African Development Bank Group

FUNDING AND FINANCING FREE AND ECONOMIC ZONES IN AFRICA AND THE ROLE OF THE AFRICAN DEVELOPMENT BANK

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Introduction

- Free and economic zones, sometimes collectively called Special Economic Zones (SEZs), are expected to play critical roles in the sustainable socio-economic development of any country.
- Their objectives include, but not limited to, employment generation, promotion of export-oriented growth, facilitation of the attraction of foreign direct investment, integration of local firms into global value chains, lowering transaction costs for FDI activities, kick-starting industrial sectors and the promotion of technology transfer to local economies, increasing the ease of doing business and streamlining administrative procedures (including the time required to set up operations), and contributing to the improvement of the overall investment environment.
- It is against this background that recent estimates indicate that there are over 4,800 SEZs globally and still counting.

What Does the Record of Free and Economic Zones Show?

- In spite of the above anticipated advantages, with the exception of a few (particularly in South East Asia and Europe), SEZs' successes have been mixed. The same applies to China's financing of some economic and trade zones in some countries in Africa.
- A number of reasons have recently been advanced for some of the poor results:
  - First, a number of traditional export processing zones have been successful in attracting investment and creating employment in the short term but became uncompetitive when wages started to rise, or trade preferences disappeared (UNCTAD, 2018).
  - Second, in many cases, the cost of investments in zone infrastructure and maintenance outweigh the benefits.
  - Third, some investors take advantage of tax breaks without delivering substantial employment, export earnings, technology transfer or domestic skills upgrade.
  - Fourth, many African countries lack the requisite success factors, including strong commitment and pragmatism from the top leadership; preferential policies and broad institutional autonomy; staunch support and proactive participation of governments, especially in the areas of public goods and externalities; public-private partnerships; huge foreign direct investment and large investment from the diaspora; business value chains and social networks; and continuous technology learning and upgrading (Zeng, 2010).
  - These are further compounded by issues of corruption, poor governance at various levels of government in the continent, flawed concept, poor coordination, and bad project management.
  - In addition, the modernization of SEZs has been necessitated by the fact that SEZs today operate in an ever more challenging environment as a result of the new industrial revolution (NIR), driven largely by technology (especially ICT, including the rise of e-commerce, artificial intelligence (AI) and robotics).
- Thus, these zones will need to rethink their competitive advantages since the importance of traditional locational advantages are eroding just as they need to pursue business activities in a more socially and environmentally responsible manner that advances the Sustainable Development Goals (SDGs).
- In general, in Africa, however, developing innovative financing will be critical to the development of SEZs and executing specific projects within them.

Some Innovative Financing Sources for Funding Projects in Free and Economic Zones in Africa

➢ Impetus from the State of External Inflows

- Over the last decade, the flow of external financing to Africa—an important supplement to fiscal revenues—has increased and the relative importance of its components has changed. Private capital flows to Africa—driven by investment from the BRICS (Brazil, Russia, India, China and South Africa) countries and portfolio flows—as well as remittances have overtaken aid flows.
- The trend of falling ODA to Africa, especially the bilateral component, is expected to continue in the near term. This is particularly severe for fragile states and the lowest income countries in the Continent which are highly dependent upon official assistance.
- These factors have combined to give a new impetus to find ways and means of increasing resource mobilization in Africa to effectively and sustainably bridge the persistent development-financing gap, including for funding SEZs projects.
- We therefore need to start looking at aid as complementary and catalytic to new sources of development finance in general and funding projects in free and economic zones in particular.

Source: Authors, using UNCTADStat Data.

Key Investment Drivers and Considerations

- But before looking at these financing sources, it is important to note that pre-feasibility assessments and full feasibility studies/master plans not only to determine the requirements, but also the costs (direct and indirect), expected opportunities and benefits (direct and indirect) are imperative.
- Direct costs are likely to include those for land acquisition, land development, real estate development, and infrastructure provision while indirect costs may include training/capacity development, and exposure to latest knowledge and skills.
- On the other hand, direct benefits may include better physical and social infrastructure (energy/power, water and sanitation, ICT, sewerage, gas, drainage, street lighting, firefighting, and transport (roads, railways, airports, waterways), recreation facilities, health care facilities and shopping centers etc)), fiscal incentives, VAT suspension, and other non-fiscal incentives (including good legal and regulatory frameworks, and other support and specialized infrastructure) while indirect benefits may comprise of employment creation, skills acquisition and upgrading, foreign exchange earnings, technology transfer, technical expertise development, and quicker goods and services handling.
- In essence, the key drivers of investments in projects in free and economic zones will be consumer demand, financial viability (IRR and ERR), including ROE, financial sustainability, and development impact.
- Adopting a “holistic” or “one-stop-shop”, especially for Staple Crop Processing Zones (SCPZs) will also be an important consideration before committing resources.
- Another important consideration is that of adopting an approach is private sector led but government enabled.

Key Innovative Sources of Finance for Funding Projects in Free and Economic Zones in Africa

Innovative Government Financing Instruments

- **Transforming Africa's "Inherited Natural Wealth into Created Wealth"**
  - **Taxing rents through negotiation and legislation seems more effective than government ownership**
  - **A tax regime that raises revenue without discouraging private sector participation should be encouraged.**
- **Resource-backed financing**
- **Tapping carbon finance markets**
- **Commodity-linked debt instruments**
- ***Bringing the Informal Sector into the Tax Net***
  - **Ghana's Identifiable Grouping Taxation (IGT) scheme,**
  - **Algeria's presumptive tax for the mainly informal entrepreneurs, and**
  - **Zambia's flat-rate 'base tax' for rural areas, 'peddler's licence' for street sellers, and 'presumptive taxation' of 3 percent on gross income for urban areas.**
- ***Government infrastructure bonds***
- ***Private sector Local currency infrastructure bonds***
- **The use of Sovereign Wealth Funds (SWFs) (Local and Foreign)**
  - The global Sovereign Wealth Funds (SWFs) currently control an aggregate of approximately US$8.00trillion in assets under management (AUM).

Key Innovative Sources of Finance for Funding Projects in Free and Economic Zones in Africa (contd.)

Innovative Private Financing Instruments

- **Public-Private Partnerships**
  - In order for this to be successful, governments need to: make PPP-friendly policies and regulations; develop market instruments and capacity to meet long-term equity and debt financing needed by projects; develop credible, bankable projects, which could be offered for financing to the private sector companies and the banking system; and develop the capacity in public institutions and officials to efficiently manage the PPP process so as to maximize returns to all shareholders. Indeed, good private sector investors are looking for clarity and consistency in policies and regulations, and projects to commit their resources, especially in Africa where investment returns are about the highest globally.
- ***Specialized free and economic zones and infrastructure funds***
- ***Incentivizing Private investment***
- ***Private equity funds***
- ***Corporate bonds***
  - South Africa's private sector has been able to tap local capital markets to finance infrastructure projects in water, transportation, and power. The country's capital markets are well developed and long-term credit is available, as well as expertise to arrange more complex transactions such as the EUR 2.5 billion Gautrain project.
- ***Mobilizing other domestic resources***
  - Removing exemptions and strengthening tax administration would increase public tax revenues. In African countries, where large informal sectors impede effective direct taxation, excises, value-added taxes, and other indirect taxes can be relied upon.
- ***Tackling sector-specific inefficiencies***
  - Governments need to provide incentives to reduce market inefficiencies - planning for timely delivery of projects to avoid costly emergency measures, maintenance of existing infrastructure to limit expensive rehabilitation, improving efficiency of utilities, and strengthening medium-term expenditure frameworks, accounting frameworks and auditing procedures.

Key Innovative Sources of Finance for Funding Projects in Free and Economic Zones in Africa (contd.)

Unlocking Value from Foreign Financing

- ***Use of diaspora bonds***
- ***Securitizing remittances***
- ***Transforming Foreign Direct Investment***
  - For example, the upstream and downstream linkages of FDI can be improved through increasing rather than consumption, funded in part through taxation as well as ensuring that policies to attract FDI encourage re-investment of profits.
- ***Tracking and Stopping Illicit Financial Flows***

The Role of the African Development Bank Group (AfDB Group)

- The AfDB's Ten-Year Strategy for 2013–2022, which reflects the aspirations of the entire African continent, is designed to place the Bank at the center of Africa's transformation and to improve the quality of Africa's growth.
- To support the dynamics of growth in Africa, accelerate its economic transformation, and tackle Africa's fundamental development challenges, the AfDB has adopted five major priorities, the "High 5": Light up and power Africa; Feed Africa; Industrialize Africa; Integrate Africa; and Improve quality of life for the people of Africa – all of which are aligned to the Ten-Year Strategy.
- Given that Africa has the world's most persistent infrastructure deficits – ranging from US$130b to US$170b per annum, and given the lean resources at its disposal, the Bank is seeking new and creative ways of mobilizing resources to support its regional member countries (RMCs), especially by leveraging its own resources.
- Apart from **technical assistance** and **policy advice**, the Bank Group is using its existing instruments better, while developing new ways of ensuring that a dollar invested by the Bank unlocks significantly more from other investors.
- In particular, wider use of **public-private partnerships**, **co-financing arrangements** and **risk-mitigation instruments** continue to draw in new investors.
- The Bank has introduced the use of **quasi-equity instruments**, such as subordinated loans
  - To raise the overall return on investment, and/or to enhance credit structures to acceptable risk levels.
- **Issuing of bonds in local currencies, providing guarantees, and participating in currency swaps markets**.
- The is promoting **capacity building** in RMCs to build efficient and sustainable institutions and regulatory frameworks that are robust enough to develop even the most complex projects.
- To address exchange rate risk, the Bank has developed the innovative **Currency Exchange Fund**.
  - The Fund helps investors hedge against interest rate risks associated with infrastructure financing in local currencies.

The Role of the African Development Bank Group (AfDB Group) (Contd.)

- The use of a suite of **Risk Mitigation instruments** and services.
  - An example is the provision of **guarantees** (PRG/PCG) for large infrastructure projects to cover key non-commercial risks, or sharing risks with counter-parties in order to support a financing platform which aids the creation market access to institutional investors interested in infrastructure assets.
  - *Partial Credit Guarantee (PCG)* products for debt instruments cover the payment of principal and/or interest up to a predetermined amount, and thereby assists in improving the terms of commercial market debt through longer tenured loan maturity, reduction of loan interest rate costs, increase in the loan issue amount, and/or enabling access to alternative financial markets/investors.
- The AfDB recognizes that risk mitigation is crucial for attracting SWF investments by assuaging investors' concerns over potential losses that are often significant in infrastructure projects.
  - In response to these risks, the Bank has developed a number of **risk mitigation instruments as mentioned above, including Partial Risk Guarantees (PRGs), Partial Credit Guarantees (PCGs), Political Risk Insurance (PRI), Currency Risk Coverage and Export Credit Guarantees (ECGs).**
- ***NEPAD Infrastructure Project Preparation Fund (IPPF)**:*
- ***Infrastructure Consortium for Africa***
- ***EU-Africa Partnership on Infrastructure***
- ***Programme for Infrastructure Development in Africa (PIDA**.*
- The AfDB is championed a new innovative initiative – **Africa50** - deployed to finance only transformational projects deemed a priority and show a good return.
  - With its headquarters in Casablanca, Morocco, Africa50's investor base is currently composed of twenty-seven African countries, the AfDB and two African Central Banks, with over US $850 million in committed capital.

The Role of the African Development Bank Group (AfDB Group) (Contd.)

- Just a few days ago, the African Development Bank (AfDB), the European Commission, Mariner Investment Group, LLC (Mariner), Africa50 Fund, and Mizuho International plc agreed on a landmark **Room2Run**, a $1 billion synthetic securitization corresponding to a portfolio of seasoned pan-African credit risk.
- Room2Run is the first-ever portfolio synthetic securitization between a Multilateral Development Bank (MDB) and private sector investors, pioneering the use of securitization and credit risk transfer technology to a new and previously unexplored segment of the financial markets.
- Structured as a synthetic securitization by Mizuho International, Room2Run transfers the mezzanine credit risk on a portfolio of approximately 50 loans from among AfDB's non-sovereign lending book, including power, transportation, financial sector, and manufacturing assets.
- According the AfDB President, Dr. Adewumi Adesina, "Room2Run gives us fresh resources to invest in the projects Africans need most". According to him, Room2Run provides the capacity to address Africa's persistent infrastructure finance gaps.
- Thus, with respect to Room2Run, AfDB has committed to redeploy the freed-up capital into renewable energy projects in Sub-Saharan Africa, including projects in low income and fragile countries.

The Role of the African Development Bank Group (AfDB Group) (Contd.)

- With respect to free and economic zones, it is important to note that the AfDB is placing special emphasis in supporting its RMCs in establishing **Staple Crop Processing Zones (SCPZs)** and holding a series of workshops/seminars and producing relevant supporting knowledge products.
- Specifically, the AfDB is targeting the development of agro-based special economic zones as the backbone for Africa's agro-industrialization, through Staple Crops Processing Zones (SCPZs).
- SCPZs are agro-based spatial development initiatives designed to concentrate agro-processing activities within areas of high agricultural potential to boost productivity and integrate production, processing and marketing.
- By bringing adequate infrastructure (energy, water, roads, ICT) to rural areas of high agricultural potential, they attract investments from private agro-industrialists and entrepreneurs to contribute to the economic and social development of rural areas.
- SCPZs will build this capacity along 18 priority commodities identified under the Bank's Feed Africa so that large stocks of marketable food products are produced and can be locally or globally traded, driving Africa to become a net food exporter.
- The processing zones are projected to create new markets for farmers' produce and raw materials, which will become production centers for finished value-added products. The zones are also expected to reduce post-harvest losses and integrate agricultural value chains with supportive logistics, such as warehousing and cold chains. It is expected that the development of agricultural value chains based on these zones could potentially create market opportunities for millions of African farmers.
- According to the President of the AfDB, Dr. Adewumi Adesina, "The zones will allow African countries to substantially reduce food imports, and become net exporters of processed foods and commodities". According to him, "I am convinced that just as industrial parks helped China, so the SCPZs will contribute to creating new economic zones in rural areas that will help lift hundreds of millions out of poverty through the transformation of agriculture into a viable and profitable business that will unleash new sources of wealth".

The Role of the African Development Bank Group (AfDB Group) (Contd.)

- Plans are also under way to reach 15 countries in the next five (5) years, including Ethiopia, Democratic Republic of Congo (DRC), Zambia, Guinea, Burkina Faso, Madagascar, Cote d'Ivoire, Senegal, and Mozambique.
- Three (3) operations were slated for the Board for the year 2018 for Togo, DRC and Ethiopia. The total contribution of the Bank is UA 102 million, with UA21 million, UA 70 million and UA 11 million, respectively.
- That for Togo – Togo Agro-Food Processing Zone – was approved by the Board in July 2018.
  - This pilot project will be implemented over a five-year period at a total pre-tax cost of about UA 45,066,070 (about CFAF 35.194 billion) (about US$63.1 million), broken down as follows: (i) ADF loan: UA 8.04 million (17.8%); ADF grant: UA 4.046 million (10.3%); Transition Support Facility (TSF) of the Bank Group (Pillar I) loan: UA 8.32 million (18.5%) (ii) Banque Ouest Africaine de Développement (BOAD): UA 12,804,920 (28.4%); (iii) Saemaul Globalization Foundation (South Korean): UA 3,524,190 (7.8%); and (iv) State ((including Project Preparation Fund): UA 7,741,950 (17.2%).
  - The project has four components: (a) support policy, governance and incentive measures; (b) infrastructure for processing and accessing agricultural inputs and services; (c) capacity building for actors in priority agricultural chains; and (d) coordination, management, monitoring and evaluation.
  - It will be implemented by the Agency for the Promotion and Development of Agropoles in Togo (APRODAT), which was established by Decree No. 2018-036/PR of 27 February 2018 to promote and develop ten agropoles over the next fifteen years.
- In 2019, the AfDB expects to deliver six more operations on SCPZs in the following countries: Senegal, Cote D'Ivoire, Burkina Faso, Guinea, Zambia, and Mozambique.

Conclusion

- For a long time, development financing (including for SEZ projects such as SCPZs), in Africa was largely dependent on external sources.
- Of late, however, several countries are making important sorties into the capital markets. Domestic resource mobilization for that purpose is on the increase.
- Increasingly, where policy reforms have clarity and predictability, private investors are able to turn these obstacles into opportunities.
- However, the development and project financing gap seems daunting. So now is the time to think out of the box, time for a step change. More than fifty years after independence, it is time for that step change. The step change involves Africa taking ownership, mobilizing its own energies and resources, putting those savings to build Africa's infrastructure (including well planned and designed, viable and well planned and executed SEZs projects, especially the SCPZs) and in the process getting a good return.

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