoxically, though, low complexity can indicate higher-than-average growth potential in the short term. This is because relatively unsophisticated economies can invest in new areas with reasonable expectations of quick gains. For example, a country that exports iron could produce steel with a high potential for a quick return while making its export basket more complex.

Bearing this in mind, the atlas's authors look at Tunisia's export landscape and pinpoint the industries that would most reward investment. They measure a new product's value across two criteria: "distance" between the product and the economy's capabilities; and "sophistication", an indicator of that product's potential benefit to growth. This potential benefit is measured by the average increase in GDP per capita seen in other countries that produce that product.

The garment sector is the area that would be easiest for Tunisia to enter, given its current capacity, according to the atlas. But making garments would yield fewer benefits than venturing into other sectors that might be more difficult. Products with higher potential value for job growth and export revenue include construction materials, petrochemicals, miscellaneous chemicals, home and office products, and machinery.

These are difficult sectors for Tunisia because they require skills the country currently does not have, given what it exports. Even so, policymakers and potential investors should recognise the lucrative opportunities these products represent to strengthen and diversify Tunisia's economy.

To bolster capacity and competitiveness in these activities, economic policymakers in Tunisia should follow a three-pronged approach.

First, the government should unlock Tunisia's foreign and domestic investment potential. The new government should continue its fight against official corruption by relaxing legal barriers to foreign investment that previously allowed regime officials to solicit bribes in exchange for a workaround.

The government should empower small and medium enterprises by easing access to finance and lightening regulatory burdens.

Legislators should also strengthen Tunisia's fractured banking sector and weak stock market. Tunisian banks are saddled with abnormally high levels of non-performing loans, 13% in 2010, among the highest in North Africa, according to World Bank data. The stock market is significantly undercapitalised at only $4.5 billion—one-tenth the value of the Moroccan exchange despite the countries' comparable export baskets and GDP per capita, according to the World Bank.

The second pillar should be a coherent national policy that strengthens the links between education, innovation and the economy. Ties between universities and local industry are important for entrepreneurial innovation, which is often achieved when universities share research and exchange ideas with local industry as well as respond to regional industrial demands. Faculty could tailor curriculums to meet local business needs, develop on-campus entrepreneurial incubators for students and recent graduates, and provide on-campus job training.

The third pillar should be to reinvigorate the private sector to improve job quality and quantity. The government should empower small and medium enterprises by easing access to finance and lightening regulatory burdens in starting and pursuing business ideas. For example, entrepreneurs looking to create a business on an online or mobile platform are currently limited to the domestic market because Tunisians are restricted from holding foreign currencies.

Public-private partnerships could also encourage new business initiatives and foreign investment. Tunisia has succeeded in the past with similar ventures to extract phosphates and build infrastructure.

The new Tunisia, unshackled from a corrupt regime, has a potent new opportunity to use its educational and demographic strengths to explore inclusive, market-led industrial growth. But before this tale of two regions can be rewritten, there is work to be done. Improving access to capital and lowering the barriers to entrepreneurship are critical reforms that would make Tunisia more attractive to foreign investment, which is the cornerstone of industrial growth. GG

Microcredit: the tarnished Nobel medal

Grameen Bank's microcredit model has earned prestigious plaudits. But did it reduce poverty and create profitable businesses?

Poor returns

by Ivo Vegter

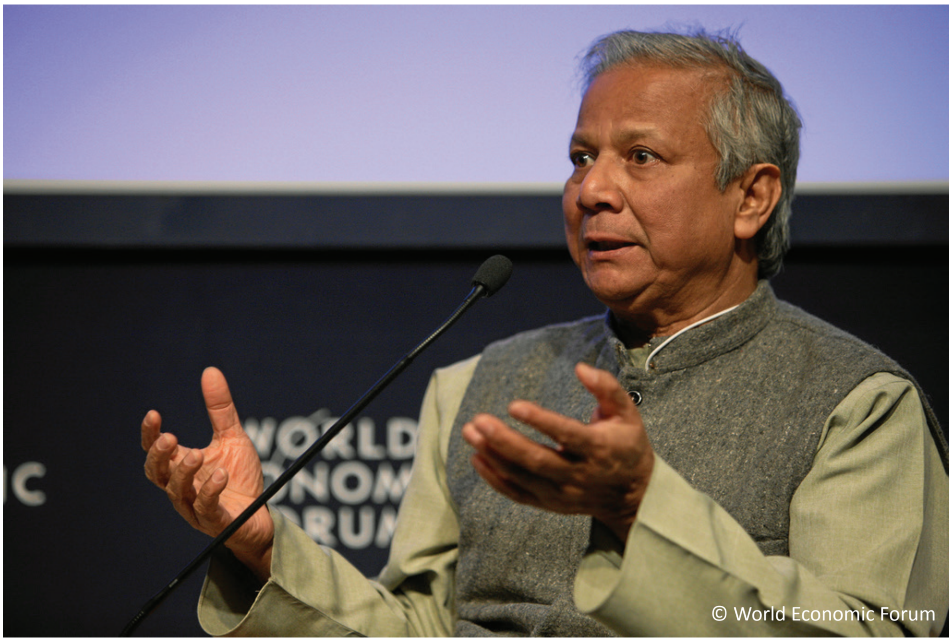
"Poverty will be eradicated in a generation. Our children will have to go to a 'poverty museum' to see what all the fuss was about."

Thus declared Muhammad Yunus, a professor in rural economics at Chittagong University in south-eastern Bangladesh, when he pioneered a new credit model for the poor in a nearby village, Jobra, in the late 1970s. He called it the Grameen Bank Project, a name derived from the Bengali word for "rural village".

Thirty years later the Nobel committee awarded its 2006 peace prize to Mr Yunus and his bank. The citation recognised that "loans to poor people without any financial security had appeared to be an impossible idea", but that Mr Yunus had "developed microcredit into an ever more important instrument in the struggle against poverty".

Grameen sidestepped traditional credit models, which considered it imprudent to extend small loans to the poor because they lack reliable income and assets as collateral. The only recourse for poor borrowers had been moneylenders who charged high fees and interest rates to justify the high risk of non-repayment.

Mr Yunus wanted to eliminate this perceived exploitation and break the vicious



Muhammad Yunus: alms up

cycle that low income and low savings implied low investment. He built his concept on the notion that the poor possess skills that can be capitalised. His project sought promising borrowers who had no financial means but would have the potential to generate income through self-employment.

Grameen would issue simple loans at very low rates. Risk was reduced by selecting groups of borrowers and making them jointly liable to meet their repayment commitments. The hope was that borrower groups in this collectivist model would exert peer pressure to encourage productive use of loans and reduce default risk. This would lower institutional lending costs and interest to borrowers.

The bank explicitly pitched itself as a way of “bringing capitalism down to the poor”, according to Milford Bateman, an independent development consultant. This approach secured it lavish support from the international development community, he wrote in *Le Monde Diplomatique* in November 2012. Led by the Ford Foundation, funders were lining up to back what appeared to be a credible alternative in the small-scale development finance sector.

By 1996 the bank had issued $1.7 billion in loans to 434,000 groups comprising more than 2m individuals, 94% of whom were women, according to the bank. It boasted repayment rates of 98%. It made a modest profit of $460,000 that year.

This seemed to be a fairy tale come true. By the late 1990s the microcredit model was the most high-profile and well-funded of all international development policies, according to Mr Bateman.

Shahidur Khandker, lead economist at the World Bank’s rural development team, found Grameen-style microcredit effective in reducing poverty among people who can become self-employed, and more cost-effective than other anti-poverty projects.

Not everyone agreed, however. As early as 1995, the libertarian economist Jeffrey Tucker described microcredit as a cult. “A closer look...shows the movement to be financially dangerous, subtly coercive, and, in its most famous case, an enemy to children and families,” he wrote in an editorial for *The Free Market*, a publication of the Ludwig von Mises Institute, a US-based think-tank.

He noted the strong social pressure and indoctrination that the bank imposes on its mostly female borrowers, including vows to maintain small families, “emancipate” themselves from traditional marriage obligations, engage in subsistence farming and collectively participate in physical training exercises and parades.

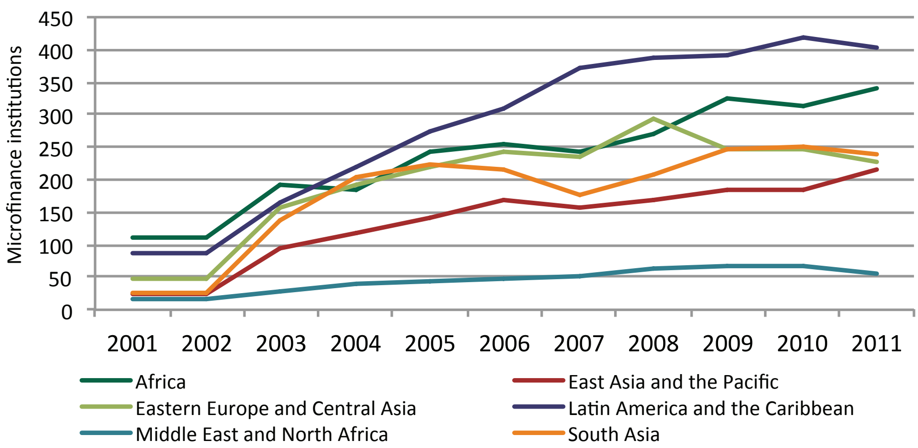
Jonathan Morduch, while a lecturer at Princeton University, published a paper in 1999 on the Grameen Bank in the *Journal for Development Economics*. Despite reporting a profit, the bank is extensively subsidised, Mr Morduch found. At first, mostly international donor organisations backed the bank, but later, guaranteed Bangladeshi central bank bonds and soft loans from developed countries funded Grameen. Between 1985 and 1996, subsidies amounted to $175m, compared to a cumulative profit of less than $1.5m.

Although it is not dishonest to declare a profit after receiving subventions, Mr Morduch also revealed that the bank’s profitability in some years is an artefact of accounting methods that "do not conform strictly to international accounting standards". The bank remains "constrained by high expenses per unit transacted and relies on the generosity of donors and socially-conscious investors", he wrote. "Microfinance programmes that target the poorest borrowers generate revenues sufficient to cover just 70% of their full cost."

The Grameen model is not financially sustainable, argued Jacob Yaron, a World Bank research economist, in a 2004 paper for the bank's journal, *Research Observer*. "Because of high risks, heavy transaction costs, and mounting loan losses, many of the programmes have drained state resources to little purpose, reaching only a small part of the rural population and making little progress towards self-sustainability," he wrote.

The Grameen Bank itself recognised the problem, according to Mr Bateman. World Bank indicators show that poverty rates in Bangladesh continued to rise, from 36% in 1995 to 45% in 2004. In 2002 the bank launched Grameen II, which sought to add revenue-generating product lines such as deposit services and more flexible business loans to the core microlending business, but also increased credit costs for borrowers.

Micro: the big picture



Source: Microfinance Information Exchange

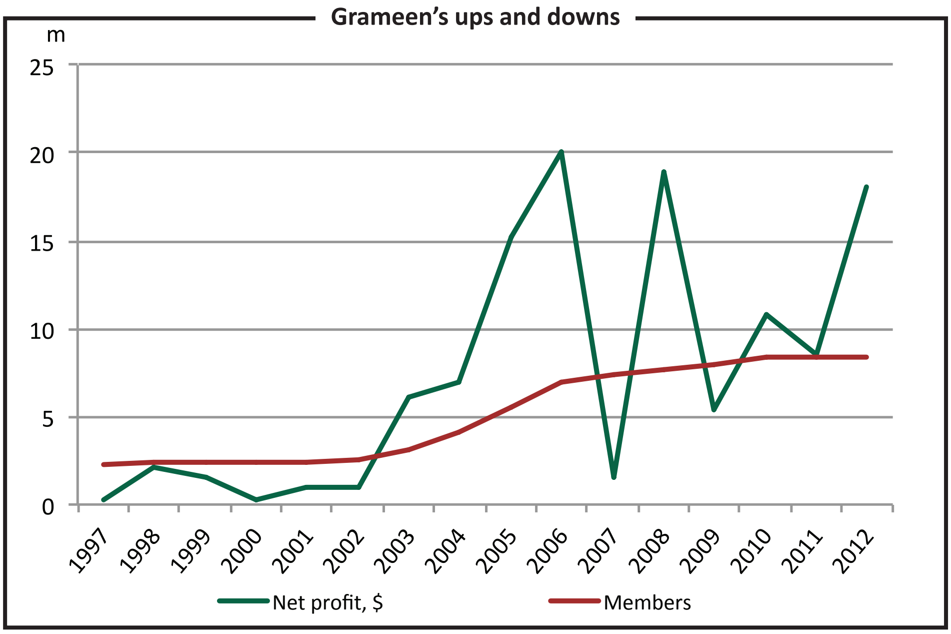
Awarding the Nobel Peace Prize in 2006 to Mr Yunus and Grameen Bank varnished over the cracks in the microcredit story. The international donor community loved the "non-state, self-help, fiscally responsible and individual entrepreneurship angles", Mr Bateman said.

Replication was the order of the day, with more than 3,000 imitations globally, and wide popularity among development finance theorists, wrote Naiefa Rashied of the University of Johannesburg's economics department in a 2010 piece in the *African Finance Journal*.

Despite its perceived success, the varnish crackled. For example, a 2008 Kellogg School of Management study found that the Grameen model had failed in South Africa. The analysis blamed laws that imposed affordability criteria on banks and lenders and therefore limited credit to borrowers who were formally employed. In addition, the dominant, protected and inefficient formal banking sector had little reason to seek new markets among the unbanked poor. Furthermore, many microcredit-funded enterprises were trying to produce goods and services that were already supplied by more efficient and established businesses in the formal sector.

A major failure of the Grameen model is that it distorts risk-taking, according to a 2013 paper in the *Annual Review of Economics* by Abhijit Banerjee, an economics professor at MIT. When lenders targeting the poor do not have an explicit charitable mission, or foreign donors or soft loans subsidise their lending capital, they operate in a low-risk environment protected by collective liability and garnishee orders (which require an employer to pay debt instalments directly to creditors on behalf of employees). Such market distortions insulate lenders from the financial risks their borrowers take.

By 2009, Grameen Bank averaged over $10m in annual profit and served 8m people in 1.25m groups with loans totalling $8.7 billion. Profit remains volatile. In 2012 the bank reported $18.3m net profit, up from $8.6m in 2011. Membership growth has slowed, with 8.5m members in 1.32m groups reported in December 2013.



Source: Grameen Bank

In Mr Bateman's analysis, the failure of microcredit to alleviate poverty lies deeper than mere questions about financial sustainability. By dominating scarce resources to "churn out rafts of largely unsustainable and no-growth informal micro-enterprises and self-employment ventures", microcredit crowds out ventures that really have the potential to innovate, scale efficiently and integrate into the economy.

In essence, the effect of Grameen-style microcredit is exactly the same as a small-business subsidy system. It creates what Mr Bateman calls a "hot-house" that benefits inefficient businesses that replicate existing ideas at the competitive expense of true entrepreneurs that grow the economy.

But Mr Bateman goes further, attacking the kinds of enterprises that are favoured, such as subsistence farming and basic crafts, rather than broader commercial and manufacturing industries. "Essentially, the problem is that the microcredit movement has built into the local financial system an 'adverse selection' bias, one that had inevitably led on everywhere to the gradual primitivisation, de-industrialisation and informalisation (sic) of the local economy," he wrote. "In turn, this can only lead to the local community's further descent into generalised poverty and underdevelopment."

The uncritical replication of these microcredit policies has created widespread social and economic problems.

Mr Bateman is scathing about the failure of microcredit in South Africa. He argues that it has been the primary driver of household over-indebtedness. Nearly half of the country's 19m credit-active consumers have impaired credit records. Another 15% are "debt-stressed", or have missed one or two payments without being reported to the credit bureau. This means that nearly 65% of all credit-active consumers are over-indebted.

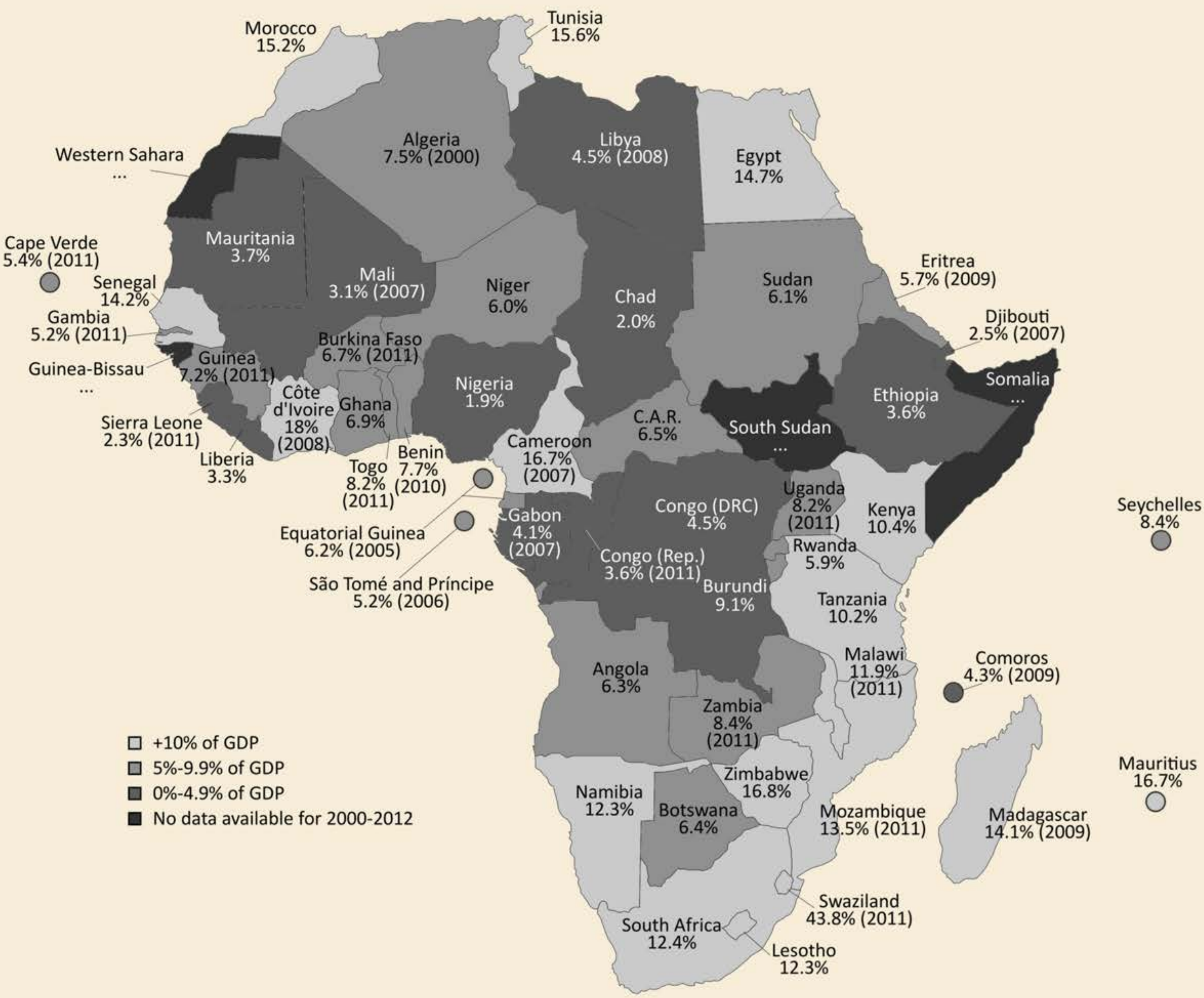
Another, more important factor, lies with institutions that rely on salaries as collateral, through garnishee orders. Nearly 95% of all so-called microcredit is little more than a salary-advance scheme, wrote Iniobong Akpan in his 2005 masters in commerce thesis for South Africa's Rhodes University.

The uncritical replication of these microcredit policies has created widespread social and economic problems. For example, over-indebtedness, and the sentiment among workers that employers were collaborating with microlenders who instituted onerous garnishee orders, were widely reported to have contributed to the labour unrest that culminated in the police massacre of 34 striking workers at the Lonmin platinum mine in Marikana, South Africa in August 2012.

At the outset, Mr Yunus wanted to address traditional lenders' exploitation of the poor. The problem is not only that this practice has now been cloaked in the Nobel-sanctified mantle of Grameen, but that it is far from clear that the Grameen model actually works, either for the lender or the borrowers.

More than three decades later, there is no evidence of a link between the Grameen Bank and the Bangladeshi poverty rate. The sustainability of this microcredit model for lenders is doubtful, without the help of subsidies. While anecdotal success stories exist, the broader impact on poor borrowers is variable.

Grameen survives largely through subsidies and grants, borrower indoctrination and by spreading default risk to rural communities. This results in gambles that are either too high or too low. Its returns are primitive, unproductive or failed businesses. And despite Mr Yunus's confident prediction a generation ago, we do not need to visit a museum to see poverty. GG



Made in Africa

Source: World Bank
Manufacturing as % of GDP, 2012 unless otherwise indicated

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