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Special Economic Zones (SEZ): Will they unlock the AfCFTA potential?

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This article examines the potential of the special economic zones model in the developing African business scene. Following a brief overview, the report examines the impact of the COVID-19 pandemic and other barriers facing African SEZs. It then explores the potential for AfCFTA to accelerate the success of the trend. The article concludes by identifying some of the opportunities this scenario offers to stakeholders across the continent's major industry sectors.

Overview: SEZ's in Africa

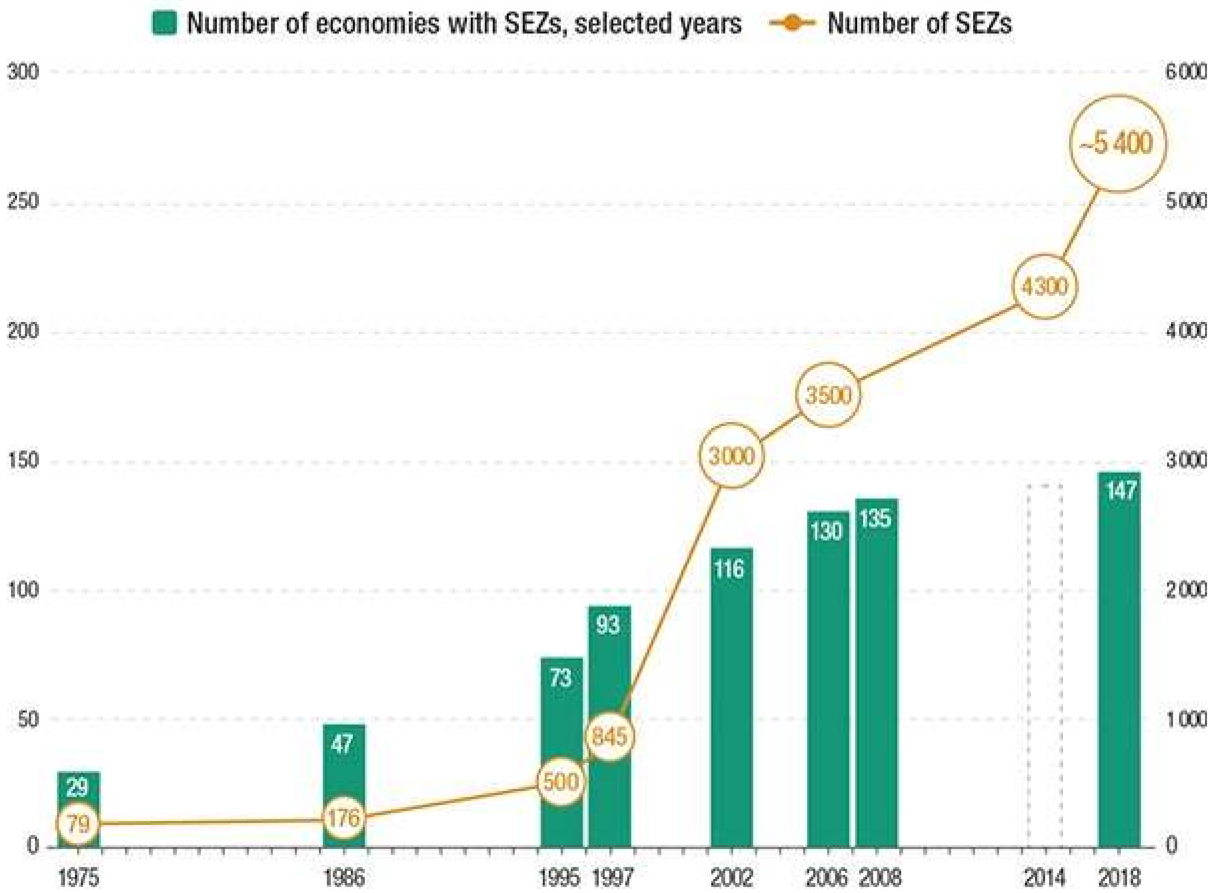
African countries have long sought to replicate East Asia's industrial success with special economic zones (SEZs). The target is to offer fiscal and regulatory incentives to increase industrial activity. Some governments also provide enhanced infrastructure within these delimited geographic zones.

Since their adoption in the 1970s, SEZs significantly boosted foreign direct inflows (FDI) flows into the continent, which stood at US$45 billion in 2019.[1]

These SEZs created direct and indirect jobs in the large construction, manufacturing, mining and utility sectors. They also generated jobs in supply chains across highly skilled sectors such as telecommunications and digital products. To date, SEZs created an estimated 60 million jobs on the continent.[2] In their latest World Investment Report, the United Nations Conference on Trade and Development (UNCTAD) lists over 5,350 active SEZs in over 140 economies, with slightly over 200 in Africa (Chart 1).[3] Kenya (61), Nigeria (38), Ethiopia (18) and Egypt (10) are among the leading four countries with the most SEZs according to the report (Chart 2).[4]

The term SEZ embraces a wide range of business models and activities. The simplest are geographic zones that facilitate cross-border business activities, such as export processing, bonded warehouses, and free-trade zones. Some SEZs host multiple tenants, while others serve only one anchor tenant. While SEZs may be privately or publicly owned, the current trend is toward mixed public-private ownership. The success of an SEZ depends on many factors. According to Teo Eng Cheong, CEO International for the Surbana group, the first success factor is alignment to clear objectives; another is a good fit between the location and the economic activity within the special zone. Some SEZs focus on creating jobs. Others promote exports to generate foreign reserves, develop specific industries, or seek technology transfer. As one SEZ cannot simultaneously fulfil every one of these objectives, it is critical to identify the critical success factors and align SEZ capabilities and incentive programmes to reach those targets.

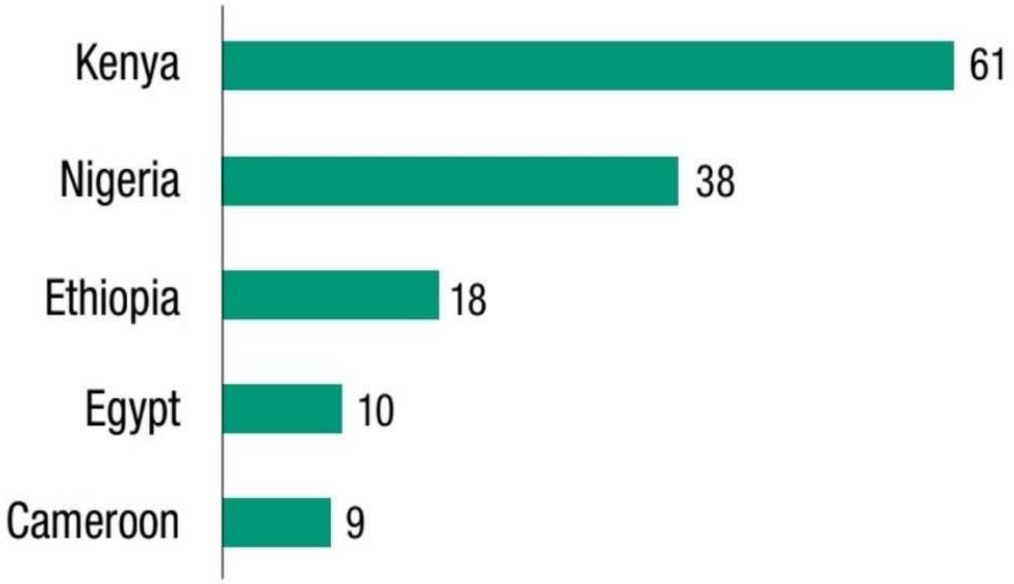
Chart 1: Historical Trend in SEZs (Number of Countries and SEZs)



Source: UNCTAD

In many African countries, SEZs account for a significant share of country FDI. For example, it is 21% and 10% in South Africa and Kenya, respectively.[5] In terms of success, African SEZs stand out globally. In their latest FDI Global Free Zones of the Year 2020 ranking[6], two African SEZs feature in the top 10; the Tangier Med Zones (Morocco) and Freeport (Mauritius). The Tangier Med Zones - established in 1999 and covering 2,000 hectares - rose to second place from fifth in the 2019 ranking. This is the first time an African zone scored that high in the FDI ranking. The entire complex generated US$10 billion worth of exports in 2019, up 10.9% from a year earlier, according to company figures. It plays host to about 1,000 export-oriented firms employing some 90,000 people by the end of 2019.

Chart 2: Africa: Economies with the most SEZ's, 2019



Source: UNCTAD

Many African countries sought to position the SEZ model as a critical element of their industrial policy. Unfortunately, the results are mixed, with few outright successes other than Mauritius. Aside from partial successes by Kenya, Madagascar, and Lesotho, few African zones could attract significant investment, promote exports, and create sustainable employment.[7]

Most SEZs faced both policy and operational barriers. At the policy level, many were confronted with distorted incentives, conflicts of interest among host governments and investors, and political instability. At the operational level, emergent issues included a tendency to focus on short-term gains, weak infrastructure, improper use of the zones, and environmental management failures.

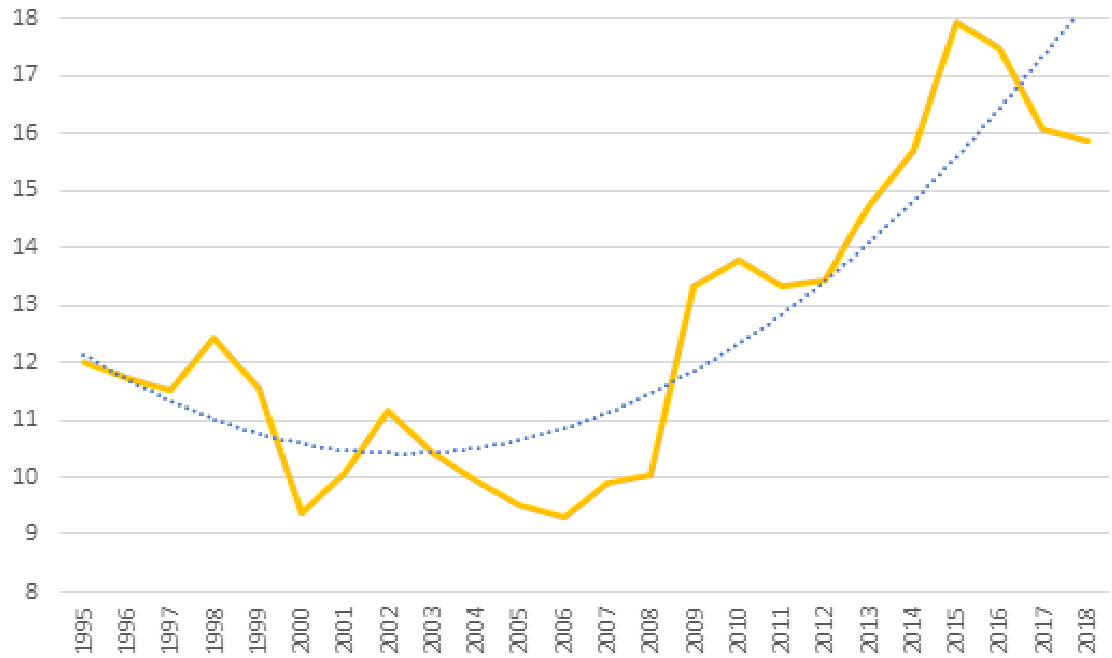
Challenges: Covid-19 and other Obstacles

The Covid-19 pandemic compounded these challenges in the African SEZ sector. Many of the government measures aimed to tackle the spread of the virus hurt the performance of SEZs. For example, moves to enforce social distancing unfortunately soon led to slowdowns of the zones' production lines. Production processes were heavily shaken by widespread supply chain disruptions, which resulted in inconsistent flows of intermediate materials to later manufacturing stages. Similarly, consumption expenditures and demand declined significantly, as did the appetite of financiers to invest in the troubled foreign corporate sectors.

The World Trade Organisation (WTO) predicted the fall in world trade of 13-32% in 2020[8], translating into considerable losses to the sub-sector. The estimated loss of export earnings for the African continent in 2020 will stand at more than US$500 billion. The International Monetary Fund's (IMF) World Economic Outlook Database estimates that Africa's exports represent only about 2.6% of total world exports in 2018. The continent will bear the brunt of the losses.

Furthermore, the usual obstacles of trade barriers still bedevil the sub-sector. African businesses often face higher tariffs to export within Africa than when exporting abroad. The African Union puts the average tariff of 6.1%. It is therefore unsurprising that intra-Africa trade remains limited at 15% of Africa's total trade. Thus, the intra-regional value chain is fragile compared to Asia, where it stands at 80% (Chart 3). This is partly why Africa SEZs provide low returns - return on investment dropped from 11.9% in 2010 to 6.5% in 2018, according to the World Investment Report (2019).

Chart 3: Intra-Regional Merchandise Trade, Africa, 1995-2018 (% of Total Trade)



Source: UNCTADStat

The recovery of the global economy from the impact of the Covid-19 pandemic will bring new hope. Africa's economy shrank by 2.1% in 2020, while 3.4% growth is projected for 2021.[9] Despite early worries about the potential spread of the virus, Africa avoided the severe initial outbreaks seen elsewhere in the world. Notwithstanding structural vulnerabilities and commodity dependence, recent macroeconomic indicators reveal a relatively stable growth path compared to other developing regions. Another positive development is the advent of regional cooperation via the Africa Continental Free Trade Area (AfCFTA). This treaty can support regional trade and FDI and serve as a platform for regionally coordinated responses to a crisis.

What is AfCFTA?

The AfCFTA is a flagship project of the African Union blueprint and Master plan - Agenda 2063 "The Africa We Want". Signed during the Golden Jubilee of May 2013, the pact covers 50 years: 2013 to 2063. The trade pact aims to boost intra-African trade through a comprehensive and mutually beneficial trade agreement among the member states. The deal covers trade in goods and services, investment, intellectual property rights and competition policy. It builds on and embraces the successes of the Regional Economic Communities (RECs). In 2018, the AfCFTA Establishment agreement was signed in Rwanda by 44 Heads of State and Government of the 55 African Union (AU) Member States[10] and officially came into effect in January of 2021.[11]

AfCFTA has the potential to be a crucial ingredient in lifting people out of poverty and invigorating Africa's growth trajectory. Trade reforms will raise the competitiveness of African micro, small and medium-sized enterprises (MSMEs). These measures will facilitate job creation and attract investment. A new World Bank report envisions the fully implemented trade pact as speeding wage growth for women and boosting regional income by 7% (US$450 billion). The Bank sees AfCFTA lifting 30 million people out of extreme poverty by 2035.[12]

Continent-wide tariff liberalisation accompanied by reduced non-tariff barriers—such as quotas and rules of origin— is expected to boost income by 2.4%, or about US$153 billion. Trade-facilitation will provide another US$292 billion. These measures include reduced red tape, lower compliance costs for businesses engaged in trade, and the integration of African companies into global supply chains.[13]

Preliminary estimates identify other significant potential gains from structural reform. These include strengthening Africa's bargaining power in international trade negotiations, the sustainable increase in its share of global trade, and the emergence of strong regional value chains and their integration into global value chains. Such gains would enhance the continent's integration into the global economy, in which manufactured goods primarily dominate trade with increasing technological content. The trade pact is expected to increase intra-African trade by 52.3%.[14] Some expect its implementation to promote industrialisation and double intra-African trade by 2022 and to require a more extensive and more sophisticated range of investments.

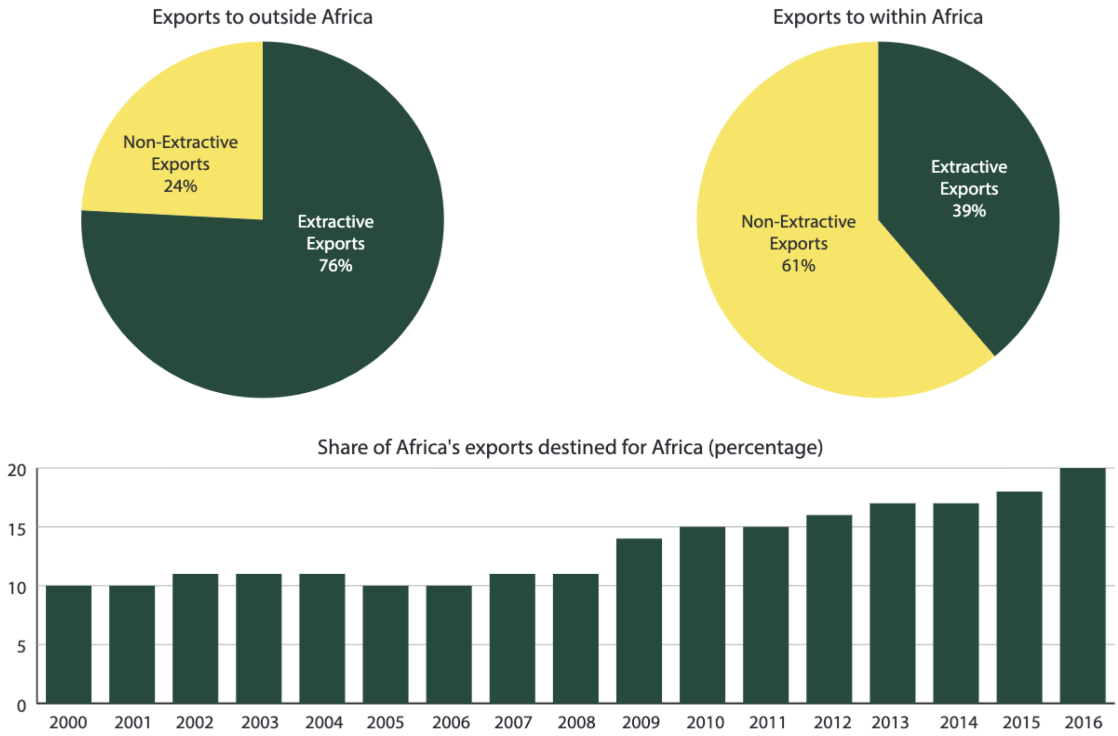
Why SEZs are crucial to fulfilling the AfCFTA dream

The trade pact covers many SEZ-linked issues: duty-free treatment of goods, rules of origin, trade facilitation, customs cooperation, Non-Tariff Barriers (NTBs), legal framework harmonisation, and compliance with international standards. These provisions place African SEZs right in the middle of the AfCFTA's mission. They will unleash both commercial opportunities and competitive pressures. The AfCFTA will stimulate increased domestic investment and FDI. This path is likely to lead to technological upgrading – a critical driver for industrialisation. For example, the growing production of non-extractive exports (Chart 4) is expected to drive industrialisation. African SEZs now have an opportunity to become key players in supplying the AfCFTA market - a market of 1.3 billion people across 55 countries with a combined gross domestic product (GDP) valued at US$3.4 trillion.[15]

Through the AfCFTA, SEZs can provide Africa with a path towards export generation, providing not only growth, but also diversification. The latter is particularly critical for Africa as it plans to diversify away from its heavy reliance on commodities export. In Sub-Saharan Africa, the proportion of manufactured goods in total exports remains low. SEZs account for nearly 10% of exports in countries such as Kenya and Ghana. Enabled by the AfCFTA, Africa's manufacturing output is expected to double to US$1 trillion, creating 14 million jobs by 2025.[16]

The move to AfCFTA worries some actors, who fear that unfair competition may result from goods produced at low cost in African SEZs then traded under AfCFTA preferential treatment. However, AfCFTA proponents point out that excluding goods produced in SEZs will reduce the effectiveness and efficiency of the AfCFTA. The African Union asked UNCTAD to look into this issue. The resulting 2018 UNCTAD paper points out that as SEZs are no longer restricted to geographic enclaves, attempting to use rules of origin as a tool to avoid unfair competition is likely to be "ineffective and counterproductive."[17]

Chart 4: Growing production of non-extractive exports, Africa



Source: IMF, Credit: IMF[18]

The Covid-19 crisis and its resulting impact on global value chains mean that inter-regional sourcing will be crucial. The plan to invigorate local supply chains and individual economies gives SEZs opportunities to build their local supply chains. African producers source only 13% of their inputs regionally, compared with 22% in Southeast Asia. Furthermore, the trade pact breathes new life to many marginal SEZ programs that were underutilised even before the pandemic and bound to fail. Moreover, AfCFTA could also unlock more FDI into the continent, especially in the manufacturing and services sectors. The elimination of tariffs under the Agreement could support market-seeking FDI. Regional integration also means foreign investors targeting value addition to local commodities and natural resources, as well as increased intra-African investment, will become interested as major economies on the continent seek a first-mover advantage.

Action: Unlocking Financing for AfCFTA

Selecting from the myriad possibilities presented by AfCFTA requires shifting the focus to financing. The key sources of finance are either public or private. The latter is either domestic or FDI and includes investment from commercial firms and venture capital funds. Private sources bring essential advantages, such as combining liquidity and risk appetite and providing significant expertise. One vital alternative source is capital markets. To date, there has been little use of either equity or bonds to finance SEZ development in domestic or international capital markets. However, both are possible sources of finance. SEZs can explore this capital source to unlock their potential.

For example, it is possible to create and list a private company on a local stock exchange to own or manage SEZ infrastructure and operations. Such a listing would raise funds through a primary issuance on a stock exchange, supplemented through bank loans or local bond issuances. Success in launching such a project would depend on factors such as the development of a credible business plan, appropriate levels of return and adequate liquidity in local markets. International capital markets have deep investor bases, including ‘frontier market’ investors with a relatively high appetite for risk.

One key advantage of seeking finance from international markets is their high liquidity levels. They also may provide, depending on the deal structure, access to management expertise and technology transfer. In most African domestic capital markets, a shallow investor base often limits liquidity. However, smaller issuances –below US$10 million – of bonds or shares may attract domestic investors. Such issuances would also be more likely to be in a local currency, avoiding the issues of hard currency exchange risk and providing a lower yield than that expected by international investors.

What also helps the AfCFTA case is that some international investors are now distancing themselves from the conservative view of African transactions as “high risk,” to be compared only with high-yielding US dollar or euro investments. These investors have yet to be satisfied by the meagre yields available in European and US markets in recent years. Furthermore, liquid assets remain highly volatile. PwC expects the value of assets held worldwide by pension funds, insurance companies, sovereign wealth funds, and high-net-worth individuals to rise from US$115 trillion in 2012 to US$195 trillion by 2020.[19]

The data supports this change of perception. In 2016, Moody’s released a report showing that the rate of project-finance defaults in Africa between 1983 and 2015 was the second-lowest in the world at just 2.7%.[20] As a result, the idea of investing in Africa with more conservative instruments, rather than through “high risk, high return” private-equity deals is gradually gaining ground. The potential for funds to invest in Africa is enormous.

Opportunities within the SEZ sector

The SEZ model evolves as the continent develops. Some governments now extend favourable fiscal and regulatory incentives beyond the boundaries of the original enclaves. New opportunities arise as SEZs moves beyond the original model based on providing infrastructure within enclaves. Although manufacturing continues to play a leading role, construction and trade are in hot pursuit.

Value-added Manufacturing: most African SEZs now focus on manufacturing and exports in low-skill, labour-intensive industries such as garments and textiles. However, diverse and higher value-added sectors offer new opportunities. The AfCFTA aims to open markets to a new world of investors keen to value-add in SEZs. The target industries include automotive assembly and components, chemicals and petrochemicals, construction and building materials, readymade garments, agribusiness, and food processing.

A good example is the Kigali Special Economic Zones (Rwanda). Opened in 2013, this SEZ hosts a variety of domestic and foreign firms operating in different sectors.[21] By 2016, it employed around 2% of the country’s labour force and managed to increase and diversify its exports substantially. The Suez Canal Economic Zone in Egypt is another success story.[22] This SEZ offers investment opportunities across a range of economic sectors. These include logistics, ICT, renewable energy, business parks and real estate developments, infrastructure services and transport links. Others, aiming to attract investors to downstream processing industries, linked SEZs to natural resource endowments. This served to diversify export profiles skewed towards unprocessed resources. For example, Nigeria established several special zones focused on oil refining.

Construction opportunities: FDI in SEZ development is on the rise. According to the UNCTAD World Investment Report (2019), 51 ongoing SEZs projects in Africa are under development, with a further 53 in the pipeline. For investors, this provides opportunities to help establish SEZs within the continent. Chinese companies, such as Holley Group and Yantian Port Group, actively participate in SEZ construction and are active across Africa. There are increasing opportunities for other developers and investors to participate.

Financing African trade: trade finance is a lubricant without which opportunities for growth and development fade away. The lack of availability of this resource could jeopardise the AfCFTA deal. According to the Africa Development Bank's (AfDB) survey, *Trade Finance in Africa: Overcoming Challenges,* it showed that although banks currently support one-third of Africa's trade, the annual trade finance gap exceeds US$ 90 billion.[23]

This survey reveals that only 20% of bank-intermediated trade finance was devoted to intra-African trade in 2014. This low participation is despite trade finance being a relatively low-risk activity. For commercial banks in Africa, the survey estimated a default rate on trade finance transactions in 2011 and 2014 at 4 and 5%, respectively, compared to 9 and 12% Non-Performing Loan (NPL) ratios for all bank asset classes. SEZs need adequate trade finance to reach their potential. This gap thus presents enormous opportunities for private investors.

Conclusion

Creation of the vast AfCFTA regional market is a significant opportunity to help African countries diversify their exports, accelerate growth, and attract FDI through SEZs. The landmark trade deal will foster the transformation of African economic geography with new cross-border linkages within the continent and the global economy. It provides a unique opportunity for countries in the region to competitively integrate into the global economy, reduce poverty, and promote inclusion. Many SEZs played vital roles in structural transformation by promoting broader participation in regional value chains and catalysing industrial upgrading.

Of course, challenges remain. It is well known that infrastructure deficits and the fragmentation of supply chains constrain many African countries. Africa thus needs to progress much faster in developing its core infrastructure. Cross-regional corridors and urban infrastructure projects are necessary to play a catalytic role in Africa's transformation and regional integration. Perhaps, to reverse this pattern, a massive and strategic investment in connectivity and infrastructure is essential. Besides, harmonising regulations related to different countries and sub-regional blocks is needed to strengthen the trade pact.

It is fair to tout the AfCFTA as an economic and globalisation game-changer and view the SEZ as its engine. SEZs represent a potential opportunity to accelerate early-stage industrialisation in Africa. Economies of scale and competitiveness gains associated with the reform could accelerate industrialisation in Africa and diversification of its sources of growth, which could lift its living standards closer to those in high-income countries.

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