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TOPIC GUIDE

How do new exports emerge in the developing world?

Imani Development

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1 Introduction to the topic guide

Export diversification is increasingly seen as key to ensuring that trade remains a robust determinant of growth for Low Income Countries (LICs)1. In general, poorer countries that manage to grow also manage to diversify and structurally transform their economy in the process2. Export diversification also acts as a hedge against terms of trade shocks – and maintaining stability in exports further contributes to longer term economic growth3. In other words, economic growth and structural change tend to depend as much on what a country exports4 as the volume of its exports.

This guide provides case studies of export diversification in developing countries. The case studies have been drawn from different developing regions, income levels and sizes. Some are well governed, some very corrupt. Some are landlocked, others are coastal or well connected to large markets. One is mineral rich while others have no natural resources to speak of. The case studies also look at different sectors and cover trade in services as well as trade in goods.

The case studies are as follows:

Figure 1: Case studies examined in this report

AFRICA	ASIA	EASTERN EUROPE	THE AMERICAS
• **Ghana:** Value addition to Cocoa (Butter and paste) • **Lesotho:** Clothing Exports • **Mauritius:** Tourism, Medical Tourism and Financial Services Exports • **Nigeria:** Finanical Services Exports	• **Bangladesh:** Clothing	• **Czech Republic:** Automotives	• **Costa Rica:** ICT • **Argentina:** Wines

The case studies conform with cross-country empirical studies of export diversification (briefly reviewed in the first section of this guide). Comparative advantage is central to, for example, Bangladesh's clothing exports (where labour intensive production meets labour abundance), Mauritius' tourism (natural beauty) and Argentina's wines (natural resources). 'Proximity products' drive export diversification in Ghana, with cocoa paste and cocoa butter growing from the foundation of cocoa bean production. In Lesotho, trade preferences are key to the growth of the clothing exports to the USA, while changing business practice (fast fashion) drives their integration into the Southern Africa clothing value chain. Changing business practice, with outsourcing and offshoring, is also fundamental to Bangalore's ICT story. Foreign Direct Investment (FDI) and regional integration are key to many of the case studies, particularly the growth of car exports from the Czech Republic to the EU.

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1 Durlauf S., A. Kourtellos and T. Chih Ming, *Are Any Growth Theories Robust*, Economic Journal 2008, IMF, Sustaining Long Run Growth And Economic Stability In Low Income Countries – The Role Of Structural Transformation And Diversification, 2014.

2 Cadot O., C. Carrere and V. Straus Kahn, *Export Diversification: What's Behind The Hump*, Review of Economics and Statistics, 2011

3 Meilak C., *Exports and Growth*, Journal of Development Economics, 2008.

4 Hausmann R., J. Hwang and D. Rodrik, *What You Export Matters*, Journal of Economic Growth, 2007.

There are also some surprises and idiosyncrasies that are worthy of note. The growth of financial services exports from a country as corrupt as Nigeria shows what can be achieved by direct sectoral support and champions of change, with help from petro dollars and a large and successful diaspora. Costa Rica's drive to bring in Intel to kick start ICT in the country illustrates how activist investment promotion can contribute to broader reform efforts.

Bangalore's ICT boom shows how timing can play a role, and also how size matters: even with low education indicators, the region had enough graduates to make the business case for offshoring.

Luck played a key role in the 'other' services diversification story of Mauritius, financial services, where cultural ties with India resulted in a Double Tax Agreement that placed the island as the gateway to much foreign investment to the sub-continent. That said, Mauritian policy makers ensured that good fortune was translated into a positive economic result.

In the case of Argentinian wines, the sector flourished while the rest of the country struggled partly because the devalued currency allowed them to price aggressively on the US markets.

We hope that the case studies provide some insight into how some of the findings of the cross-country empirical investigations actually play out. More than that, we hope they also illustrate that each country's experience is nuanced, with specific factors, sometimes chance, sometimes leadership, playing a role.

The introductory section reviews some of the fundamental drivers of export growth and diversification. It also places the case studies that follow in the context of the broader issues of exports and development.

1.1 Exports and development

Developing countries that have managed to integrate into the global economy over the past decades have achieved higher economic growth rates, better schooling and longer life expectancy5. Access to larger markets and openness to foreign investment and skills have allowed countries to not only increase production but also transform their economies and increase their absorption of technology. `Many have traded their way into economic development.

The figure below illustrates an analysis of the relationship between export intensity and developing country poverty, suggesting that a higher ratio of exports relative to GDP results in a lower percentage headcount of poverty.

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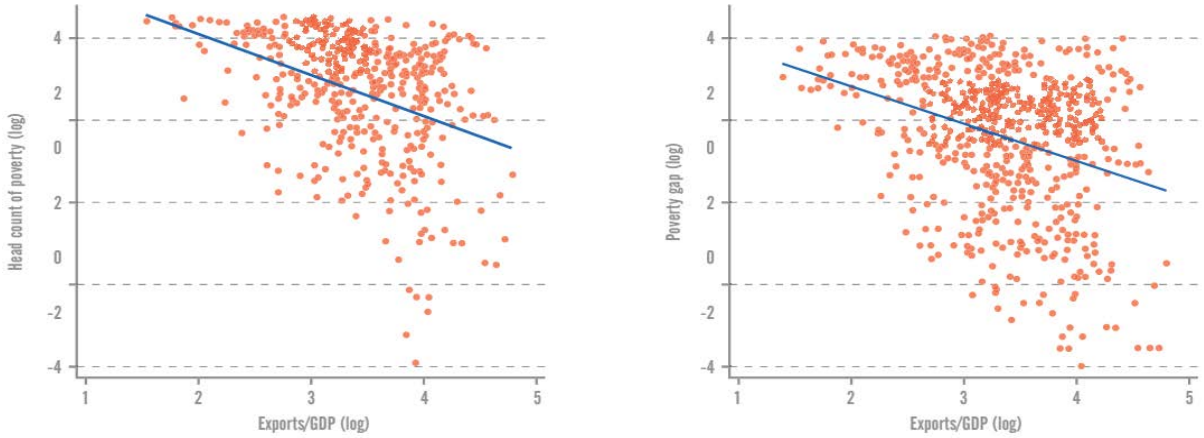
5 World Bank, Globalization, *Growth and Poverty: Building an Inclusive World Economy*, 2012.

Figure 2: Linear relation between export intensity and poverty



Source: European Commission, 2015

1.2 Gains from exporting

The benefits of exports are varied, going way beyond 'vent for surplus'. The benefits include greater competitiveness, knowledge transfer and allocative efficiency6. Because firms must compete, they have to become more innovative, use better business practices, and use technology more efficiently in order to be competitive within a global economy. Also, when firms enter foreign markets they are exposed to international technology trends, international product design and international consumer behaviour, which contributes to knowledge transfers. This develops the competitive performance of the firms entering exports.

Exports are also important for employment. For example, Rodrick's study of unemployment in South Africa suggests that one of the root causes was the failure to grow manufacturing sector exports since the early 1990s7. Evidence also indicates that businesses able to survive in global markets enjoy faster sales and faster employment growth than the firms focused on domestic markets.8 This has been evident in the case of Bangladesh where employment in the clothing industry stands at 3-million. However, and unsurprisingly, there are no guarantees of exports generating jobs. To date in Ghana we haven't seen a significant impact on employment from the cocoa paste and butter. The sector is heavily automated and employs only approximately 1,200 people.

Exports also have an impact on job quality, where job quality can be defined as wages, job security, hours worked and number of accidents on the job. Robertson, Brown and Le Borgne Pierre reviewed countries with prominent textile and garments manufacturing, and found that the increased exposure to trade and investment in the textiles garment industry resulted in more and better jobs than jobs in agriculture9. Note however that the correlation between export growth and economic upgrading is stronger than the correlation with social upgrading10.

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6 Harcourt, T, *Why Australia Needs Exports: The Economic Case for Exporting*, 2000

7 Daniel Lederman William F. Maloney, *In Search of Empirical Guidance for Industrial Policies*, 2012

8 Montgomery, D. & Tuladhar, S. D., *Macroeconomic Impacts of LNG Exports from the United States*, 2013

9 William Milberg and Deborah Winkler, *Economic and Social Upgrading in Global Production Networks: Problems of Theory and Measurement*, 2010

10 *Ibid*.

1.3 The importance of export diversification

The story of exports and economic growth has long been told, However, recently a more nuanced narrative has been emerging of the causality and conditioning factors linking trade and development.

Empirical work in the past few years has suggested that benefitting from integration in the global economy for poorer countries often requires financial sector development and investment in skills, economic institutions to address weaknesses in the real economy11.

Furthermore, export diversification is increasingly seen as key to ensuring trade remains a robust determinant of growth for LICs12. It is seen as (a) central to structural change13, and (b) acts as a hedge against terms of trade shocks - maintaining stability in exports and thereby contributing to longer term economic growth14.

1.3.1 What you export matters

We take the link between export diversification, greater macroeconomic stability and economic growth to be self-evident. However, the link between export diversification, structural transformation and economic growth needs some explanation.

For exposition purposes, it is probably best to start with the empirical findings that diversification of exports for LICs is linked to structural transformation and economic growth. New exports are correlated with growing 'Economic Complexity' which in turn can help explain up to one third of differences in economic growth across a cross section of countries15.

In exploring these links, it is helpful to take the perspective that economic development is a process of learning how to produce and export more complex products. From this perspective, a country's growth path is shaped by its ability to accumulate the capabilities to produce competitively more sophisticated goods and services. Being 'competitive' in production is of central importance. Any country can produce any good or service (within reason) given enough financial support and protection in the market. Structural transformation only leads to economic development if it is efficient and sustainable. And the acid test of competitiveness, for LICs at least, is the ability to export. There is also the above mentioned 'learning' from exporting, creating a virtuous cycle. Exporting is also important in that it alleviates any demand constraints that might result from relying on the domestic market.

1.3.2 Horizontal and vertical diversification

Export diversification is often characterised as horizontal or vertical. Horizontal diversification is an increase in the number of exported goods or services. The early stages of development generally rely more on horizontal diversification because of significant positive externalities and dynamic learning. The positive effects from horizontal diversification are a function of the technological and absorptive capacity of domestic firms, geographic and social proximity to markets, trade openness, costs of trade and labour mobility16.

Vertical export diversification involves moving up the value chain, in the case study of Ghana we look at moving from cocoa bean growing to processing cocoa butter and paste.

11 Lel Geff and Singh, *Does Trade Reduce Poverty? A View From Africa*. IMF 2013.

12 Durlauf S., A. Kourtellos and T. Chih Ming, *Are Any Growth Theories Robust*, Economic Journal 2008, IMF, Sustaining Long Run Growth And Economic Stability In Low Income Countries – The Role Of Structural Transformation And Diversification, 2014.

13 Hausmann R., J. Hwang and D. Rodrik, *What You Export Matters*, Journal of Economic Growth, 2007.

14 Meilak C., *Exports and Growth*, Journal of Development Economics, 2008.

15 Hidalgo C.A., *The Dynamics of Economic Complexity and the Product Space over a 42 year period*, 2009

16 Herzer, D. and Nowak-Lehmann, D. F. *What does export diversification do for growth? An econometric analysis*, Applied Economics, 2006.

The benefits of vertical diversification are a function of the same conditions for horizontal diversification, but are also affected by trust between firms in the value chain and the power dynamics17.

1.4 The paths of export diversification

The probability that a country will develop the capability to competitively produce one good is closely linked to its current capabilities to produce other goods that are 'proximate' or close in the 'product space'18 and for which current capabilities can be easily adapted. For example, manufacturing electronics involves skills and capabilities that can easily be used in a large range of additional manufacturers. In contrast, oil extraction requires skills that are less easy to redeploy (e.g. operation of a drilling rig).

Crucially, not all products have the same value addition and the same impact on progress to a more sophisticated economy. And there are current productive capabilities that can be reallocated for the production and export of other goods with higher value added and a higher score in terms of economic complexity. So while current comparative advantage significantly shapes the path of export diversification, there is scope for activist policies to steer a country onto a higher growth path by nudging exports towards particular sectors. This activism needs to be cognisant, however, of the vital importance of being competitive in production.

1.4.1 Determinants of diversification

Cross country empirical assessment of the determinants of export diversification have identified the following determinants19:

Figure 3: Determinants of export diversification

+		Foreign Direct Investment (FDI)
+		GDP per capita
+		Openness to international trade
+		Depreciation of the exchange rate
+		Gross fixed capital formation (GFCF)
+		Growth in the share of manufacturing in GDP
-		Public Sector recurrent expenditure
+/-		Distance to market and access to seaport

The impact of the different determinants is highly context specific. The stock of Foreign Direct Investment (FDI) is important for export diversification but varies. At regional level, for East Asia, FDI has contributed to both vertical and horizontal diversification, while

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17 Crespo, N. and Fontoura, M. P., *Determinant factors of FDI spillovers – what do we really know?,* World Development, 2007.

18 Hidalgo C, Klinger B, Barabási A and Hausmann R. *The product space conditions the development of nations*. Science, 2007

19 Tadesse B. & Shukralla E. *The impact of foreign direct investment on horizontal export diversification: empirical evidence*, Applied Economics 2013

contributing primarily to vertical diversification in Sub Saharan Africa20. For oil exporters, FDI has been found to have a limited to negative impact on export diversification21. The impact of FDI is also greater for middle income countries and the existing stock of FDI.

The impact of GDP per capita on export diversification is greater when the level of export diversification is low. Conversely, openness and GFCF have a greater impact on countries already exporting a relatively large number of products. Distance to market and access to a seaport has a relatively stronger positive impact for countries at lower levels of export diversification22.

1.4.2 Upgrading in the value chain

Upgrading in the global and regional value chain is also important for the development impact of exports23. Determinants of diversifying exports by upgrading in global or regional value chains are the same at macro level but are also driven by conditions within the chains themselves.

Structural factors include the dynamism of the final market because fast growing and evolving demand often provides space for new entrants (but can also lead to greater uncertainty and therefore risk). The absorption of new technology and production processes, central to upgrading, is a function of a range of factors. These factors include: the lead firm's engagement with suppliers; whether clustering among suppliers allows them to better carry the fixed costs of investing in upgrading and to reach critical volume; suppliers access to finance; cultural proximity; and the skills base. Because value chains are transaction intensives, the cost of trade is also crucial to ensuring upgrading is cost effective 24.

The key structural factors can be summarised as:

Figure 4: Key structural factors

+	Dynamism in the final market (also creates risks)
+	Vertical links: Lead firm linking small producers to end markets and providing assistance
+	Horizontal links: Clustering in the sector to allow small producers to spread costs and increase volume.
+	Supporting markets: Access to investment and financial services
+	Business enabling environment: Social, educational and geographic proximity Transport and communications infrastructure

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20 Alemu, A. M. *Determinants of vertical and horizontal export diversification: evidences from sub-Saharan Africa and East Asia*, Ethiopian Journal of Economics, 2008.

21 Jayaweera, S. *Foreign direct investment and export diversification in low income nations*, Honors Thesis, The University of New South Wales, Australia. 2009.

22 Tadesse and Shukrulla, *op. cit.*

23 UNCTAD, *Sector-Specific Investment Strategy and Action Plan*, G20 Indicators for Measuring and Maximizing Economic Value Added and Job Creation from Private Investment in Specific Value Chains, September 2012

24 Source: https://www.microlinks.org/good-practice-center/value-chain-wiki/depth-concepts-vc-project-managers-and-technical-staff

At firm level upgrading is affected by the extent to which lead firms are prepared to share the use of their knowhow and technology along the value. This is largely determined by trust among firms in the value chain and also the power dynamics. Upgrading is more likely where there are greater levels of trust and firms have a relatively equal share of bargaining power. Furthermore, access to capital and inputs is crucial.

An issue that has received significant attention is the skills challenge. Skills and workforce development are key to upgrading in global value chains. Traditional workforce development systems have often failed to provide the skills required, but industries are increasingly finding ways of overcoming the shortfalls of the education system25.

Looking to our case studies, the presence of a domestic and regional textile industry has allowed Bangladesh to successfully upgrade from assembly to full-package supply, driven by its "new textiles industry". After upgrading to full-package supply, they have seen a significant impact on employment, though there are still challenges to further upgrading26. On the other hand, we have Lesotho, where their lead firms, which are foreign owned and is part of a large global supply network, have headquarters in Asia. There are minimal links or technology spill overs for Lesotho. Thus, the domestic industry has not undergone significant upgrading.27

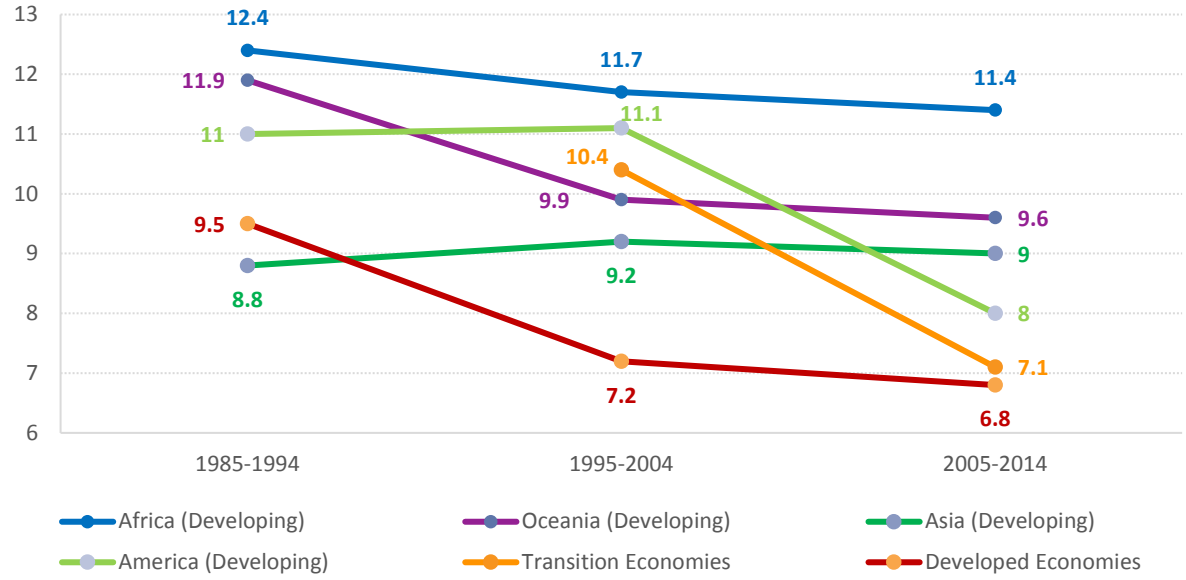
1.5 Global drivers of export growth

There are several "exogenous" developments that have driven export growth over the past decades and have contributed fundamentally to the scope for export diversification.

1.5.1 Containerisation and international transport costs

The effect of containerisation on trade suggests that efficiency gains in modern shipping led to an increase in global trade of at least 75%, with a stronger effect on North–South trade.28

Figure 5: Freight costs as percentage of imports (10 year averages)



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25 K.F. Stark, P. Bamber and G. Gereffi, *Upgrading in Global Value Chains: Addressing the Skills Challenge in Developing Countries*, OECD 2012

26 Fernandez-Stark K., Stacey Frederick & Gary Geref, *The Apparel Global Value Chain: Economic Upgrading and Workforce Development*, Duke, November 2011

27 Ibid.

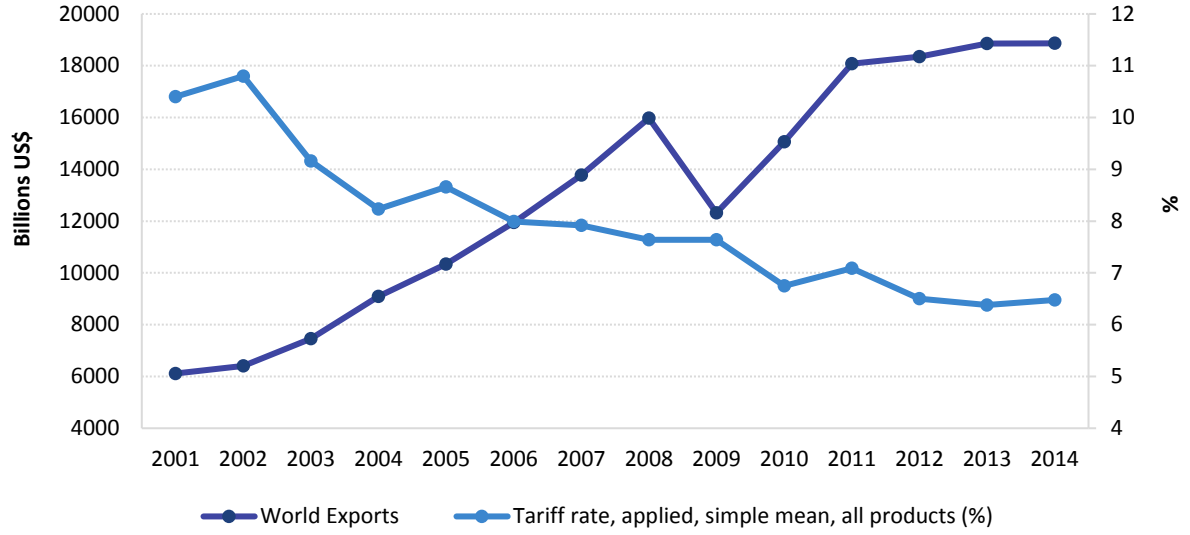
28 Bernhofen D., Zouheir El-Sahli, Richard Kneller, *Estimating the effects of containerization on world trade*, 2011

According to UNCTAD's 2015 Review of Maritime Transport29, despite a global decrease in shipping costs, developing countries (particularly in Africa and Oceania) still face higher transport costs.

1.5.2 MFN tariff reduction and tariff preferences

Tariffs have declined from 30% to 4% during the period 1990 to 2008. This has been an important driver of export growth. The figure below shows the historical change in the average applied tariff, and growth in global trade. The average applied tariff almost halved between 2001 and 2014, and global exports tripled, in the same time.

Figure 6: Global exports and the simple mean tariff rate (2001-2014)



Source: ITC TradeMap & World Bank Database

1.5.3 The growth of global and regional value chains

The sharp decrease in communication and transport costs has led to a radical shift in the approach to international trade. Production of goods and services is now split across the globe and consequently the nature of trade is changing. Due to global production networks, intermediary goods and services now account for the majority of world trade. Furthermore, countries are increasingly seen as trading in tasks as much as they are seen as trading in finished goods.

Value chains allow countries to enhance their production capacities and competitiveness. Countries can trade globally at lower cost by focusing production on certain parts or certain tasks which feed into global production network, rather than producing a complete product or service. Developing countries' participation in these value chains has increased significantly with over 50% of developing countries' exports (measured as value added) comprising GVCs. Traditionally value chains developed in North-North trade and North-South trade, but the value chains are increasingly important for South-South trade. The share of trade in parts and components in South-South trade increased from 6% in 1988 to just under 25% in 2013. However, while the rise of the GVC creates an opportunity it also threatens to leave LDCs further marginalised30. Currently Africa's contribution to global value chains is low, at 1.5%, and participation is in the lower value, lower end stages of production31.

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29 UNCTAD, Review of Maritime Transport 2015

30 Li Yong and M. Smeets, *Value Chains and Industrialisation* ECPDM.2014

31 Trade Policies and Regional Integration in Africa, Chapter 3, *African Economic Outlook* 2014

OECD (2015) shows that participation in GVCs is often complementary to participation in regional value chains. An example is China, where 13% of the value of its exports comes from neighbouring countries.

1.6 Participation of SME's in exports

It is all too easy in discussing export diversification to lose sight of the firms involved. We have already explored the issue of foreign versus domestic ownership. But size is also relevant.

SME's have been found to be extremely important for the sustainability of exports in Asian countries. For example, in India, between 1998 and 2008, 38-40% of total export were contributed to by SME's. In China SME's contributed to 60% of total exports.32 ASEAN SME's, also accounted for 9.3% of world supply chain trade between 2009 and 2013, but supply chain engagement is still dominated by large firms. However, data shows that SME's have a more significant impact on economic activity domestically, than on exports. In countries such as Japan and Korea (Republic of) more than 80% of employment and 50% of GDP is driven by SMEs.33

Table 1: SMEs participating in exports

COUNTRY	SHARE
China	60%
India	38-40%
Vietnam	20%
Singapore	16%
Malaysia	15%
Indonesia	18%
Thailand	46%
Phillipines	22%
Pakistan	25%

SME's are also important for African business. For example, in South Africa, 91% of formal business entities are SMEs. In Ghana SMEs make up 92% of formal businesses, and contributes 70% to GDP.34 They also make significant contributions to employment, especially SME's that export, for example, SME's that export employ 17% more and have 12% higher earnings, than non-exporting SME's in Africa.35

The participation of SME's in Africa remains low, however: if we look at South Africa as an example, large firms still account for approximately 90% of total exports.36

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32 Edinburgh Group, *Growing the global economy through SMEs*, 2013

33 Naoyuki Yoshino, Ganeshan Wignaraja, *SMEs Internationalization and Finance in Asia*, Asian Development Bank Institute, February 2015

34 Abor J. and Quartey, P., *Issues in SME Development in Ghana and South Africa*, International Research Journal of Finance and Economics, 39: 218–28, 2010

35 Martijn, A, *Learning-by-Exporting and Destination Effects: Evidence from African SMEs*, 12th European Trade Study Group (ETSG) Annual Conference Proceedings, Lausanne: HEC Lausanne, 2010

36 Rahul Anand, Roberto Perrelli, and Boyang Zhang, *South Africa's Exports Performance: Any Role for Structural Factors?* IMF Working Paper, February 2016

1.7 Export constraints

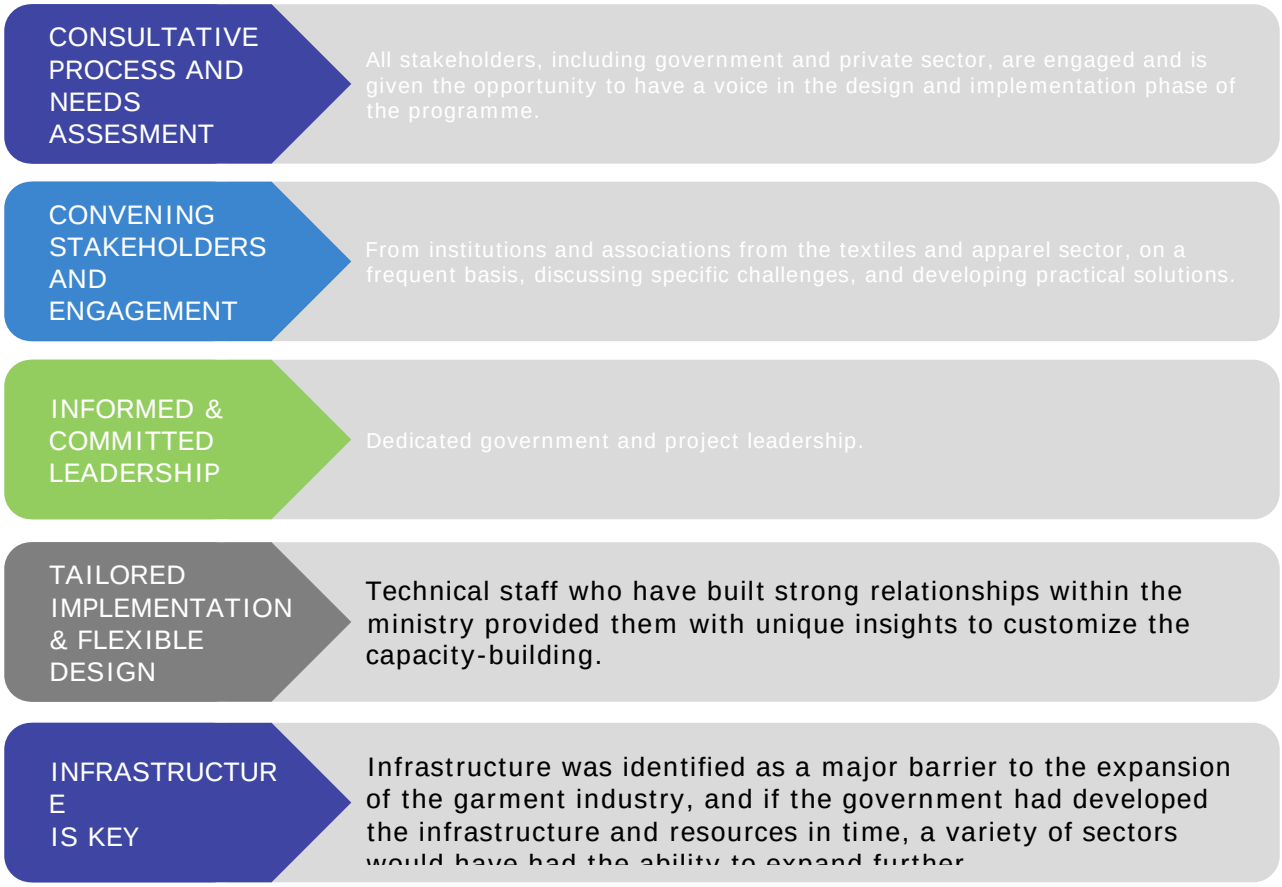
The OECD found that the quantity of transport infrastructure such as rail and road have a significant impact on trade as does the quality of electricity supply. 37 They also found that the 10% increase in the reliability of electricity results in a nearly 2% increase in trade to GDP, and the impact is more significant on exports than on imports.38

Surveys undertaken by the World Economic Forum found that 29% of firms in developing countries consider access to electricity as their main constraint, and 68% report it in the top three. Access to credit is also a significant constraint to business operation, but non-exporters are effected more than exporters.39

1.8 Aid for trade: lessons from Lesotho

Lesotho's success in apparel exports (see the case study later in the guide) is, in part, due to targeted aid for trade in building productive capacity, regulation, trade policy and trade negotiation. Under the ComMark Lesotho Textile and Apparel Sector Programme, the ODI identified key lessons for aid for trade programming.40

Figure 7: Lessons from Lesotho



37 Jean-Jacques Hallaert Ricardo Cavazos Gimin Kang, *Estimating the Constraints to Developing Countries Trade, A Taxonomy of the Binding Constraints to Trade Expansion of Landlocked Countries, Small and Vulnerable Economies, and Commodity Exporters*, OECD, April 2011

38 *Ibid.*

39 *Ibid.*

40 ODI, *Aid for Trade in Lesotho: ComMark's Lesotho Textile and Apparel Sector Programme*, 2009

2 Case Studies

2.1 Africa

2.1.1 Ghana

- Ghana is the second largest producer of Cocoa beans in the world.
- Processed cocoa products have doubled their share of the total value of the Cocoa sector since 2001. Cocoa paste and butter export have grown from 3% in 2001 to 7% of total exports by 2015.
- Ghana is the only cocoa producing country with a controlled marketing system. However, the system is 'hybrid' rather than fully state controlled and since the early 80's the sector has generally been guided by market forces.

2.1.1.1 Critical Success Factors

- A booming cocoa bean industry has been the primary input for value addition.
- Activist policy and institutional development providing extension services, on a public-private partnership basis, and market and product development.
- Infrastructure development reducing the cost to exports.
- Foreign investment has provided access to technology and networks.

2.1.1.2 Country Context

Ghana is a lower middle income, coastal country on the west coast of Africa, with a population of almost 30-million.

Table 2: Ghana Governance and Competitiveness Indicators

GOVERNANCE INDICATORS	
Institutions (out of 140) *	72
Infrastructure (out of 140) *	115
Macroeconomic Environment (out of 140) *	136
Corruption Perception Index (out of 168) **	56
COMPETITIVENESS INDICATORS	
Openness to Trade (out of 138) ~	106
Foreign Market Access/Trade Preferences (out of 138) ~	95
Cost to Export_1 (US$ per container) ***	875
Cost to Export_2 (Border Compliance US$) ***	490
Logistics Performance Index (out of 160) ^	88
Financial Market Development (out of 140) *	76
Labour Market Efficiency (out of 140) *	94
Health and Primary Education (out of 140) *	118

* World Economic Forum's Global Competitiveness Index assesses the competitiveness landscape of economies, providing insight into the drivers of their productivity and prosperity (2015 data).
** Transparency International: Each year countries are scored on how corrupt their public sector is seen to be (2015 data).
*** World Bank's Doing Business Indicators focuses on regulations and regulatory processes involved in setting up and operating a business ($/container, 2014 data/$ border compliance 2015).

~ World Economic Forum's Enabling Trade Index assesses institutions, policies, infrastructures and services that facilitate trade in goods across borders (2014 data).
^ World Bank's Logistics Performance Index is an interactive benchmarking tool created to help countries identify the challenges and opportunities they face in their performance on trade logistics (2016 data).

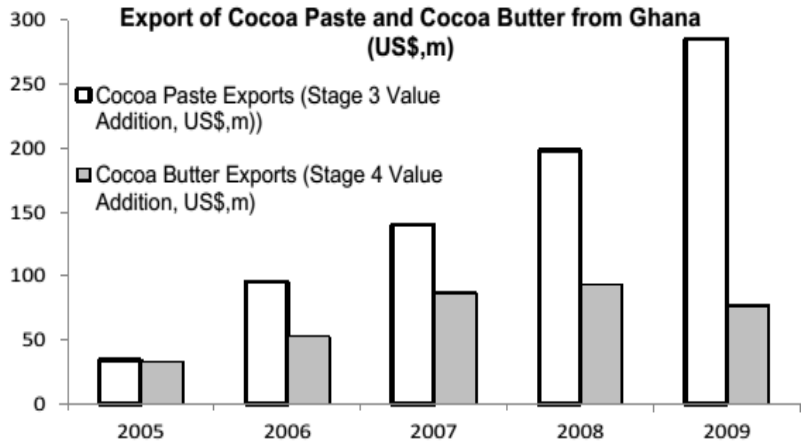
In terms of Governance, Ghana is mid raking in its institutions, but the private sector benefits from a relatively low perceived level of corruption. However, Infrastructure and macroeconomic management rank poorly and are a constraint to economic growth.

Indicators of competitiveness point to structural challenges. Trade arrangements are relatively restrictive, which is particularly damaging for integration in regional and global value chains. Access to foreign markets is also relatively restricted, although tariffs on cocoa beans and processed products are set at zero for the main markets of the EU and the USA and there is only moderate tariff escalation in markets such as Japan, Russia and Malaysia41. The private sector is also constrained by a second-tier financial sector, moderately inefficient labour markets and human capital.

Trade facilitation is, however, relatively good. The cost of exporting a 20-foot container is an estimated $875 compared with a global average of $1,560. And the cost of border compliance is $490 compared to the average of $583 for Sub Sharan Africa (see table).

The Ghanaian economy is still dominated by small and medium sized firms, which are predominantly Ghana owned enterprises. In contrast, cocoa processing firms are largely foreign owned and large42. There are five large processing companies focusing on butter, paste and nibs, powder. Secondary processing, chocolate and confectioneries/sweets, remains limited43.

Figure 8: Cocoa paste and butter exports (2005-2009)



Source: ACET, 2013

Exports for cocoa paste and butter, has grown significantly since 2005, along with production. Specifically, cocoa paste, as an intermediary production has increased by 340% in the period, and cocoa butter has increased by 190%.

41 Source: http://www.cocoaconnect.org/publication/indirect-taxes-and-custom-tariffs-cocoa-beans-and-cocoa-semi-finished-products

42 World Bank, *Enterprise Survey*, Country Profile: Ghana, 2013

43 African Center for Economic Transformation, *Optimal Agro-Industry Policy: A Case Study of Ghana Cocoa Processing*, November 2013

This has predominantly been exported to the EU and US.44 Cocoa paste and butter exports have grown from, non-existence in the early 1990s, to 7% of total exports by 2015.

2.1.1.3 'Proximity' to an existing comparative advantage

The proximity model, set out in the introduction, clearly explains the path of export diversification in Ghana's cocoa sector. The table below shows that exporters of Cocoa butter, powder and paste where able to build on a sector with a very strong revealed comparative advantage. Crucially, the value-added exports also have a strong revealed comparative advantage.

Table 3: Ghana product space summary

PRODUCT	EXPORT RCA	PRIMARY CONNECTION
Cocoa	410	Cocoa Butter
Cocoa Butter	72.1	Cocoa Beans, Powder & Paste
Cocoa Powder	65.8	Cocoa Paste & Butter
Cocoa Paste	186	Cocoa Powder & Butter

Source: Observatory of Economic Complexity

* "Formally, if represents the exports of country in product, we can express the revealed Comparative advantage that country has in product as:

$$RCA_{cp} = \frac{X_{cp}}{\sum_c X_{cp}} \Big/ \frac{\sum_p X_{cp}}{\sum_{c,p} X_{cp}}$$

** We use this measure to construct a matrix that connects each country to the products that it makes. the entries in the matrix are 1 if country exports product with revealed Comparative advantage larger than 1, and o otherwise."45

2.1.1.4 Competitiveness of production

Access to high quality, competitively priced inputs

Ghana's cocoa is of high quality and can sell at a price 10% higher than the world price. High quality is in part the result of climatic conditions, but is also due to ensuring appropriate farmer practices and effective quality management systems and control. This allows cocoa processing to have the highest quality input for production of cocoa butter, powder and chocolate.46

The Ghana cocoa value chain is confined to the production of intermediary goods, such as the grinding of nibs into cocoa paste. The commercial and retail chocolate sector is highly competitive.

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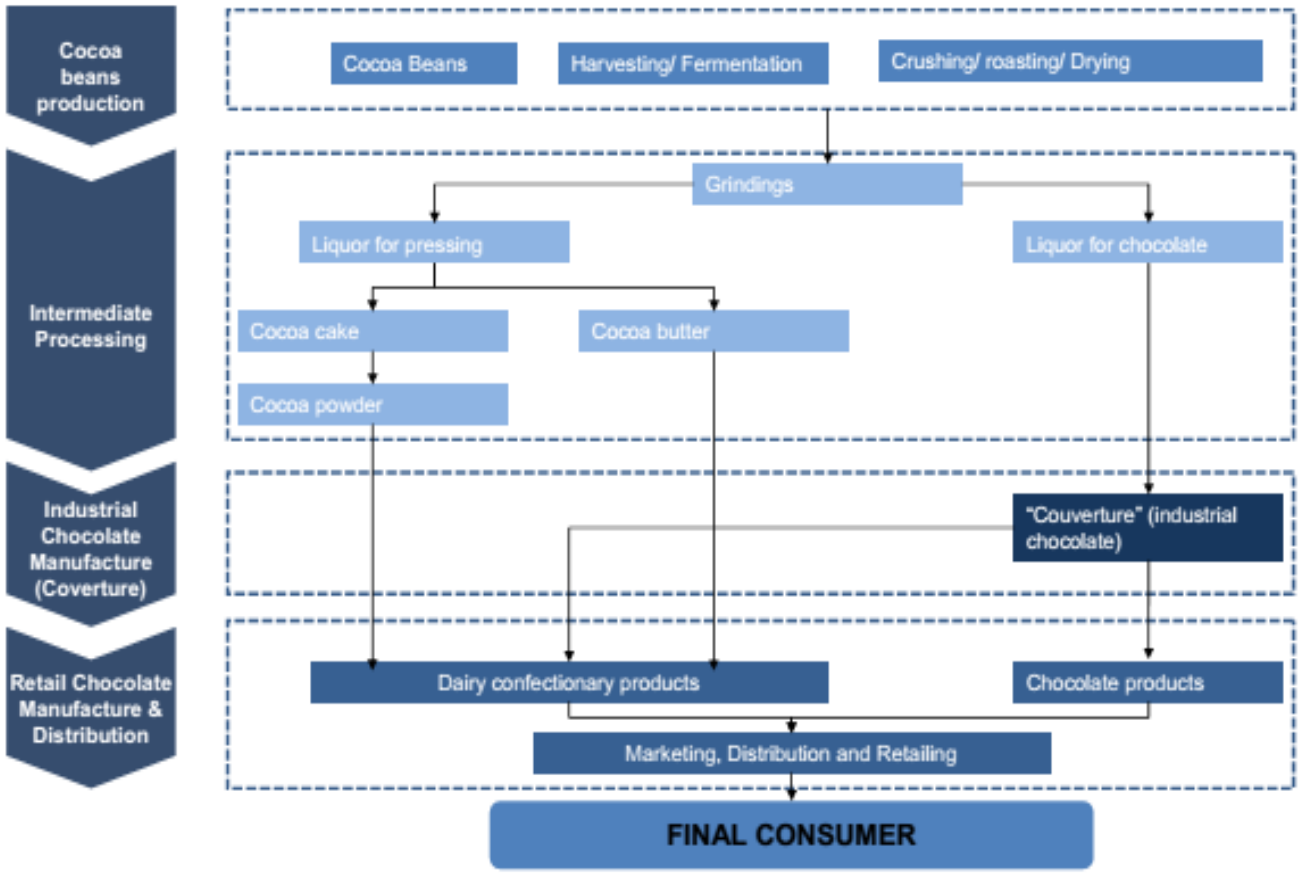
44 African Center for Economic Transformation, *Optimal Agro-Industry Policy: A Case Study of Ghana Cocoa Processing*, November 2013

45 Center for International Development at Harvard University, *The Atlas of Economic Complexity: Mapping Paths to Prosperity*, 2011

46 Essegbey, G & Ofori-Gyamfi, E. *Ghana Cocoa Industry: An Analysis from the Innovation System Perspective*, 2012

Figure 9: Cocoa industry value chain



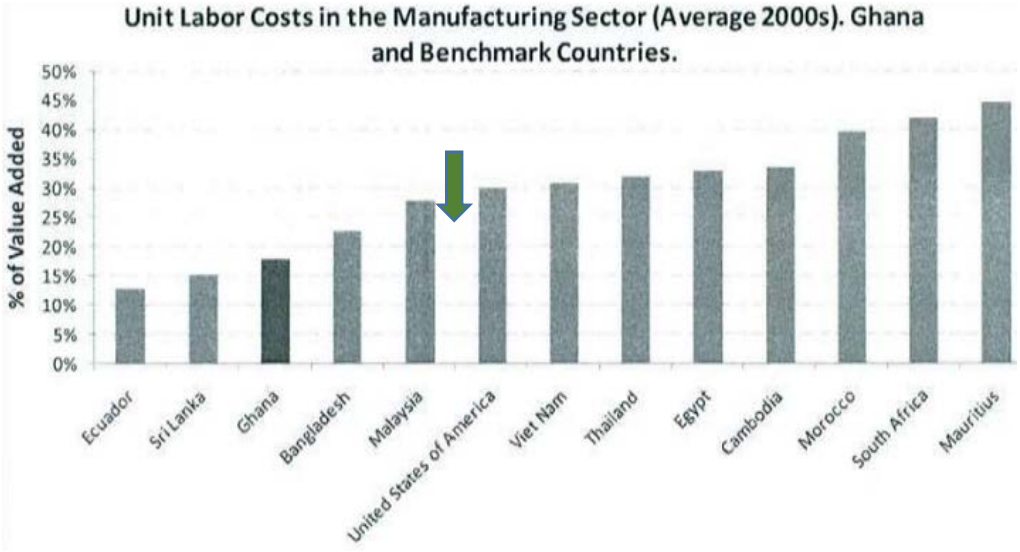
Source: ACET, 2013

Relatively low labour costs for processing

Compared to countries such as the United States, Egypt, South Africa, and Mauritius the labour cost as a percentage of value addition of Ghana is less than half. This was partly enabled by contract flexibility, and a relatively low minimum wage to value added ratio per worker. However, to limit the scope for abusive labour practices there are formal procedures for dismissal. 47

47 USG-GoG, *Ghana Constraints Analysis*, August 2011

Figure 10: Unit labour costs by country



Higher freight costs for value added products

Freight costs of many processed commodities such as cocoa butter and powder are generally y higher than that of primary unprocessed cocoa beans.48 Considering that Ghana's main processed cocoa trading partners are in the US, South America, Europe and Asia, this increases the difficulty of competing in the international market.49

2.1.1.5 Foreign participation and investment

The amount of FDI inflows has increased significantly since the 1990s and, over the past two decades, the level of FDI as a percentage of GDP exceeds that of its peers.50

Foreign owned firms have established processing operations (intermediary goods) in Ghana, to either form part of their global value chain, for further processing to final goods, or they supply their trading partners in the US and Europe. These firms source all of their cocoa and some of their other inputs from Ghana, creating backward links to agriculture and other sectors.

Table 4: Main cocoa processors in Ghana

COMPANY	PRODUCTS	FOREIGN OWNED	INPUTS	EXPORTS
Real Products Limited	Natural cocoa butter, natural cocoa liquor and natural and alkalized cocoa powder for export	Yes	Cocoa Sourced from Ghana	70% of its production to its parent company (US)
Plot Enterprise Ghana Limited	Cocoa liquor, butter and cake	Yes	Cocoa Sourced from Ghana	US, Europe, Asia, Australia and the Middle East

48 African Center for Economic Transformation, *Optimal Agro-Industry Policy: A Case Study of Ghana Cocoa Processing*, November 2013

49 ITC, TradeMap, http://www.trademap.org/, 2016

50 USG-GoG, Ghana Constraints Analysis, August 2011

Cargill Ghana Limited	High-quality cocoa powders and cocoa butter	Yes	Cocoa Sourced from Ghana	50–70% of its cocoa powder to Europe and the US chocolate producing firms
ADM Cocoa (Ghana) Limited	Cocoa liquor, a semi-finished product	Yes	Cocoa Sourced from Ghana	Europe and the US

Source: IGC, 2012

2.1.1.6 Activist Policy Making

Ghana is the only cocoa producing country with a controlled marketing system, overseen by the Ghana Cocoa Board (COCOBOD). However, the system is 'hybrid' rather than fully state controlled and since the early 80's the sector has generally been guided by market forces51. Effective policies and organisational structures have protected the farmers' share of the cocoa revenues over time and inhibited COCOBOD from returning to the politicisation it suffered in the past.

Institutional support has been important to the development of the sector. In the first instance by providing effective quality control of cocoa production52.

A public private partnership between leading processors and the government's Cocoa Swollen Short Virus Disease Control Unit (CSSVDCU) has also provided extensions services to producers to comply with organic and fair trade certification. This has been important for increasing returns but as importantly because this offers good opportunities to develop market niches.

The Cocoa Research Institute of Ghana (CRIG) has contributed to market innovation through research and development with its new products unit promoting cocoa's anti-oxidant qualities for the domestic market as well as working on alcoholic beverages based on Cocoa53.

Government has also contributed to the growth of Cocoa paste and butter exports through the Free Zones (also called Export Processing Zones or EPZs). Ghana's EPZs include four zones in Ghana – Tema, Ashanti, Sekondi and Shama. The Ghana Free Zones Programme is also completely private sector driven.

Some of the key fiscal incentives include 100% exemption of direct and indirect taxes, as well as duties from all imports. 100% exemption on income tax for the first 10 years of operation, and thereafter, a maximum rate of 8%. Shareholders are also exempted from withholding taxes on dividends. 54

Furthermore, there are no restrictions on foreign ownership55, with minimal customs formalities, and no pre-shipment inspection. And foreign investors are also allowed to

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51 Institute of Development Studies (IDS), *An African Success Story: Ghana's Cocoa Marketing System*, 2009

52 A. Essegbey and E. Ofori-Gyamfi, *Ghana's Coffee Industry – An analysis from the innovation perspective*, Technology and Investment, 2012.

53 *Ibid.*

54 William Angko, *Analysis of the Performance of Export Processing Zones in Ghana*, Journal of Business Administration and Education, 2014

55 For example, Barry Callebout established in the Tema EPZ in 2001. http://www.ghanaweb.com/GhanaHomePage/NewsArchive/artikel.php?ID=17547

operate foreign bank accounts with banks in Ghana. The above is all conditional that 70% of production is exported.56.

2.1.1.7 Improved cost effective distribution and infrastructure

Ghana has managed to slightly improve its main distribution factors such as timeliness and customs procedures, but the most progress has been seen in infrastructure and international shipments. Ghana might not be ranked with the top performers in the LPI, but they do outperform the Sub-Saharan average, and other countries at the same income level. This was achieved through increased public spending on infrastructure, especially on road rehabilitation and feeder roads in cocoa growing areas, connecting it to processing zones and ports (Tema and Takoradi).57 Thus, reducing the transportation cost, which has a significant impact on the competitiveness of cocoa paste and butter exports.

Illustrated in the table, Ghana's road indicators perform relatively well in comparison with Low-Income countries. Also, indicating good quality unpaved road networks, which is important for transport from cocoa farms to main distribution roads.

Table 5: TABLE 1: Ghana's road indicators benchmarked against Africa's low- and middle-income countries

INDICATOR	UNIT	LOW-INCOME	GHANA	MIDDLE-INCOME
Paved road density	km/1000 km2 of arable land	86.6	158.1	507.4
Unpaved road density	km/1000 km2 of arable land	504.7	804.0	1,038.3
Paved network condition	% in good or fair condition	80.0	75.0	79.0
Unpaved network condition	% in good or fair condition	57.6	74.0	58.3

Source: Gwillliam and others 2009. Derived from AICD national database

2.1.1.8 Challenges

To date there has not been a significant impact on employment from value addition with only approximately 1,200 employed in the new areas of production by 2013. And the company with the largest processing capacity, employed the least number of people (99). Furthermore, another company which employed 82 employees, only employed 10 nationals58. This is because to be internationally competitive production needs to be technology and skill intensive.

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56 African Center for Economic Transformation, *Optimal Agro-Industry Policy: A Case Study of Ghana Cocoa Processing*, November 2013

57 World Bank, Logistics Performance Index, 2016

58 George Owusu Essegbey, Eugene Ofori-Gyamfi, Technology and Investment, Ghana Cocoa Industry: An Analysis from the Innovation System Perspective, July 2012

2.1.2 Lesotho

- Lesotho's clothing exports, non-existent before the 1990s, grew exponentially in the early 200s, accounting for more than 50% of total exports and still accounted for over 40% in 2014.
- Fundamental to export growth has been integration into:
- International value chains, linking Asia with US markets
- The regional value chains, linking to retailers in South Africa
- Duty free access and foreign direct investment (FDI) have been key drivers of exports to both markets.
- Activist government policy, supported by Aid for Trade, has been important in addressing significant challenges to competitiveness.

2.1.2.1 Critical Success Factors:

- Lesotho, unlike most countries in Sub Saharan Africa (SSA), has been able to take advantage of trade preferences under AGOA.
- It has also profited from the Southern Africa Customs Union (SACU) with South Africa, to a degree that other members of SACU (Botswana, Namibia and Swaziland) have not.
- In export to South Africa, changing business practice has been a critical success factor. The 'fast fashion' model has made geographic proximity a significant factor in competitiveness and helped drive integration in the regional retail chains.
- FDI has been actively promoted as the key diver of the sector.
- Government has actively promoted interventions to address the relatively higher labour costs of Lesotho, supported by significant Aid for Trade.

2.1.2.2 Country Context

The Kingdom of Lesotho is a small, mountainous and landlocked country, with a population of only 2.1-million, uniquely surrounded by its only neighbour South Africa. With a GDP of $2.1-billion, the per capita GDP remains low at just over a $1000.

Lesotho has experienced significant improvement in its institutions and macroeconomic managements and how its is perceived with regards to corruption. However, infrastructure has remained a significant challenge.

Lesotho's own trade arrangements are relatively restrictive, but the ranking of 102 overstates the impact of trade policy because Lesotho is in a Customs Union with its main trading partner – South Africa. In contrast, the market access offered to Lesotho is a source of competitive edge, ranking 23rd in the World.

In addition to markets access, a further competitive advantage for Lesotho is that it has a relatively flexible labour market. Other indicators point to structural constraints on competitiveness. Financial markets are poorly developed and the investment in human capital is low. Transport indicators are also poor. However, they probably overstate the challenge as transport to South Africa which is both a key market and a major export gateway by the port of Durban, is relatively easy.

From the direct perspective of the private sector, in 2009 firms reported access to finance and corruption as the two main obstacles to business.59

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59 World Bank, Lesotho Country Profile, 2009

Table 6: Lesotho governance and competitiveness indicators

GOVERNANCE INDICATOR	
Institutions (out of 140) *	45
Infrastructure (out of 140) *	113
Macroeconomic Environment (out of 140) *	44
Corruption Perception Index (out of 168) **	61
COMPETITIVENESS INDICATORS	
Openness to Trade (out of 138) ~	102
Foreign Market Access/Trade Preferences (out of 138) ~	23
Cost to Export_1 (US$ per container) ***	1,795
Cost to Export_2 (Border Compliance US$) ***	150
Logistics Performance Index (out of 160) ^	154
Financial Market Development (out of 140) *	127
Labour Market Efficiency (out of 140) *	75
Health and Primary Education (out of 140) *	130

* World Economic Forum's Global Competitiveness Index assesses the competitiveness landscape of economies, providing insight into the drivers of their productivity and prosperity (2015 data).
** Transparency International: Each year countries are scored on how corrupt their public sector is seen to be (2015 data).
*** World Bank's Doing Business Indicators focuses on regulations and regulatory processes involved in setting up and operating a business ($/container, 2014 data/$ border compliance 2015).
~ World Economic Forum's Enabling Trade Index assesses institutions, policies, infrastructures and services that facilitate trade in goods across borders (2014 data).
^ World Bank's Logistics Performance Index is an interactive benchmarking tool created to help countries identify the challenges and opportunities they face in their performance on trade logistics (2016 data).

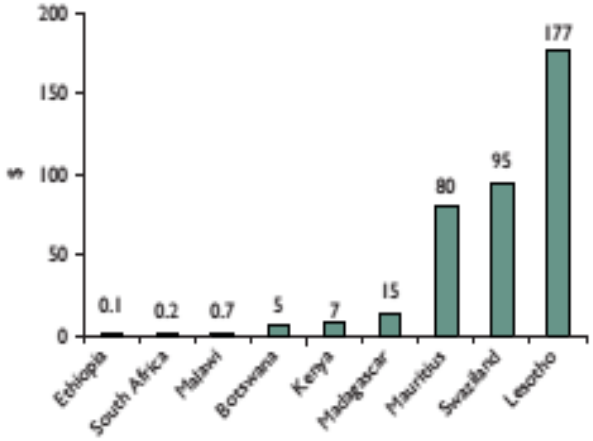
2.1.2.3 Background

Lesotho's formal garment industry started out in the 1980s, driven primarily by South African-based clothing companies seeking to avoid sanctions imposed on South African manufactured goods. Lesotho also enjoyed preferential access to Western Nations.[60] However, actual activity in the apparel industry was still minor, and investments were small scale.[61]

Take off came when Lesotho became eligible for the USA's Africa Growth and Opportunities Act (AGOA). AGOA granted duty free access to the US clothing market even if the fabric used was made outside of Africa or the US (e.g. in China or India). Direct investment by large Asian clothing manufacturers in Lesotho resulted in a rapid rise in exports to the US, going to $129m in 2001 and further increasing to $317.8m in 2002. The impact on employment was equally striking, going from 9,847 in 1999 to 23,518 in 2001, and peaking at 53,067 in 200462. The extent of Lesotho's success becomes clear when exports are compared to the size of the population (see figure).

[60] Overseas Development Institute (ODI) - Aid for Trade in Lesotho: ComMark's Lesotho Textile and Apparel Sector Programme, 2009
[61] Gibbon, P, AGOA, Lesotho's "clothing miracle" and the politics of sweatshops, Review of African Political Economy 30(96): 315-320, 2003
[62] http://pdf.usaid.gov/pdf_docs/PA00K1NW.pdf

Figure 11: Per capita exports to the US



Source: Apparel data, Edwards and Lawrence 2009; population data, United Nations database.

While the US market remains dominant – the destination for 735 of all exports in 2015 – South Africa has become increasingly important with its share in exports rising from 15% in 2011 to 24% in 2015. Exports to the EU have been minimal (see table). Lesotho also sells significant volumes of ring spun yarn to regional textile mills.

Table 7: TABLE 2: Lesotho's trade destinations

COUNTRY	2011		2015	
Total	$396m		$421m	
US	$315m	80%	$310m	73%
South Africa	$61m	15%	$102m	24%
EU	$1.6m	0.4%	$0.27m	-

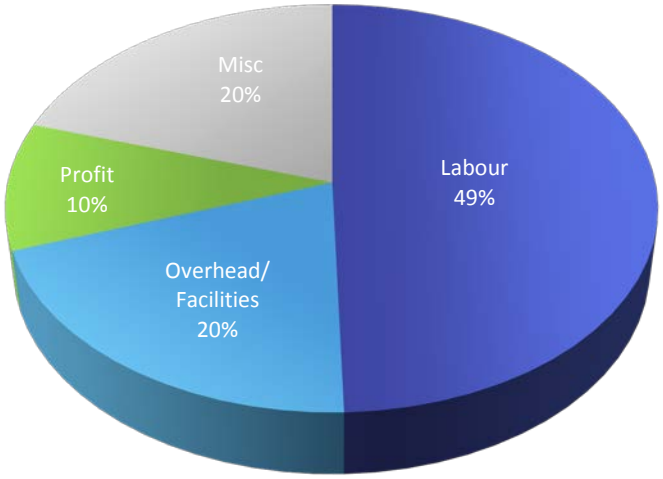
Source: ITC trade Map, Mirror Data, M. Immanuel and R. Sandrey, Tralac 2016

2.1.2.4 Labour costs and productivity in Apparel

A key determinant of success for apparel manufacturing is related to overhead and labour costs, which together represent most of the cost of apparel manufacturing. In Lesotho it represents 69% of total costs related to apparel manufacturing63.

63 World Bank, *Lesotho Country Economic Memorandum: Growth and Employment Options Study*, 2006

Figure 12: Breakdown of non-material costs of apparel



Source: World Bank, 2006

The hourly wages in the apparel sector in Lesotho is $0.46. This is significantly higher than ways in much of the rest of Africa and India (see table) but slightly lower than China and a third of the rate in South Africa. However, Lesotho's productivity has allowed it to compete. Labour cost per shirt is comparable to the region and to India.

Table 8: Floor and labour costs in apparel assembly

COUNTRY	DAILY PRODUCTIVITY	LABOUR COST PER SHIRT	HOURLY WAGE FOR APPAREL ASSEMBLY
Mozambique	10-1	$0.16	$0.25
Ghana	12	$0.12	$0.18
Ethiopia	10-12	$0.12	$0.14
Kenya	12-15	$0.18	$0.30
Madagascar	14-15	$0.16	$0.26
Lesotho	18	$0.19	$0.46
South Africa	15	$0.65	$1.79
India	16	$0.17	$0.27
China	18-22	$0.29	$0.72

Source: Labour productivity and costs are from Eifert, Gelb, and Ramachandran (2005) except for those for Ethiopia, which were calculated using Global Development Solutions (2005).64

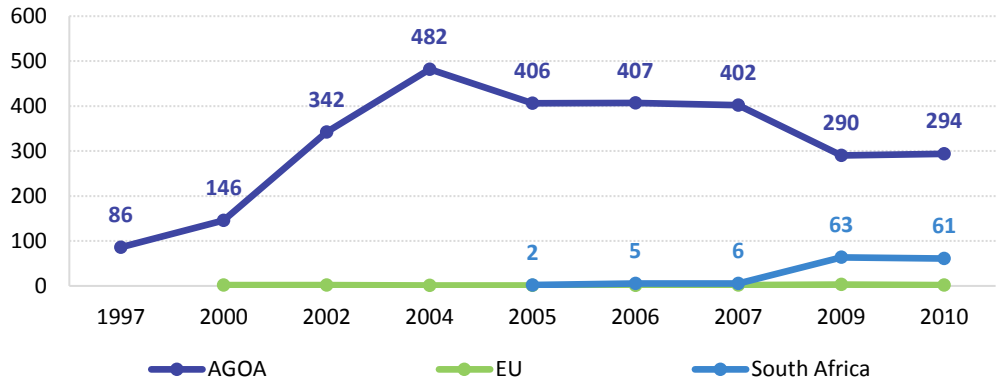
2.1.2.5 Duty Free Market Access

The importance of market access arrangements has already been mentioned but needs to be emphasised. Since 2000, the African Growth and Opportunity Act (AGOA) allowed

64 "Daily productivity is the number of men's casual shirts made by a machine operator in one day. a. Mozambique wage indicates the minimum industry wage specified under the national labour law. b. Data for China is for export processing zones only." All of the initial calculations were completed by Mallika Shakya - Apparel Exports in Lesotho: The State's Role in Building Critical Mass for Competitiveness, 2011

Lesotho to export clothing quota- and duty-free into the United States (US)65 , benefiting from an average tariff preference of 11.4%. Crucially, AGOA allows for third party fabric to be used, enabling clothing exporters in eligible countries in Africa (of which Lesotho was one) to use third party fabric (e.g. Chinese cloth) and still export to the US duty free.

Figure 13: Lesotho apparel exports (US$-millions)



Source: ITC TradeMap, 2016

Lesotho's membership of the Southern Africa Customs Union (SACU) also provides it with duty free and quota free access to the South African market. To export duty free to South African markets, producers in Lesotho can use fabric from third parties but have to pay a tariff (of up to 45%) on imports. The tariff cannot be claimed back on exporting within SACU.

2.1.2.6 INtegration into Global and Regional Value Chains

In 2012, Lesotho had 31 apparel firms, 37 apparel plants, and 1 textile mill operating in the formal apparel and textile industry. All of the apparel firms were foreign owned, of which 21 plants were Asian owned and 15 were South African owned. These firms could be classified in two different types of value chains, with different dynamics and characteristics. The two type of value chains are (a) US buyer-governed value chain and (b) the South African retail-governed value chains. They differ in investor motivation, governance structure and firm-setup, and end markets. 66

The global value chain

Lesotho's integration into global value chains was driven by Taiwanese investors interest in costs (including investment incentives) and AGOA market access. The firms head offices are generally based in Taiwan, and they source from their own fabrics or global producers. They produce for exports, mostly for the US, with a narrow range of basic products made in large volumes67. Critical decision-making functions on input sourcing, product development, design, logistics, merchandising and marketing are located abroad. The production plants in Lesotho are generally only used for Cut-Make-Trim activities. Ultimately, then, the driver of these triangular manufacturing networks is the extraction of rents from preferential market access agreements68.

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65 AGOA was signed into law on 18 May 2000 as Title 1 of the US Trade and Development Act. AGOA offers tangible
incentives for African countries to continue efforts to open their economies and build free markets. www.agoa.gov/.

66 Cornelia Staritz & Mike Morris, *Local embeddedness, upgrading and skill development: global value chains and foreign direct investment in Lesotho's apparel industry*, Working Paper, 2013

67 Gibbon, P, *Governance, entry barriers, upgrading: a re-interpretation of some GVC concepts from the experience of African clothing exports*, Competition & Change 12(1): 29-48

68 Cornelia Staritz & Mike Morris, *op. cit.*

The regional value chain

A fundamental driver of the development of SACU regional supply has been the result of changes in business practices. Clothing and textile industries have embraced this idea of an integrated, vertical supply chain wholeheartedly, led by the Spanish retailer ZARA. Reducing unnecessary excess in the supply chain translates into lower costs at the outlet, allowing increased profitability, especially important in challenging markets. Woolworths and Truworths have both started to operate on a "fast fashion" model, such as ZARA's.69

Additionally, South African apparel retailers are starting to source increasing volumes from Southern Africa, and Lesotho in particular. In 2015, Woolworths (South Africa) sources about 15% of their total garment purchases from Lesotho. Other South African origin garment-manufacturing firms have also been establishing operations in Lesotho.

A key consequence of the fast fashion model is that prices, though still central, are not the sole determinant of competitiveness. A critical factor is time – the longer the time frame between developing and delivering the complete style range the greater the risk of not meeting the demands of the consumer (resulting in markdown sales). The regional supply in SACU clothing is primarily driven by the needs for proximity to customer to minimize lead times.70 This makes Lesotho a particularly attractive destination for South African apparel production.71

2.1.2.7 Investment promotion and facilitation

A key issue for the sector has been the availability and cost of factory sites and related red tape. The permit to construct a factory or any other commercial building takes on average 16 months. It takes 601 days to obtain a construction permit, compared to the 260 days Sub-Saharan Africa average, and 157 days in developed countries. Furthermore, the unsubsidised rate of renting a factory shell in Lesotho was more than twice the rate of developed countries and South Africa. 72

The Lesotho government has actively intervened to address these constraints. It constructed industrial zones and services factory shells. The six industrial zones can be reached by tarred road, within the reach of public transport, and have access to apparel distribution hubs in Johannesburg, connected by rail links. Investors were then offered long-term leases, within the industrial zones, with the option of sub-leasing if necessary, because of the land tenure system, which doesn't allow for land being bought and sold.

The Lesotho National Development Corporation (LNDC), simplified and centralised rental procedures and regulatory processes. The success of the LNDC as an export promotion agency is largely due to its success as a property developer and service provider, which helped attract FDI and create the critical mass of first-generation apparel manufacturing companies in Lesotho73.

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69 This model is often compared to the Toyota Production System which focuses on reducing costs by running "lean" supply chains that eliminates wastage, reduces non-value added operations, and improves the value added.
See Emerald Group Publishing, *Lean Supply Chain: Learning from the Toyota Production System*. Source:http://www.emeraldgrouppublishing.com/learning/management_thinking/articles/pdf/toyota_tps.pdf

70 Mirabel Bausinger, Talitha Bertlesmann-Scott, Nick Charalambides, Jaco Slabbert, and Francois M van Heerden *Overcoming Barriers to Supply Chain Integration in SACU – Lessons from the Private Sector*, Imani Development & World Bank, 2015

71 Joop de Voest, Reginald Selelo and Mark Bennett, *Technical Report: Profile of Lesotho's Textile and Apparel Manufacturing Industry*, 2012, 1–55. Cornelia Staritz and Mike Morris, *Local Embeddedness, Upgrading and Skill Development: Global Value Chains and Foreign Direct Investment in Lesotho's Apparel Industry*, 2013.

72 World Bank, *Doing Business: Lesotho Economy Profile*, 2016

73 Cornelia Staritz & Mike Morris, *op. cit.*

2.1.2.8 Aid for Trade

In 2001 the government, through its Ministry of Trade & Industry, Cooperatives and Marketing (MTICM), commissioned a study of the apparel sector. This DFID funded study found the Lesotho government and its agencies lacked the sector-specific expertise needed to support the apparel industry, meaning that the study's recommendations could not be implemented.

Thereafter, in 2003 the Ministry approached the regional development agency ComMark Trust to fill this gap and help implement the recommendations of the study. As a result, ComMark assisted the industry with capacity building and technical assistance, called the Lesotho Textile and Apparel Sector Programme 2003-2009. This also involved forging partnerships between industry and government. The programme had four key components to its success: 74

- Trade negotiation support: This support focused on extending AGOA. Lobbying was a key component provided through, amongst others, the African Coalition for Trade (ACT) and the African Cotton Textile Industries (ACTIF). Further support in other trade agreements was provided through e.g. the DfID Trade Advocacy Fund (TAF).75
- Technical advisory: Support was provided to the inter-ministerial task team aimed at addressing the concerns of new and existing textile investor, investment promotion mission activities, specifically to South Africa; and commissioning a range of related research. The Lesotho Textiles Exporters Association (LTEA) was established to continue the support. Technical advisory has also been provided through the TAF programme.
- Training scheme: In 2004, the ComMark Training Co-financing Fund was established with the objective of encouraging factory owners to invest in training to enhance the productivity, through the improvement of internal management systems, and consequently increasing global competitiveness. Further, training and capacity building was also provided through the TAF programme and Enhanced Integrated Framework (EIF).
- Apparel Lesotho Alliance to Fight AIDS: In order to safeguard worker's wellbeing, which was the human capital base of the industry, HIV/AIDS programmes needed to be introduced. This enhanced productivity and strengthened the credentials of Lesotho as an ethical source destination of apparel.

2.1.2.9 Infrastructure & cost of exports

Developing Lesotho's infrastructure considers the fact that it is land-locked and is located within South Africa – and strong economic ties makes them particularly reliant on their neighbours' infrastructure to export regionally and globally.76

Lesotho has developed nearly 800 km of tarred road and 1,600 km of gravel road, mainly linking Maseru (countries capital) and Butha-Buthe in the northern parts of Lesotho, and also with Mohale's Hoek in the southern parts of Lesotho. These roads also specifically link with the South African road network at key points for exporting, for example, Caledonspoort, Ficksburg and Maseru are open 24 hour/ day. This allows Lesotho to tap into the export capacity at the South African ports.

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74 Overseas Development Institute (ODI), *Aid for Trade in Lesotho: ComMark's Lesotho Textile and Apparel Sector Programme*, 2009

75 Imani Development provided key negotiations, technical and capacity building support to the Ministry of Trade and Industry in Lesotho, within the Trade Advocacy Fund (TAF) Project throughout 2015.

76 KPMG, Lesotho Country Profile, 2012

Lesotho itself does not have railway infrastructure, however, again, exports from Maseru are loaded at the nearby railways in Ficksburg (South Africa), with links to the major South African ports such as Durban77.

2.1.2.10 Future – Sustainability under AGOA

There is real concern the next AGOA in 2025 might see the end of preferential market access for Lesotho. With concerns regarding their political instability and the need to become more competitive in production, there is real risk that Lesotho will lose AGOA access with a negative impact on employment and growth. At the September 2015 Ministerial AGOA forum, African Trade Ministers recognised the urgency of planning ahead, and created a task force which will outline strategies for US-Africa trade in to guide relations past the next review78.

2.1.3 Mauritius

- Mauritius is a middle-income country that has accomplished several stages of economic transition, from success in sugar to clothing and fabric exports to exporting services.
- Tourism growth increased from 6% in 1999 to 11% in 2000. Its direct contribution to GDP is 6.7% and its indirect contribution estimated to be 25%.
- Medical Tourism has grown on the success of mainstream tourism.
- Financial services exports have helped the finance and insurance sectors become a major part of the economy, contributing 10.4% to GDP in 2015.
- Good governance, activist policy and relatively strong human development have underpinned diversification and growth.

2.1.3.1 Critical Success Factors

- Tourism has grown on the back of natural beauty, stability and cultural proximity to French and English speaking markets.
- Medical Tourism has grown on the success of mainstream tourism, actively supported by government and the openness of the trade regime.
- Financial services exports have benefited from active government support. But luck also played a role. Cultural ties with India resulted in a Double Tax Agreement that positioned Mauritius as the gateway for much foreign investment in the subcontinent. That said, Mauritian policy makers ensured this good fortune converted into a positive economic impact.

2.1.3.2 Country Context

Mauritius is an upper middle-income island nation of 1.3-million people and is one of the most competitive, stable, and successful economies in Africa, with a Gross Domestic Product (GDP) of $11.5-billion and per capita GDP of over $9,000.79 Mauritius ranks as the number one country in Africa on the World Banks Ease of Doing Business Indicators, Governance Indicator Rank and Global Competitiveness Forum.80

Mauritius has low levels of corruption coupled with strong institutions. Infrastructure, health care and financial markets are also well developed. Based on the Global Enabling Trade indicator Mauritius ranks 3rd for domestic market access and indicators from the World Bank show that it is one of the most cost effective country from which to import and export.

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77 Lall, S, *AGOA and manufactured exports by a landlocked, least developed African economy: Lesotho,* Journal of Development Studies 41(6), 2005

78 AGOA.info, *Lesotho: Bracing for the post-AGOA period*, 2016 https://agoa.info/news/article/6288-lesotho-bracing-for-the-post-agoa-period.html

79 World Bank, World Economic Indicators 2015

80 Investment Climate Statement: Mauritius 2014.

Table 9: Mauritius governance and competitiveness indicators

GOVERNANCE INDICATORS	
Institutions (out of 140) *	34
Infrastructure (out of 140) *	37
Macroeconomic Environment (out of 140) *	73
Corruption Perception Index (out of 168) **	45
COMPETITIVENESS INDICATORS	
Openness to Trade (out of 138) ~	4
Foreign Market Access/Trade Preferences (out of 138) ~	5
Cost to Export_1 (US$ per container) ***	675
Cost to Export_2 (Border Compliance US$) ***	269
Logistics Performance Index (out of 160) ^	N/A
Financial Market Development (out of 140) *	34
Labour Market Efficiency (out of 140) *	57
Health and Primary Education (out of 140) *	42

* World Economic Forum's Global Competitiveness Index assesses the competitiveness landscape of economies, providing insight into the drivers of their productivity and prosperity (2015 data).
** Transparency International: Each year countries are scored on how corrupt their public sector is seen to be (2015 data).
*** World Bank's Doing Business Indicators focuses on regulations and regulatory processes involved in setting up and operating a business ($/container, 2014 data/$ border compliance 2015).
~ World Economic Forum's Enabling Trade Index assesses institutions, policies, infrastructures and services that facilitate trade in goods across borders (2014 data).
^ World Bank's Logistics Performance Index is an interactive benchmarking tool created to help countries identify the challenges and opportunities they face in their performance on trade logistics (2016 data).

A high percentage of firms are domestically owned (more than 80%) and most firms are small in nature, comprising of 5-19 employees. There are only a few firms that employ more than 100 workers81.

2.1.3.3 Background

Before becoming a predominantly service economy, the sugar industry was the core of the Mauritian economy. Although sugarcane still covers nearly half of the island's land area and 90% of its cultivated land, the industry's relative importance has declined over the years. It now accounts for less than 1% of GDP (MR 2771-million)82, compared to 13% in 1979 and 23% in 1970.83

The export of textiles and clothing was also a strong sector in the economy. Although it still contributes approximately 5% to GDP per annum, its significance has declined as the value of preferential access agreements declined (especially with the end of the Multi-Fibre Agreement). That said, the AGOA with the United States, which was renewed for an additional ten years in 2015, has provided some respite for the sector.

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[81] World Bank Enterprise Surveys Mauritius 2009

[82] Mauritius Chamber of Commerce and Industry Economic Data (2015)

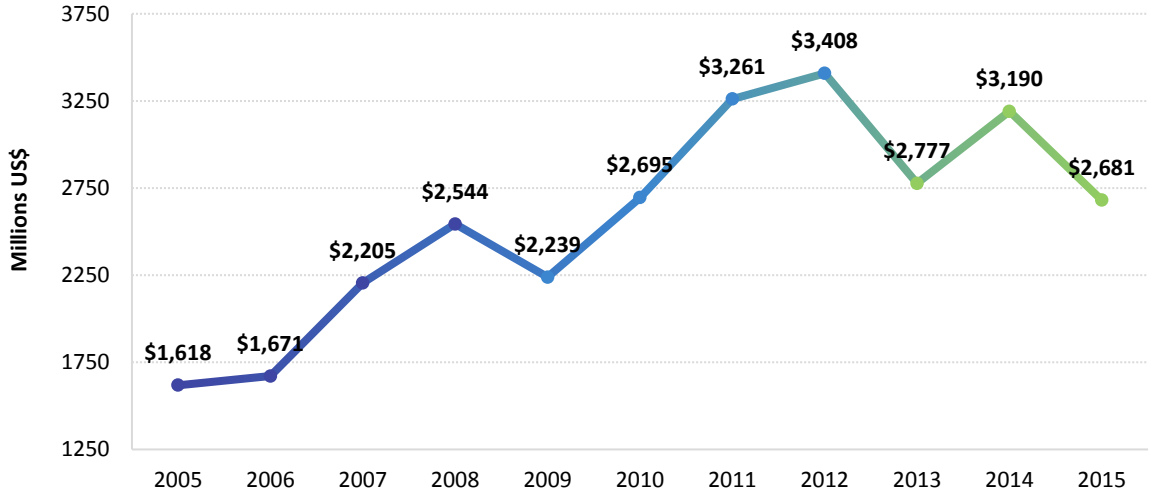
[83] Embassy of the United States, 2003. *Port Louis – Mauritius.* Available online: https://mauritius.usembassy.gov/chapter_2.html

In response to the challenges facing the sugar and clothing sectors, the Mauritian government launched a programme of reforms in 2005. The programme aimed to increase foreign investment and economic growth by simplifying business procedures, bettering investment conditions, and increasing economic openness.

Transition to Services

The service sector has grown from 62% of GDP in 2000 to 72.5% in 201384.

Figure 14: Mauritius total services exports (2005-2015)



Source: ITC, TradeMap

Since the mid-1990s the tourism industry has developed as the second fastest growing sector (after finance) of the economy. The tourism sector grew from 6% in 1999 to 11% in 2000.85 The real growth rate of tourism in 2015 was 9.3% and its contribution to GDP was 6.7%. It is also the second largest foreign-exchange earner, with gross earnings amounting to $1,408-million in 2015.86

When looking at the multiplier effect of tourism, its impact on the economy is even greater. The multiplier effects consider the direct, indirect and induced impact of tourism on the economy. The total contribution of travel and tourism was estimated to be $2.869-billion in 2014 (25.5% of GDP) and is expected to grow by 3.6% to $2.974-billion (25.4% of GDP) in 2015. 87.

2.1.3.4 EXPLOITING A Natural Advantage IN TOURISM

There are several reasons for the success of tourism in Mauritius. The country is a beautiful island economy surrounded by exotic beaches and its position in the Indian Ocean makes for warm temperatures throughout the year. Many luxurious hotels and golf resorts are available for tourists, some ranking among the best in the world. There are a variety of other sport activities like sailing, windsurfing, waterskiing, paragliding, diving and tennis are on offer. Competitions like the Indian Ocean Island Games, Iron Man, the AfrAsia Bank Mauritius Open and international fishing tournaments are also held in Mauritius.

Tourist arrivals reached 1,151,723 in 2015, an increase of 10.9% over 2014. Major tourist markets are France (22%) followed by Reunion (13%), United Kingdom (11%), South

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84 Powell, J., 2015. *Factors Contributing to the Rapid Growth of Mauritius' Service Economy*. USITC Executive Briefing on Trade.

85 Embassy of the United States, 2003. *Port Louis – Mauritius.* available online: https://mauritius.usembassy.gov/chapter_2.html

86 Statistics Mauritius, *International Travel and Tourism*, 1st Quarter 2016, available online: http://statsmauritius.govmu.org/English/Publications/Pages/Intl-Trvl-and-Tourism-Qtr1_2016.aspx

87 World Travel and Tourism Council, 2015, *Economic Impact 2015 Mauritius*.

Africa (9%), and Germany (7%).88 One of the reasons for the high number of French visitors is due to Mauritius being both an English and French speaking nation. However, the number of French tourists has decreased in recent years from 282,469 in 2011 to 246,334 in 2015. One of the reason is the air tax on the Paris-Mauritius route which is high relative to many other destinations89.

Targeting Market Segments

Eco-tourism is also becoming more popular and aids in the preservation of the natural beauty of Mauritius. Government has strongly given its support to eco-tourism.

High-end tourism is preferred over low budget tourism. The Mauritian government encourages boutique luxury hotels, 4 and 5-star beach resorts, golf courses, spas and beauty centres. Tourism is directed primarily at the high-spending European market.

2.1.3.5 Institutions and regulations

The Mauritian government has been central in providing stability, preventing destructive externalities, and stimulating backward links in the economy. Political stability coupled with sound and pragmatic economic policy has placed Mauritius in a strong position.

In addition, there is a strong relationship between the public and private sector, developed by the Joint Economic Council (JEC). The JEC forms a central part of the countries' institutional landscape, and represents several sector-specific groups. The main objective is ensuring private representation in all key government lead economic decisions.

Support to the private sector is also provided through the Mauritius Export Development and Investment Authority (MEDIA), the Export Processing Zone Authority (EPZD), and the Development Bank of Mauritius. The Investment Council has promoted Mauritius as an international investment opportunity and facilitated and provided counselling on opportunities and even helped set up the businesses.

Building a business services ecosystem

The government has also become adept at providing services beyond tourism, creating a favourable business environment and business-friendly regulations have contributed to the growth of Mauritius' service sector.

The Business Facilitation Act of 2006 is particularly notable for having liberalised the overall business climate in Mauritius. Among other things, the Act streamlined the licensing of new businesses and cutting the time between incorporation and operation to three days. It also liberalised the provisions regarding the entry and stay of foreign professionals in the country90. The reforms resulted in low corporation tax, simplified business procedures, better investment conditions, and increased economic openness.91 .

2.1.3.6 FDI driven tourism and travel growth

Openness to foreign investment and foreign skills is part of the 'brand' of Mauritius. According to the World Bank report "Investing Across Borders", Mauritius has one of the world's most open economies to foreign ownership and is one of the highest recipients of FDI per capita.92

Total FDI averaged $33-million annually for several years up to 2005. It then rose dramatically. Since the 2006 reforms, Mauritius has attracted about $2.4-billion from

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88 Statistics Mauritius, Ministry of Finance & Economic Development, International Travel & Tourism Statistics 2015

89 Interview with Boris Reibenberg, Chairman of Tourigolf, on Beachcomber Hotels News, 2014

90 Powell, J., 2015. *Factors Contributing to the Rapid Growth of Mauritius' Service Economy*. USITC Executive Briefing on Trade.

91 *Ibid.*

92 Investment Climate Statement: Mauritius, 2014.

foreign investors93. The main sources are France, South Africa, the United Kingdom, and the United Arab Emirates.94 .

Investment into travel and tourism in Mauritius has been a significant contributor to the growth of the industry. In 2005 capital investments into the sector was $128-million. In 2006 this figure increased to $214-million and increased again to $263-million for 2007/08. Capital investment in the tourism industry in 2015 was $134-million.95 FDI is expected to rise by 6.3% per annum over the next ten years, to $260-million by 2026.96 The number of hotels in Mauritius amounts to 115 licensed establishments in 2015 compared to 95 in 200097.

2.1.3.7 Air travel

Air Mauritius, which remains majority government owned, continues to be used as strategic tool for tourism (and to support e.g. the growth of the logistics hub by offering direct flights to Singapore). However, the airline has often struggled and been operating at a loss. The government, in the past, has restricted competition to protect the company98 which pushed up the price of air travel. However, government recently introduced an open-skies policy which has resulted in an increase in the number of airlines flying to Mauritius. Access has also been granted to new sixth freedom carriers which has resulted in an intensification of competition. The open skies policy and the sixth freedom carriers have gone a long way to reduce the negative impact of Mauritius being a slightly isolated location. Having more carriers' flying to Mauritius has resulted in increased competition thus lowering airfares and making Mauritius a more accessible and attractive destination.

2.1.3.8 Medical Tourism

Building on a successful tourism industry, the medical tourism industry in Mauritius is starting to gain traction. The Mauritian government has fostered the development of the medical tourism industry by encouraging improvements in medical education, establishing a favourable legal framework for medical services providers, and exempting cosmetic and plastic surgery from the national value-added tax (VAT). It is the policy of the government to make Mauritius a medical tourist hub and to increase the number of medical tourists to 100,000 by 202099.

The objective is to develop medical tourism as another pillar of the economy. As mentioned previously, Mauritius' natural beauty, pleasant climate, and diverse population draw potential patients.

Medical infrastructure joined up with tourism infrastructure

Private hospitals and clinics work in close collaboration with hotels to provide a full health package to foreign patients that includes medical procedures, accommodation, and airport transfers. For example, Apollo Bramwell hospital through its partnerships provides physician appointments, visa assistance, communication with local embassies, liaison with insurance companies for payment, hotel reservations, airport transfers, interpreter services and excursion and site seeing tours.

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[93] This breaks down to $443million in 2010, $339-million in 2011, $419-million in 2012, and $307 in 2013.

[94] Investment Climate Statement: Mauritius, 2014.

[95] World Travel and Tourism Council, 2016. *Economic Impact 2016 Mauritius.*

[96] *Ibid.*

[97] Statistics Mauritius, Ministry of Finance & Economic Development, Mauritius in Figures, 2015

[98] https://www.iata.org/policy/promoting-aviation/liberalization/agenda-freedom/Documents/mauritius-report.pdf

[99] Various sources show that the 2015 figure for medical tourists is between 15,000 to 20,000 patients.

Human health and social work activities have grown at an annual average rate of 12.4% during 2006-2013 and accounted for 4.3% of Mauritian GDP in 2013.100 The number of foreign patients receiving medical treatment in Mauritius increased from about 1,000 in 2005 to about 15,000 in 2014101 . The source countries for foreign patients in 2011 include Madagascar (28%), Reunion (14%), Seychelles (9%), Europe (10%), UK (5%) and the rest of the World (17%).102

The private sector comprises of 17 multi-speciality clinics and 11 speciality clinics and employs 533 generalist and 302 specialist doctors. The private sector absorbs 30% of total expenditure on health103.

The major hospital groups in the country who treat foreign patients include Fortis Clinique Darné (a joint venture between Fortis Healthcare of India and Mauritian Industrial Group CIEL), Apollo Bramwell Hospital (a joint venture between the Apollo Group of India and the local British American Investment Group), and Dr Agarwal's Eye Hospital from India and Metropolis Mauritius (another joint venture between Metropolis Healthcare and Bramser Lab Services).104

Other clinics which attract international patients include the specialist cosmetic and hair surgery clinic Centre Esthetique de L'Ocean Indien, the dental clinic Dentcare, the Harley Street Fertility Centre and the rehabilitation centre Les Marianne.105 These hospitals are generally also examples of large FDI injections into the economy. It is estimated that the Apollo group invested $30-million when they first entered the economy in 2009 in a joint venture with a local corporate group. Fortis Healthcare also invested a significant portion when they entered the economy in 2008.

In 2010, Parenteral Drugs (India) Ltd acquired a majority stake in a local pharmaceutical manufacturing company. What is evident is the growth in the medical tourism industry is correlated to growth in FDI. This has been made possible by pro-business policy and openness to new markets.

Medical tourists seek cardiology, ophthalmology, orthopaedics, cosmetic surgery, fertility treatment, dentistry, hair crafting, and stem cell treatment. Mauritius is known internationally as a high-end tourism destination, so medical tourism is being sold on quality rather than only on price106. The table below compares the cost of medical procedures between various countries.

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100 Powell, J., 2015. *Factors Contributing to the Rapid Growth of Mauritius' Service Economy*. USITC Executive Briefing on Trade.

101 Board of Investment, Mauritius, available online: www.investmauritius.com

102 Sonoo. J., 2012. *Impact of Medical Tourism on Health Sector in Mauritius*. AfSBT International Congress

103 *Ibid.*

104 International Medical Travel Journal, 2016. *Attracting Investment by Developing Medical Tourism in Mauritius.* Available online: https://www.imtj.com/news/attracting-investment-developing-medical-tourism-mauritius/

105 *Ibid.*

106 *Ibid.*

Table 10: Cost comparison of treatments in 2012 (US$)

PROCEDURE	USA	THAILAND	SINGAPORE	INDIA	MAURITIUS
CABG (coronary artery bypass graft)	100,000	11,000	18,500	10,000	12,000
Valve replacement	160,000	10,000	12,500	9,000	10,000
Angioplasty	57,000	13,000	13,000	11,000	5,000
Hip replacement	43,000	12,000	12,000	9,000	8,500
Knee replacement	40,000	10,000	13,000	85,000	7,000
Spinal fusion	62,000	7,000	9,000	5,500	5,000
Face lift	20,000	4,800	6,250	3,100	4,000
Breast augmentation	10,000	3,150	8,000	3,200	5,000
Breast reduction	10,000	3,900	8,000	3,000	5,000
Liposuction	10,000	2,100	5,000	2,500	3,400
Nose surgery	7,300	3,850	4,400	1,800	3,500

Source: Board of Investment, 2012

In addition to offering competitive prices coupled with favourable surroundings, Mauritian service providers have invested in the latest technologies in cosmetic surgery and dentistry equipment. The private health centres and clinics are also supported by modern medical diagnostic centres and laboratories. The government has also focused on retraining and re-skilling its labour force. The depth and quality of Mauritius' medical education and training have increased considerably in recent years. All medical staff involved in medical tourism are bilingual, speaking both English and French.

2.1.3.9 Financial services

Another case of diversification has been the financial service industry. As mentioned previously Mauritius ranks highly as a pro-business environment and this has been one of the contributing factors resulting in the finance sector becoming the fourth pillar of the Mauritian economy. The Mauritian government has supported the sectors competitiveness through financial innovation, the preservation of tax and non-tax competitive advantages, and through the maintenance of macroeconomic stability. This has helped generate significant foreign exchange earnings. The finance and insurance sector contributed 10.4% of GDP in 2015107.

A number of laws and government initiatives have encouraged growth in the Mauritian financial services sector, including the establishment of the Global Business Sector (the country's offshore financial jurisdiction) in 1992; the Business Facilitation Act of 2006; the Banking Act of 2004 and its 2007 amendments; the Insurance Act of 2005 and Insurance Amendment Act of 2007; the Financial Services Act of 2007; the Securities Amendment Act of 2007 and the Economic Crime and Anti-Money Laundering Act (Powell, 2015). These acts have aided in streamlining the licensing of service suppliers and strengthening the finance and insurance industry. Mauritius is thus positioned as an international centre for financial intermediation.

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107 Board of Investment Mauritius, Financial Services

Mauritius' favourable tax regime also makes it an attractive business location for foreign financial services firms. Mauritius has established double taxation treaties with 43 countries, including India.108 Notably, about 34% of India's inbound foreign direct investment is channelled through Mauritius due to the tax agreement between the two countries. The DTAA was a major reason for many foreign portfolio investors (FPI) and foreign entities to route their investments in India through Mauritius. Between the period of April 2000 and December 2015, Mauritius accounted for $93.66-billion (33.7%) of the total foreign direct investment allocated for India.

It must be noted, however, that in May 2016 India signed a protocol amending the Double Taxation Avoidance Agreement (DTAA) with Mauritius, which will come into force in April 2017. The reason for this was to clamp down on the previous tax treaty and to ensure that India earns the correct capital gains tax and to curb money laundering and tax abuses. This new protocol may result in a slower flow of investments through Mauritius, thus weakening the industry.109

Moody's views a systemic banking crisis as being unlikely, given factors such as the system's sound capital and liquidity buffers. The authorities have also intensified efforts to strengthen the country's crisis management framework and to reduce the costs of resolving troubled banks for the government.

2.1.3.10 Future challenges

The tourism industry in Mauritius is significantly affected by the macroeconomic condition of its leading tourism partners. These are factors that are largely uncontrollable. For example, due to the recent global financial and economic crises, and sluggish growth in the Euro zone, Mauritius' economic growth rate has declined from 5.5% in 2008 to 3.7% in 2015.110 When the Euro Zone struggles, this directly affects the level of tourism in Mauritius. To diversify this risk, Mauritius has actively pursued developing new tourism partners such as India and Singapore.

A report from Moody's111 has also highlighted some concerns in the financial sector. They estimate that the DTAA changes with India could curtail net financial flows by between 1% and 2% of GDP annually. They have also stated that the size and complexity of the sector and the large number of links between financial institutions could contribute to contagion risk. The financial sector is composed of primarily off-shore investments and deposits. The off-shore sector, mainly composed of Global Business Companies (GBCs). hold assets worth almost 50 times the country's GDP. However, Mauritius has relatively large foreign exchange reserves which amounted to $3.9-billion in March, 2016.

2.1.4 Nigeria

- Nigeria has the largest population in Africa (182-million people), is its biggest oil exporter, and one of its largest economies. Its banking sector has also become one of the leaders in Africa.
- There has been strong domestic growth in the sector, with 5,810 branches in 2014 compared to 2,193 in 200. The banking sector's contribution to GDP has also risen from less than 1% in 2000 to 3.97% in 2015.
- The banking sector is a successful exporter of financial services. The eternal assets of Nigerian banks increased from N194,585-million in 2000 to N1,702,513-million in 2011. A leading example of success is the United Bank for Africa (UBA) with subsidiaries in 20 countries in Africa.

108 Mauritius Revenue Authority, available online: http://www.mra.mu/index.php/taxes-duties/double-taxation-agreements

109 The Indian Express, 2016. *What the changes in the tax treaty with Mauritius mean for India*, investors. Online newspaper.

110 African Development Bank, 2016. *African Economic Outlook 2016.* African Development Bank Group

111 Moodys, 2016. *Announcement: Mauritius's financial sector brings both economic growth and systemic risk*. Global Credit Research.

- Though successful, the sector has faced several crises. The challenges for financial regulators in Africa are compounded when banks operate across borders.

2.1.4.1 Critical success factors

Exports are rooted in the strong domestic growth of the sector.

Strong regulatory interventions to address large flaws in the banking industry structure. This consolidated the banking sector from 89 banks to 24, through both regulatory and market–induced mergers and acquisitions.

Large populations and markets, despite poor infrastructure, can give scale to the services sector as a base from which to export (in sharp contrast to financial services growth elsewhere, e.g. in Mauritius).

Diaspora and the Remittance Corridor: inflows of capital and connections with the UK banking sector, and Nigerian expatriate network across African markets has catalysed services growth (despite no direct government support).

2.1.4.2 Country context

Nigeria has the largest population in Africa, with 182-million people112, and is also the continent's largest oil exporter. Nigeria became the largest African economy in 2013 after the Department of Statistics rebased its GDP. Its GDP for 2015 was $481-billion, down from its high of $568.5-billion in 2014 due to lower oil prices and the commodity boom ending.113

Table 11: Nigeria's governance and competitiveness indicators

GOVERNANCE INDICATORS	
Institutions (out of 140) *	124
Infrastructure (out of 140) *	133
Macroeconomic Environment (out of 140) *	81
Corruption Perception Index (out of 168) **	136
COMPETITIVENESS INDICATORS	
Openness to Trade (out of 138) ~	122
Foreign Market Access/Trade Preferences (out of 138) ~	131
Cost to Export_1 (US$ per container) ***	1,564
Cost to Export_2 (Border Compliance US$) ***	786
Logistics Performance Index (out of 160) ^	90
Financial Market Development (out of 140) *	79
Labour Market Efficiency (out of 140) *	35
Health and Primary Education (out of 140) *	140

* World Economic Forum's Global Competitiveness Index assesses the competitiveness landscape of economies, providing insight into the drivers of their productivity and prosperity (2015 data).

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112 United Nation Population Division, *World Population Prospects: The 2015 Revision*, 2015

113 World Bank, World Bank Economic Indicators

** Transparency International: Each year countries are scored on how corrupt their public sector is seen to be (2015 data).
*** World Bank's Doing Business Indicators focuses on regulations and regulatory processes involved in setting up and operating a business ($/container, 2014 data/$ border compliance 2015).
~ World Economic Forum's Enabling Trade Index assesses institutions, policies, infrastructures and services that facilitate trade in goods across borders (2014 data).
^ World Bank's Logistics Performance Index is an interactive benchmarking tool created to help countries identify the challenges and opportunities they face in their performance on trade logistics (2016 data).

Nigeria ranks 124th in the World Economic Forum's Global Competitiveness Index. The indicators reflect a mixed overall result, with some strong and many very weak pillars. Nigeria is significantly affected by poor ranking in governance and institutions indicating that it is negatively affected by high levels of corruption.

The World Economic Forum cited poor infrastructure as the most problematic factor for doing business (ranked 133rd), closely followed by human capital.114 The cost of transportation in Nigeria is also high: the cost to import/export a 20-foot container in 2014 was $1,960 and $1,564 respectively.115 Poor health in the workforce (134th) and inefficient higher education (128th) holds the country back from fulfilling its potential.116

2.1.4.3 Structural reform and policy environment

The banking sector has been on a roller coaster ride, with different phases of control, expansion, near collapse, and consolidation – not always in that order.

Before financial sector reforms in 1987 the sector was strongly limited and regulated, with interest rate controls, selective credit expansion, use of reserve requirements and other direct controls117. The country then moved away from financial repression and witnessed strong growth of the banking sector. As of 2004 there were 89 banks118. Many of the banks were found to be over-dependent on public sector funds, under-capitalised, and characterised by several weaknesses. There were challenges of poor corporate governance, poor asset quality, inaccurate reporting and non-compliance with regulatory requirements, falling ethics and huge non-performing insider related credits119. The Central Bank of Nigeria oversaw a consolidation exercise in 2005 and the banking system was rationalised from 89 banks to 24 through both regulatory and market–induced mergers and acquisitions.

Between 2004 and 2008 the increase in the oil price resulted in large inflows in foreign exchange and strong economic growth. This coupled with high levels of FDI resulted in huge liquidity and unprecedented growth in the stock exchange. The increase in capital resulted in banking sectors assets as a percentage of GDP increasing from 46.8% in 2003 to 66.7% in 2008.120 A lack of diversification, poor risk management practices and a concentration of assets and margin lending in the oil and gas sector resulted in a fragile financial system like the pre-consolidation era when the global financial crisis set in mid-2008. The result was a sharp deterioration in the quality of banks' assets which immediately led to concerns over banks' liquidity. The Nigerian banking sector was thrown into severe crisis as many of the banks became distressed. The crisis resulted in the bankruptcy of several of Nigeria's bigger banks.

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114 World Economic Forum, The Global Competitiveness Dataset, 2016

115 World Bank, World Bank Economic Indicators Doing Business project , 2014

116 World Economic Forum, The Global Competitiveness Dataset, 2016

117 Kanayo Ogujiuba & Michael Emeka Obiechina, *Financial Sector Reforms in Nigeria: Issues and Challenges*, Vol. 6, No. 6, 2011

118 Central Bank of Nigeria, *Banking Sector Reform*, Understanding Monetary Policy Series No. 7, 2011

119 Sanusi Lamido Sanusi (Gosvenor, Central Bank of Nigeria), *The Nigerian Banking Industry: what went wrong and the way forward*, Convocation Lecture, delivered at Bayo University, Kano, 26 February 2010

120 Mike Ozemhoka Asekome & Aihie John Abieyuwa, *Challenges of Banking Sector Reform in Nigeria: An Appraisal*, International Journal of Business Science, Vol. 5, June 2014

The CBN moved decisively to strengthen the industry and restore confidence in the banking sector. The initial measures taken included injection of N620-billion into nine banks; the replacement of the chief executive/executive directors of eight of the nine banks with competent managers with experience and integrity; reaffirmation of the guarantee of the local interbank market to ensure continued liquidity for all banks; and guaranteeing of foreign creditors and correspondent banks' credit lines to restore confidence and maintain important correspondent banking relationships121.

The implementation of these consolidation measures122 set up Nigeria's banking industry for post-2008 growth. Banks in Africa have been reporting stellar growth and have been expanding their loan books compared to banks in rich countries. Moody's, the rating agency, has reported that the average return on equity ranged from 20-25% in many African countries making them twice as profitable as American banks and 4 to 5 times more profitable than their European counterparts. Accordingly, the growth in banks in Nigeria appears to be a combination of consolidation, an emphasis on good governance, strict adherence to global best practice and investors looking for return in otherwise very flat markets.

There are several additional important factors that have resulted in the growth of the banking sector. Nigeria has a population of 182-million meaning that the retail consumer market is large. Nigeria is also on the forefront, in Africa, of electronic banking products and has had resounding success in e-banking. This is explained partially by the role of the CBN's drive towards cashless transactions to promote speed, flexibility and accountability.

The story of Zenith Bank

Zenith bank launched in 1990 and was listed on the Nigerian Stock Exchange in 2004. It helped to revolutionise banking in Nigeria, lifting the sector from the era of over-conservatism to one of dynamism, characterised by a culture of excellent product and service rendering and global best practices achieved through a combination foresight, skilful banking expertise and the deployment of a innovative IT infrastructure. Zenith Bank's shares are now freely traded on the London Stock Exchange, following a listing of $850-million.

In April 2007, Zenith became the first Nigerian bank in 25 years to be licensed by the UK Financial Services Authority (FSA), giving rise to Zenith Bank (UK) Limited. Zenith Bank also has a presence in: Ghana; Sierra Leone; and Gambia. In addition, the bank has representative offices in South Africa and China and plans to take the Zenith franchise to other African regions as well as the European and Asian markets.

However, the slowdown of commodity prices and the drop in oil in particular has placed the banking industry on the cusp of its second crisis in less than a decade. In July of this year the central bank dismissed the management of Skye Bank, due to failing to keep enough capital to absorb losses on its bad debts. Its share price has plunged by about a quarter and the shares of other Nigerian banks are also being affected.

2.1.4.4 The regulatory authorities

A key contributor to the success of the finance industry was effective regulation and supervision of the Banking Industry by the CBN, and the use of ICT, capacity building programmes, and promotional policies. Thus, the policy environment helped enable the development of human capital and attraction of expertise, integrating IT systems, improving the legal and regulatory framework of Nigeria, active communication, advocacy

121 *Ibid.*

122 *Ibid.*

and public relations for the Financial System Strategy 2020.123 However, with regards to financial services exports, there is no evidence of policy support124.

2.1.4.5 Nigerian diaspora

African governments are increasingly recognising the importance of their citizens living abroad or the 'new African Diaspora' in the national reconstruction, rehabilitation and economic growth process and its importance in regional development. The role of the Diaspora has been identified as both a source of financing, and as development partners. These African migrants are highly skilled professionals who can contribute to the national economic growth process through remittances and knowledge.

According to the World Bank, more than half of Nigeria's academic personnel may be working abroad and it is speculated that 75% of migrants from African countries to OECD nations had completed tertiary education125. The Nigerian Government has helped to establish the Nigerians in the Diaspora Organisation (NIDO). One of the objectives of NIDO is to serve as a forum for dialogue with government on the practical, efficient and cost-effective ways to impact the Nigerian economy. The Directorate of Technical Cooperation in Africa (DTCA) has launched a programme in which African professionals, and Nigerians in particular, will be engaged to help Africa to gain from the skills and expertise of the Diaspora. These professionals will be able to choose any country in Africa into which they may invest their expertise on short term basis126.

2.1.4.6 The remittances corridor

Remittances by African migrants have become as significant as official development assistance (ODA). In 2008 net bilateral ODA from members of its Development Assistance Committee totalled $26-billion, $22.5-billion of this went to SSA. 127Remittances inflows to SSA countries measured $25.8-billion in 2007 and 29.8-billion in 2010. In 2015 personal remittances to SSA were $37.4-billion128.

Nigeria is the largest recipient of remittances in Sub-Saharan Africa. In 2004, $2.26-billion remittance inflows were recorded by the Central Bank of Nigeria (CBN) – equivalent to 3.15% of GDP. Remittance inflows have surpassed levels of official development assistance since 2002.129

The CBN has estimated that 37% of total remittances originate through banks while the remaining 63% originate from correspondent bank transfers, SWIFT, foreign domiciliary accounts, non-commercial imports, private source imports and other in-kind transactions. Due to the remittance corridor, inflows of capital and the Nigerian expatriate network across African markets has catalysed services growth specifically in the financial sector.

2.1.4.7 Growth is driving banks to cross borders

Financial services accounted for 2.3% of Nigerian GDP in 2013 and showed a 30% growth in nominal terms the same year. The contribution of financial services to GDP in 2015 was 3.97% showing further growth and potential of the sector.130

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123 Kanayo Ogujiuba & Michael Emeka Obiechina, *Financial Sector Reforms in Nigeria: Issues and Challenges*, Vol. 6, No. 6, 2011

124 R. Chaitoo and A Bankole, Bank Services: A Case Study of Nigeria, TRALAC December 2015.

125 AFDB, *The Role of the Diaspora in Nation Building - Lessons for Fragile and Post-Conflict Countries in Africa*, 2011

126 *Ibid.*

127 *Ibid.*

128 World Bank, World Bank Economic Indicators

129 *Ibid.*

130 National Bureau of Statistics, The Federal Republic of Nigeria, *Nigerian Gross Domestic Product Report*, Quarter 1 2016

Of the 24 Nigerian banks, 11 had operations in other African countries as of 2012, with Ecobank Nigeria operating in 35 other African countries. Eight Nigerian banks also had international operations beyond Africa. In 2013, there were 20 commercial banks with 5,810 branches in Nigeria, compared to 2,193 branches in 2000. Nigerian banks' external assets increased significantly from N250-million in 1980 to N1,703-billion in 2011131.

2.1.4.8 Challenges

Domestically, the banking sector faces substantial challenges. About 40% of Nigeria's total loans are to the oil and gas industry.132 These loans seemed safe until the oil price began dropping in mid-2014. Militancy in the oil-pumping Niger Delta has made matters worse. The central bank says that bad debts in the banking system are anticipated to more than double in 2016 to 12.5%, a view supported by Nigeria's main rating agency Agusto & Co 133. Accordingly, Nigerian banks need to continue expanding regionally to both diversify their risk exposure and open up new opportunities for profits.

The growth of banks across borders also presents real challenges for financial sector regulators in Africa. It requires them to better integrate standards and regulations governing the banking industry into the agenda of regional economic communities.

2.2 Asia

2.2.1 Bangladesh

- Bangladesh's clothing exports, and to a much lesser extent fabrics, have grown from a small proportion of total export to 84% by 2015.
- By 2013, 4-million people (mostly women) where employed in the $19-billion industry.
- The sector has benefitted from trade preferences, in particular those offered by the European Union (EU) Everything But Arms (EBA) initiative.
- Domestic firms have been central to export development.
- Export Processing Zones (EPZ) were used not just by foreign investors (which account for only 5% of textiles producers) but also domestic producers. Domestic producers are key to the sector's success.

2.2.1.1 Critical success factors

- Low wages have been key to Bangladesh's competitive edge in clothing. But vertical integration, with the growth of fabric producers, and skills development have also increased productivity.
- Bangladesh has taken advantage of preferential market access to the EU under Everything But Arms (EBA) initiative.
- Domestic industries, central to the success of the sector, could benefit from EPZs to the same extent as foreign investors. This allows companies to mitigate the anti-export bias of Bangladesh's trade policy and also to cut through red tape.

2.2.1.2 Country context

Bangladesh spans the Ganges Delta. With a large population of more than 160-million, it is the world's 8th most populated country. GDP has grown to $195-billion; its per capita GDP, however, remains low at just over $1,000.

In general, governance is poor. Corruption is one of Bangladesh's key issues, as more than 50% of firms still report that they are asked to pay bribes when soliciting different operational licences or permits. This is more than double the average for countries in South

131 *Ibid.*

132 Obinna Chima, *Alade: Oil Sector Exposure constitutes 40% of Banks' Loans*, This Day, 5 October 2016

133 Obinna Chima, *Banks Fast rising Bad Debts*, This Day, 17 August 2016

Asia, and 30% more than the average low income country. Added to this is the perceived unfairness and corruptness of the courts. The one bright spot in terms of governance is macroeconomic stability, where Bangladesh ranks in the top 50 countries.

Bangladesh's own trade arrangements are relatively restrictive – however its policies for textiles and clothing has mitigated much of the anti-export bias generated by its protectionism. In contrast, its access to foreign markets is a competitive advantage, ranking 7th in the world. The cost of exports is also a slight positive, with a 20-foot container costing slightly under the world average.

The private sector is generally constrained by poor access to finance and financial services and relatively low levels of investment in human capital. However, with regards to the textiles and clothing sector there has been a concerted effort to improve skill levels.

Table 12: Bangladesh governance and competitiveness indicators

GOVERNANCE INDICATORS	
Institutions (out of 140) *	132
Infrastructure (out of 140) *	123
Macroeconomic Environment (out of 140) *	49
Corruption Perception Index (out of 168) **	139
COMPETITIVENESS INDICATORS	
Openness to Trade (out of 138) ~	126
Foreign Market Access/Trade Preferences (out of 138) ~	7
Cost to Export_1 (US$ per container) ***	1,281
Cost to Export_2 (Border Compliance US$) ***	408
Logistics Performance Index (out of 160) ^	87
Financial Market Development (out of 140) *	90
Labour Market Efficiency (out of 140) *	121
Health and Primary Education (out of 140) *	101

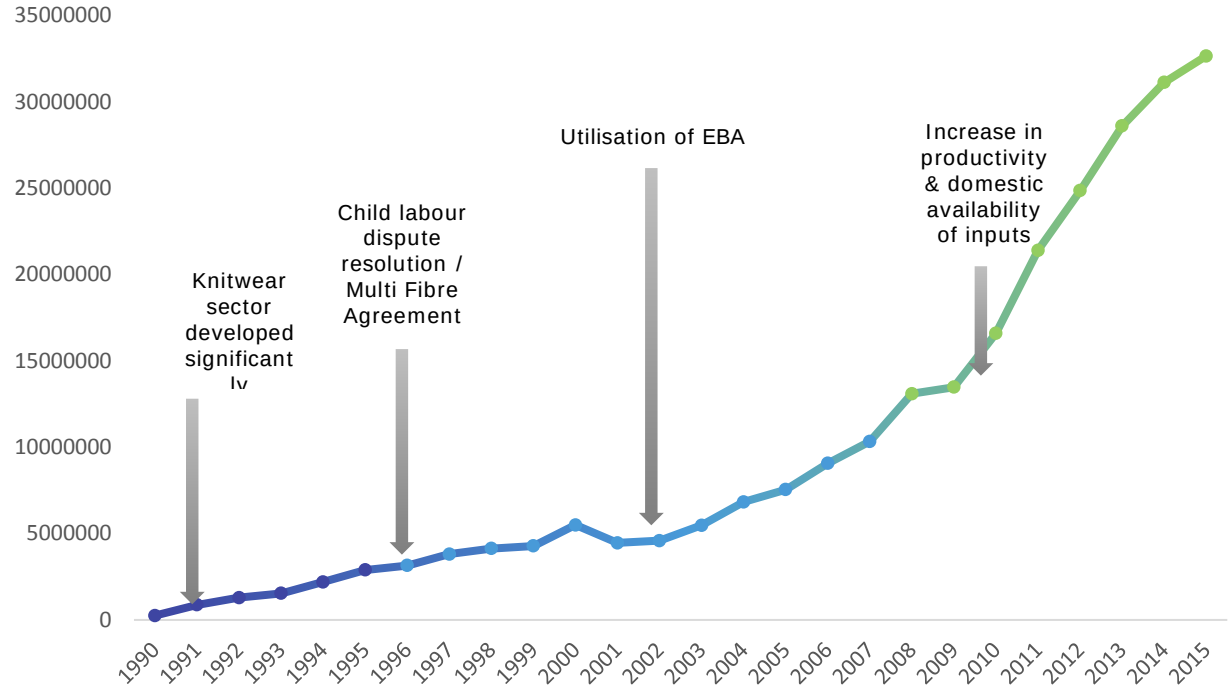
* World Economic Forum's Global Competitiveness Index assesses the competitiveness landscape of economies, providing insight into the drivers of their productivity and prosperity (2015 data).
** Transparency International: Each year countries are scored on how corrupt their public sector is seen to be (2015 data).
*** World Bank's Doing Business Indicators focuses on regulations and regulatory processes involved in setting up and operating a business ($/container, 2014 data/$ border compliance 2015).
~ World Economic Forum's Enabling Trade Index assesses institutions, policies, infrastructures and services that facilitate trade in goods across borders (2014 data).
^ World Bank's Logistics Performance Index is an interactive benchmarking tool created to help countries identify the challenges and opportunities they face in their performance on trade logistics (2016 data).

The economy is dominated by established business – on average firms are 10 years old or more. Approximately 98% of firms are private and domestically-owned, which is significantly higher than average low-income countries, but in line with ownership in Southern Asia (Per the WB Enterprise Survey). Bangladeshi firms are more likely to be

export-oriented than their neighbouring countries, and more than double other low income countries. 134

The figure below illustrates Bangladesh's export performance since the 1990s, alongside key events driving and contributing to this growth135.

Figure 15: Bangladesh's Clothing and Textile Exports (1990-2015)



Source: ITC TradeMap & COMTRADE

Originally the textiles sector was not export oriented, but specifically targeted the domestic market136. However, in the last two decades, Bangladesh has successfully grown to be the second largest clothing exporter in the world by 2008 behind China, and remains more competitive than countries such as Vietnam.137

2.2.1.3 Background

When Bangladesh gained its independence from Pakistan in 1971 it began to nationalise the clothing and textile sector. All the countries textiles factories were organised under the Bangladesh Textiles Mill Corporation (BTMC). However, following a decade of poor performance, the government began privatising factories through auctions and other means of sale. 138

The lack of investment in modernised equipment during the period of nationalisation resulted in relatively high production cost compared to India and China. Production costs were further increased by double digit inflation and high interest rates. The prices of cotton also fluctuated significantly, and the lack of research and development within the industry resulted in low quality cotton when compared to the rest of Asia. Adding to this, the energy

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[134] World Bank, Enterprise Survey, Country Profile: Bangladesh, 2013

[135] Dr. Muhammad Mushtaq Mangat, Textile and Clothing Exports of SAARC Countries: A Comparison from 1980 to 2011, 2012

[136] World Bank, *Doing Business: Bangladesh Economy Profile*, 2016

[137] The Asia Foundation, *Competitiveness in the Garment and Textiles Industry: Creating a supportive environment - A Case Study of Bangladesh*, 2010

[138] Research Journal of Engineering Sciences, *Textile Industries in Bangladesh and Challenges of Growth*, February 2013

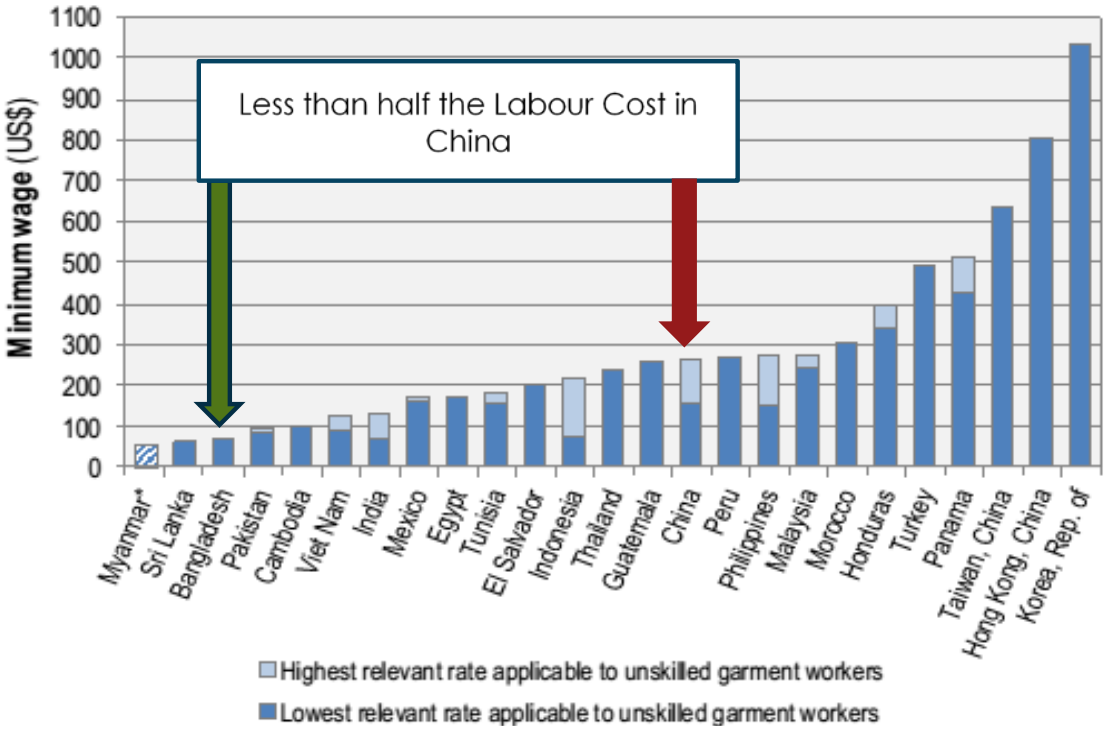
crisis resulted in the implementation of load-shedding, reducing the production capacity of multiple sectors by as much as 30%.139

In 1974 the Multi Fibre Arrangement (MFA) allowed developed countries to impose export quotas on textiles originating from developing countries. The quotas had a severe impact on growth of the textile sector in Asian countries, however not all of them were affected. The European Union for example excluded emerging markets, such as Bangladesh, from the restrictions. This differential treatment resulted in a "quota hopping" as the textile industries of affected countries outsourced production to non-affected countries. Bangladesh was targeted by the South Korean garment factory Daewoo which cooperated with the local firm Desh Garments. Over the following years local staff was trained in South Korea, thus bringing professional skills to Bangladesh. Within a short period of time, most professionals left Desh Garments and started their own garment factories, setting the cornerstone for an export-oriented local textile industry.140

2.2.1.4 Competitiveness in production

The adaptability and low cost of labour has been a key factor in the comparative advantage of Bangladesh, as other factors such as infrastructure and links remain weak. Low wages benefited the initial growth of the knitwear sector started to developed significantly throughout the 1990s.

Figure 16: Minimum wages for top apparel-producing nations



Source: ILO, 2014

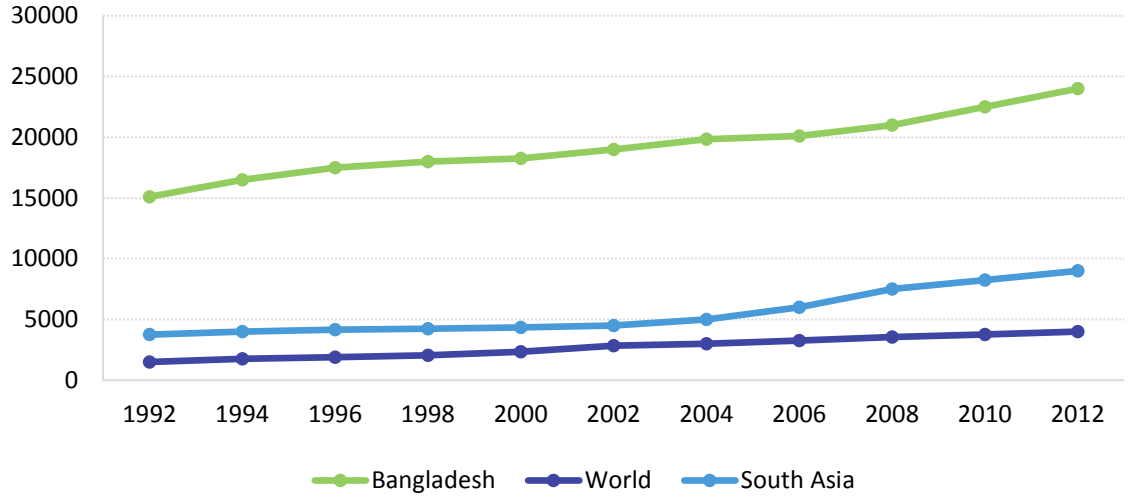
Over time, productivity in the sector has significantly improved. Currently, Bangladesh reports productivity levels that are nearly twice the average for South Asia. The increase in productivity has been largely driven by skills development and high gross fixed capital formation141.

Figure 17: Labour productivity in Bangladesh (1991-2015)*

139 *Ibid.*

140 Easterly, William, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*. Massachusetts: The MIT Press, 2002

141 Danish Trade Council for International Development and Cooperation, Labour Market Profile, 2015



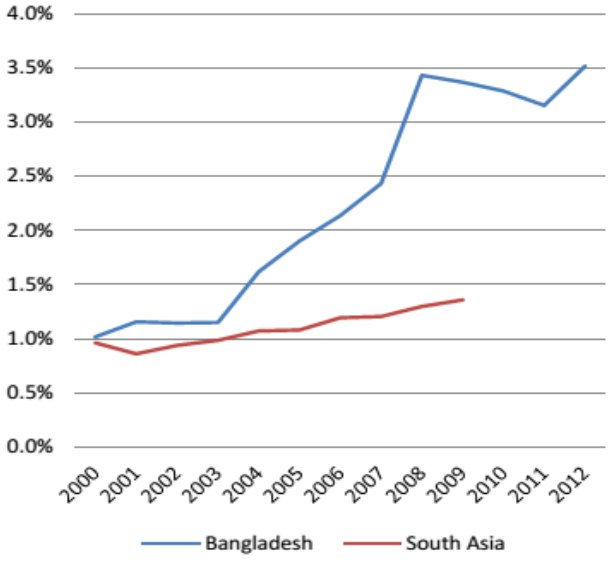
* Text GDP per Person & index with base year 2000 (=100)

Source: Labour Market Profile, 2015

Skills development

In 1994, a study covering 150,000 employed skilled workers found that less than 3% had any form of training, explaining the relatively low productivity of labour in that time and before. This picture has changed substantially, with the present workforce receiving training increasing by 8% since the mid-1990s.

Figure 18: Vocational pupils in secondary education (2000-2012)



Source: World Development Indicators DataBank

The number of vocational enrolments has grown steadily since 2000, from 150,000 to almost double by 2007, to an all-time high of over 400,000 in 2012. The ratio of vocational training to all pupils in secondary education is 3.4%, which is higher than the 1.4% South Asia average.142 Private institutions have been fundamental to achieving this growth, as it represented 89% of enrolment by 2007.143

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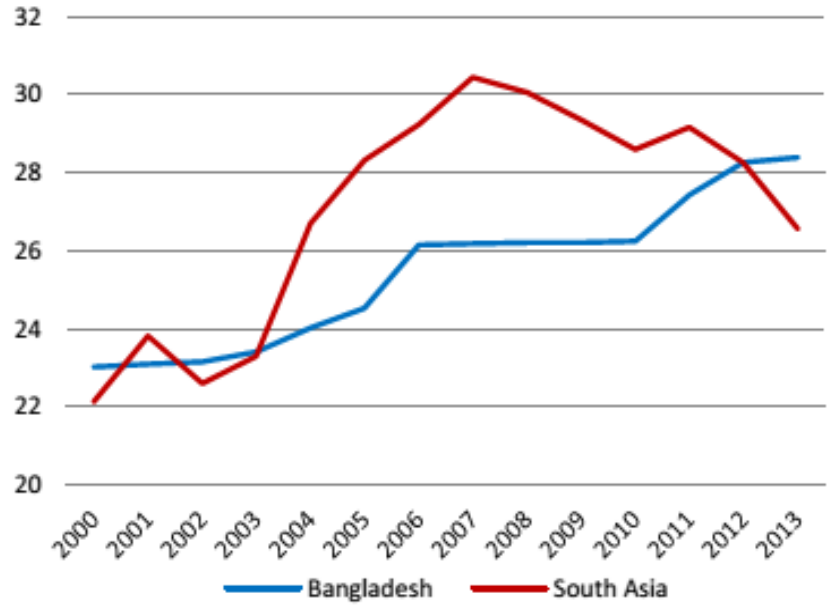
[142] NSDC, National Strategy for Promotion of Gender Equality in Technical and Vocational Education and Training (TVET), 2012

[143] National Skills Development Council, Bangladesh Skills Snapshot, National Skills Survey Snapshot, 2012

Capital formation (support overall production capacity and productivity)

Capital formation has also steadily increased since the 2000s, surpassing the South Asian average by 2012. This contributed to the increase in labour productivity in the same period.144

Figure 19: Gross fixed capital formation (2000-2013)*



*As % of GDP

Source: World Bank, 2014

Local availability of inputs

Approximately 40% of garments use domestic textile suppliers for production. Yarn production has also increased approximately four times and the production of clothing by three times between 1995 and 2011, because of a strong linkage with garment exports.145

The availability of local inputs is an important factor in competitiveness given the current rules of origin to the EU. The local availability of inputs also shortened the lead times to produce and export, which is extremely important for competitiveness in garments manufacturing. 146

144 Danish Trade Council for International Development and Cooperation, Labour Market Profile, 2015

145 UNCTAD, Sector-Specific Investment Strategy and Action Plan, G20 Indicators for Measuring and Maximizing Economic Value Added and Job Creation from Private Investment in Specific Value Chains, September 2012

146 The Asia Foundation, *Competitiveness in the Garment and Textiles Industry: Creating a supportive environment - A Case Study of Bangladesh*, 2010

Table 13: Growth in the primary textile sector (1995-2011)

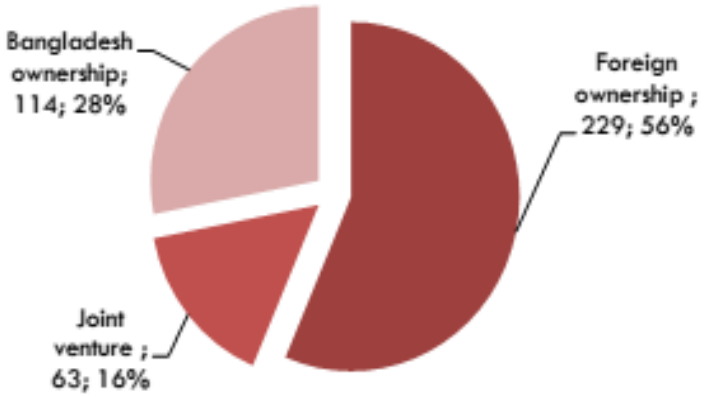
YEAR	NO. MILLS	CAPACITY (MILLIONS OF SPINDLES)	GROWTH IN NO. MILLS (%)	GROWTH IN CAPACITY (%)
1995	84	1.7	10.52	19.56
2000	116	2.29	38.09	34.52
2005	230	4.94	98.28	115.67
2011	385	8.7	67.39	76.21

Source: Bangladesh Cotton & Products Annual 2011 & BTMA Directors Report 2011

Economic Processing Zones (EPZs)

To attract more foreign investment, the Bangladeshi government established the Economic Processing Zones (EPZs) in the 1980s, managed by the Bangladesh Export Processing Zone Authority (BEPZA). These EPZs enjoy special benefit packages, which includes duty free imports, tax holidays, and exemption from dividend tax.

Figure 20: Number of operations in EPZs and % ownership (2012)



Source: BEPZA. Annual Report 2011 -12

EPZs becoming home for many large foreign and domestic textile and garment producing firms147. However, the sector is still dominated by domestic players. Between 2003 and 2011 only 11% of investment projects were foreign oriented, or 181 out of 1,645 – largely because Bangladeshi and joint venture investments were allowed in the EPZs. Of the largest 65 projects in the EPZs in 2009, 48 were in the textiles and garments value chain.148 However, it is of note that by 2012, foreign ownership increased substantially (56%), including joint ventures (16%) in EPZs.149

147 UNCTAD, Bangladesh Sector-Specific Investment Strategy and Action Plan, 2012

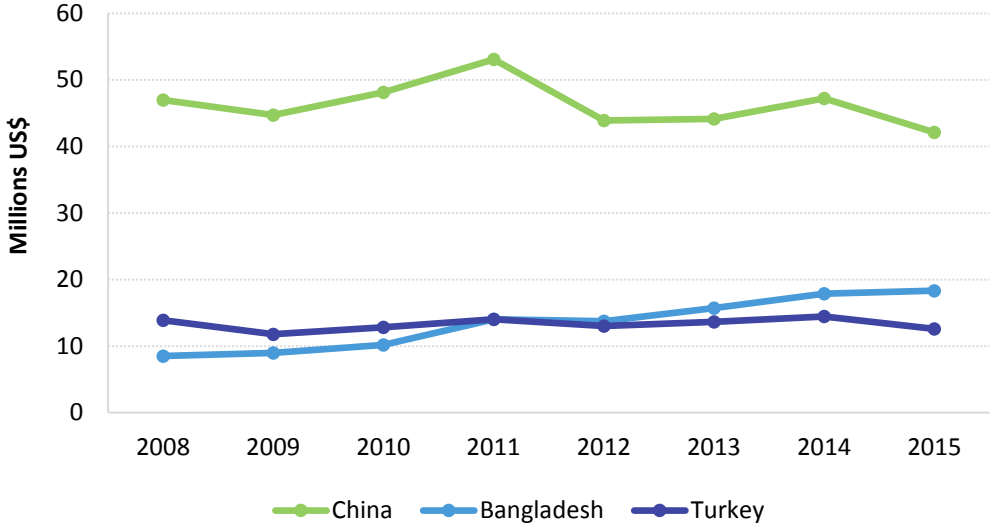
148 UNCTAD, Sector-Specific Investment Strategy and Action Plan, G20 Indicators for Measuring and Maximizing Economic Value Added and Job Creation from Private Investment in Specific Value Chains, September 2012 / Prof. Mustafizur Rahman, *Trade Benefits for Least Developed Countries: The Bangladesh Case*, 2011

149 Danish Trade Council for International Development and Cooperation, Labour Market Profile, 2015

2.2.1.5 Preferential market access - EU

Preferential market access to the EU has been fundamental to the growth of Bangladeshi apparel exports. Under the Everything But Arms (EBA), Bangladesh is eligible to export duty-free, subject to product-specific RoO requirements. EU markets accounted for 57.5% of Bangladesh's total global exports in 2000. Although the EU average tariffs are low (4.2%), the average MFN tariffs on apparels items exported by Bangladesh is high (12.1%). The duty-free market access under EBA therefore provides for a significant advantage over their competitors from China, India, Pakistan, and Turkey.

Figure 21: EU Top 3 clothing import sources



Source: ITC, TradeMap

As illustrated in the figure above, Bangladesh has become the second largest supplier of clothing150 to the EU, surpassing Turkey in 2012, and gradually closing in on China as top exporter (here it is worth noting that China's relative income growth will affect their cost base and in turn Bangladesh's competitiveness).

2.2.1.6 Regulations

The duty drawback scheme for the ready-made garments (RMG) sector received reimbursements for duties paid on imports, on the execution of an export order. This scheme contributed to the success of the sector, but still lacks effective implementation corruption remains a problem.

Income tax rates were also reduced in 2004, from 30% to 10% progressively for the period up to June 2006. Further, raw materials for garments manufacturing may be imported without duty payments. The government further introduced a Cash Compensation Scheme (CCS) through which domestic suppliers to export-oriented RMG units received cash payments totalled at 10 percent of the value addition of exported garments.151

2.2.1.7 Future – institutional development

Bangladesh still struggles with constrained institutions (such as the regulatory framework and access to credit, particularly for SME's) infrastructure (hard and soft), and compliance assurance. The lack of capacity in all the above areas, has cost implications. Bangladesh's advantages of preferential market access are often offset by the absence of the required hard and soft infrastructure. Whilst global support could assist Bangladesh in addressing these specific challenges, domestic actions are fundamental to the longevity of change. As

150 HS 61 and 62

151 IMF Working Paper, *The End of Textiles Quotas: A Case Study of the Impact on Bangladesh*, 2004

in many cases this is not an issue of financing, but rather of policy initiatives and more importantly implementation. 152

The textiles industry has grown unplanned as a backward linkage to garments exports, and a critical demand supply gap has arisen for both yarn and fabric. This will naturally deepen unless the appropriate backward links, throughout the RMG industry, are made. Bangladesh is not only handicapped by import tariffs and shipping expenses, but also the subsidised raw cotton in India and Pakistan, which is sold locally, resulting in Bangladesh spinning mills to pay more than 30% higher for the same quality cotton. In addition to this, spinning mills must pay another 6-7% for freight, handling and commission costs.153 Given current rules of origin and the importance of lead times, the textiles industry needs to be recognised as a key part of growing and maintaining the apparel and textiles industry in Bangladesh.

2.3 Europe

2.3.1 Czech Republic

- The Czech Republic has been chosen as a case study primarily as a country that made the transition from a controlled to a market economy, and graduated to high income status;
  - It also acceded to a big economic block (the EU); and
  - Was subject to political disruption with the splitting up of Czechoslovakia.
- The automotive sector is key to the Czech economy, employing 150,000 people.
- Before 2000, automotive exports were low, but grew to 16% of total exports in 2001, and 20% in 2015.

2.3.1.1 Critical success factors

- Accession to the EU trade bloc
- Historical strengths fused with influx of FDI and integration into regional value chains
- Substantial investment and focus on human capital for a high-value industry
- Geographic position and infrastructure advantageous

2.3.1.2 Country context

The Czech Republic has overcome transition from communist Eastern Europe, separation from Slovakia, and entrance into the EU. It has a population of about 10-million, it has already developed to a high-income status, and has a long tradition of automotive manufacturing. It has leveraged geographical advantages (strategically located for the EU market), the availability of high-quality labour, and high productivity to attract Foreign Direct Investment to diversify exports.

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152 Prof. Mustafizur Rahman, *Trade Benefits for Least Developed Countries: The Bangladesh Case: Market Access Initiatives, Limitations and Policy Recommendations*, 2011

153 Md. Mazedul Islam, Adnan Maroof Khan and Md. Monirul Islam, *Textile Industries in Bangladesh and Challenges of Growth*, Research Journal of Engineering Sciences, Vol. 2(2), 2013

Table 14: Czech Republic governance and competitive indicators

GOVERNANCE INDICATORS	
Institutions (out of 140) *	57
Infrastructure (out of 140) *	41
Macroeconomic Environment (out of 140) *	21
Corruption Perception Index (out of 168) **	37
COMPETITIVENESS INDICATORS	
Openness to Trade (out of 138) ~	46
Foreign Market Access/Trade Preferences (out of 138) ~	97
Cost to Export_1 (US$ per container) ***	1240
Cost to Export_2 (Border Compliance US$) ***	0
Logistics Performance Index (out of 160) ^	26
Financial Market Development (out of 140) *	24
Labour Market Efficiency (out of 140) *	47
Health and Primary Education (out of 140) *	27

* World Economic Forum's Global Competitiveness Index assesses the competitiveness landscape of economies, providing insight into the drivers of their productivity and prosperity (2015 data).
** Transparency International: Each year countries are scored on how corrupt their public sector is seen to be (2015 data).
*** World Bank's Doing Business Indicators focuses on regulations and regulatory processes involved in setting up and operating a business ($/container, 2014 data/$ border compliance 2015).
~ World Economic Forum's Enabling Trade Index assesses institutions, policies, infrastructures and services that facilitate trade in goods across borders (2014 data).
^ World Bank's Logistics Performance Index is an interactive benchmarking tool created to help countries identify the challenges and opportunities they face in their performance on trade logistics (2016 data).

Now ranked in the top 40 of the world the Czech Republic has made significant gain in developing their Global competitiveness indicators. Indicators such as institutions, infrastructure, health and primary education have enabled them to attract significant foreign investment, as an efficiency-seeking destination.154

The Czech Republic has managed to get a perfect score for trading across borders. Another key indicator in which the Czech Republic excels in is the Logistics Perception Index (LPI), ranked in the top 30 of the World. Many firms operating are older than10 years, and a large proposed are foreign owned (almost double the OECD average)155.

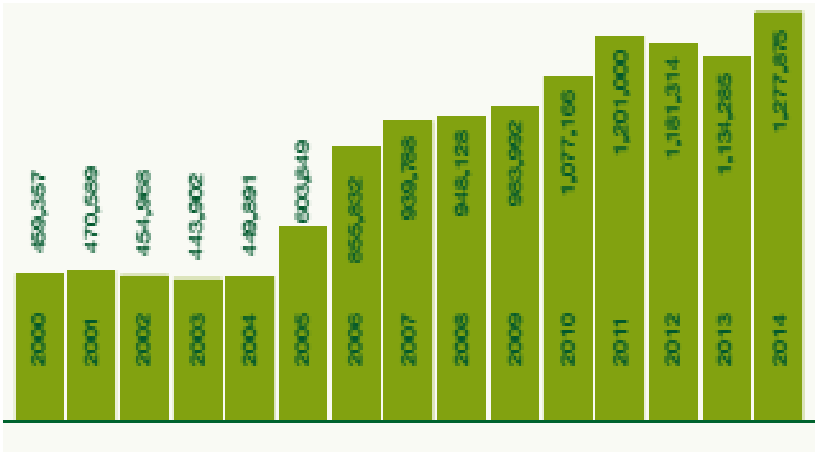
2.3.1.3 Background

The Czech Republic has been a vehicle manufacturing for more than 100 years. Started by Škoda, in a small plant called Mladá Boleslav, now a modern and extremely successful European car manufacturer. The automotive industry functions as a key sector in the Czech economy, employing more than 150,000 people in direct automotive manufacturing employment156 They have also seen significant growth in per capita GDP since 2000,

154 World Economic Forum, *The Global Competitiveness Dataset*, 2016
155 World Bank, Enterprise Survey, *Country Profile: Czech Republic*, 2013
156 AutoSAP, *Basic Overview: Automobile Industry in the Czech Republic*, 2015

achieving a successful graduation from middle-income to high-income within 10 years, fundamentally driven by the success of the automotive industry.

Figure 22: Production of motor vehicles in Czezh Republic

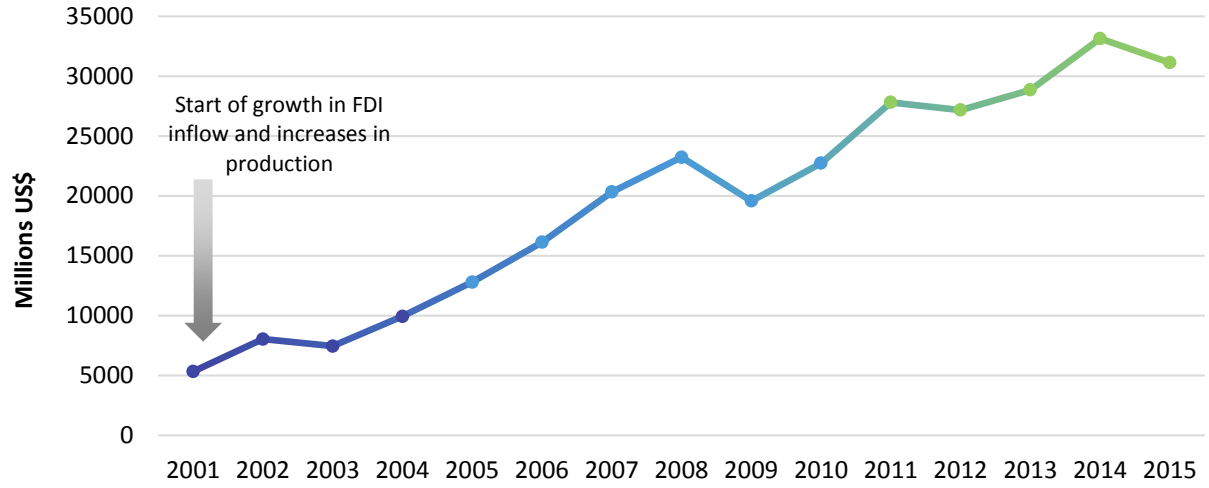


Source: AIA, 2015

The country opened up FDI in the late 1990's and, combined with moderate levels of infrastructure, knowledge and capital stock, with a relatively low cost of labour, it created a good value proposition for doing business in the country157. Together with accession to the EU, this has driven export growth.

Automotive export, which fell precipitously in the 1980 and 90s rose to 16% of total exports in 2001 and to 20% by 2015. About 80% of production is exported to the EU; for automotive components, the figure is 89%158.

Figure 23: Motor vehicle exports (2001-2015)



Source: ITC, TradeMap

2.3.1.4 Comparative Advantage

Geographic location, with a relatively cheap, skilled labour force that is disciplined in their work, together with local suppliers and good infrastructure form the core of Czech comparative advantage.

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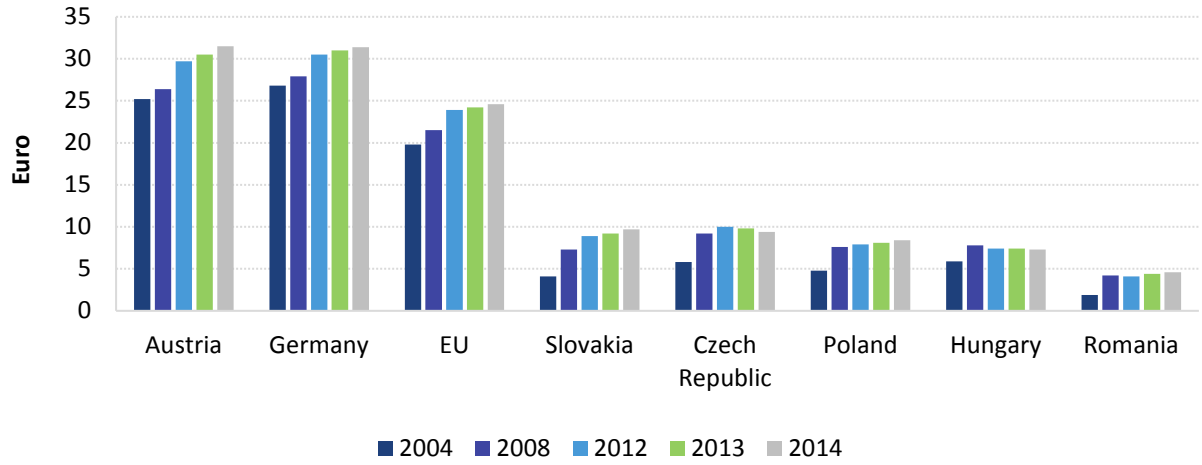
157 Paul Robert O'Shaughnessy, *The Success of the Czech Automotive Industry: An Innovative Approach to FDI and Privatization For Economic Development and Industrial Upgrading*, 2007

158 Machková, H., & Mohelský, L., *Is diversification as a Strategic Advantage? The Example of Automotive Components in the Czech Republic*. Central European Business Review, 2012

Labour costs

In vehilce manufacturing, labour cosst can amount up to 30% of total production cost.159 The cost of labour has remained remained relatively low compared to the EU average decrease after 2012, making their high skilled productive workforce and extremely attractive destination for manufacturing, as well as R&D. For example, for a large German vehicle manufacturer such as VW, a third of the labour cost has a significant impact on the total manufacturing cost, if production is shifted to the Czech Republic.160

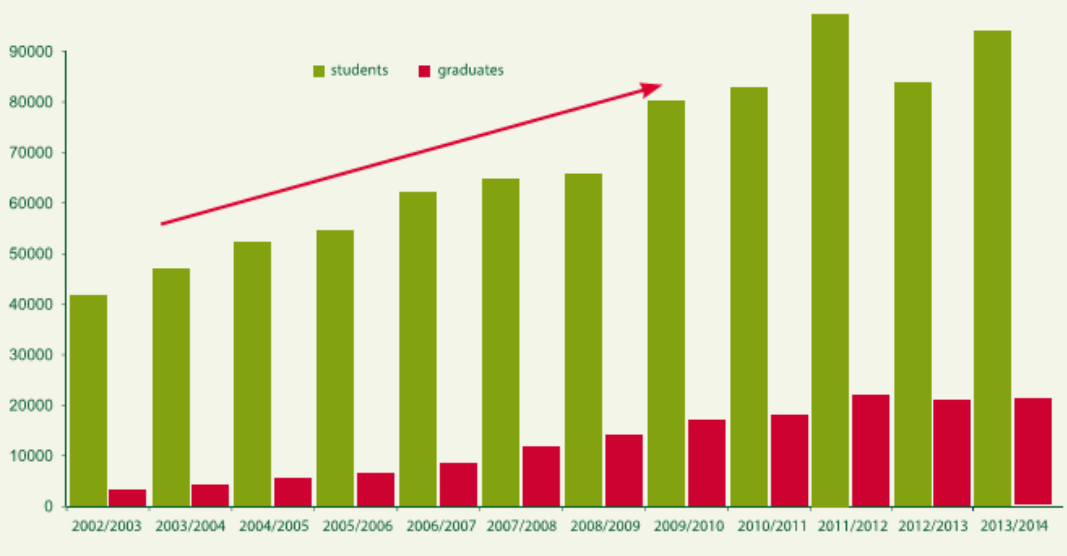
Figure 24: Labour cost relative to other producing nations in the EU



Source: eurostat, 2015

The Czech Republic has made significant efforts to increase the number of technical student and graduates since the beginning of 2000s. This has resulted in an annual enrolement of more than 80,000 technical students, by 2011.

Figure 25: Technical students and graduates from Czech universities



Source: Czech Republic, Ministry of Education, Youth and Sport, 2014

Local supply

During the 1990s, the Czech Republic, in its transition to a market economy, reformed their national “innovation system”, to alleviate some of the weaknesses inherited from the

159 Universidade Técnica De Lisboa, *Production Cost Modeling for the Automotive Industry*, 2001

160 Marcel Tirpak, *The Automobile Industry in Central Europe*, 2010

previous regime (e.g. a lack of focus on basic research, entrepreneurial spirit, inefficient university-industry and international links). Attracting R&D activity of multinationals was one of the key mechanisms to address these constraints, specifically to make local R&D more commercial and domestic industries more integrated into the global innovation network.161 The vision was that foreign-owned firms could catalyse the development of local high-tech clusters by facilitating their links to local firms through proactive and intermediate policies. This is difficult without high-quality human capital, innovative domestic firms, and research institutions.

2.3.1.5 An attractive business environment for foreign investment

The government created an agency in 1992, called CzechInvest, an economic development agency, promoting FDI more proactively. The services provided included addressing issues regarding foreign investment, technological capacity, and education, all to enhance the competitiveness of the industry. And focussed efforts towards high-tech and advanced manufacturing, and R&D activities, alongside support services such as logistics operations, software development, and customer support centres. Starting out with changes in offering tax -and financial incentives to attract FDI, they successfully secured multiple foreign investment deals such as Toyota/Citroen plant in Kolin and the Hyundai plant in Nosovice, both producing more than 300,000 vehicles per year. 162

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161 Narula, R., and J. Guimón. 2009. “The Role of Multinational Corporations in the National Innovation Systems of the EU New Member States.” In *Innovation and Institutional Embeddedness of Multinational Companies*, edited by M. Heidenreich, 311–28. Cheltenham: Edward Elgar.

162 Commission on Growth and Development, *The Automotive Industry in the Slovak Republic: Recent Developments and Impact on Growth*, Working Paper 29, 2008

PRIVATISATION OF THE VEHICLE MANUFACTURING INDUSTRY

By 1952, all sectors in the economy were nationalised and economic activity was guided by central planning. The economic reform plans that emerged had little impact. The role of entrepreneurs in the transformation of the economy was neglected and obstacles hindered the emergence of creative entrepreneurial spirit. In 1968 Warsaw Pact troops invaded the country, and their reform experiments came to an end.

The economic reform plans that followed did not remedy the inefficiency and shortage that plagued the economy. For example, the agricultural sector had a shortage of agricultural machinery and poor quality inputs, which forced them to import grains. Per capita income had also fallen well below that of other socialist and Western countries, undermining the legitimacy of the regime in power.

Unsuccessful privatisation – the story of Tatra Kopřivnice

Tatra Kopřivnice was a well-known truck manufacturer in the former Czechoslovakia, producing 15,000 trucks per annum, and employing 16,000 people. These trucks were predominantly manufactured for exports to the Soviet Union and COMECON countries, where sales and marketing operations were controlled by the states' foreign trade company. Due to the lack of competitiveness after 1989, Tatra received little to no interest in foreign investment, and the offers they received did not include maintaining the brand. Government recommended "voucher privatisation" as the most effective way of privatisation, because new owners would not understand the business and thus, no-one would interfere in the decision-making process.

This did not make Tatra more competitive: production declined by 90% in the beginning of the 1990s, and when US managers tried to buy 15% of the total shares to save the company, the local management refused, believing in making the company more cost-effective. Three changes of ownership occurred afterwards, and no new markets for existing products.

Privatisation – the story of Škoda Auto

Privatisation of Škoda Auto was the foundation of the Czech automotive industry development. This can be separated from other privatisation efforts, because government successfully identified the new owner that would turn Škoda Auto into a globally-competitive firm. Thus, the government found optimal private partners, and placed restrictions that allowed them to monitor the firm's development for the first year. Initial partners were narrowed to Renault and Volkswagen, with the latter was selected due to their proposed investment in technology, the impact on employment, and the willingness to respect the Škoda brand. The government also agreed to not maintain long-term ownership, as a measure to direct its progress.

2.3.1.6 Accession to the EU

The Czech Republic acceded to the EU, in May 2004, along with countries such as Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia. And at that point in time the Czech Republic trailed the other new Member States.163

163 Dr Ulrich Sedelmeier, *Europe after the Eastern Enlargement of the European Union*: 2004-2014, 2014

Figure 26: Czech Republic within the EU

Membership provided for preferential market access to a substantive new market – with opportunity arising to grow exports into new EU markets. The safety and geographical location connecting the east and the west is fundamental to the Czech Republic's attractiveness.164 Strategically located in the central parts of Europe.

For large motor manufacturing companies, resource-seeking and efficiency-seeking, is the key focus of investment in the Czech Republic, alongside the opportunity to gain access to efficient distribution to the regional European market. And the Czech accession to the EU also contributed to the integration into the wider EU market.165 This is confirmed in the longstanding trading partnership the Czech Republic has with the EU (more than 70% of exports) and especially Germany (30% total exports for the last 15 years)166.

`the process of accession and membership of the EU was also crucial in ensuring that the division of Czechoslovakia was managed without conflict and with minimal disruption to the economy.

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164 Commission on Growth and Development, *The Automotive Industry in the Slovak Republic: Recent Developments and Impact on Growth*, Working Paper 29, 2008

165 Radosevic, Slavo, and Andrew Rozeik, *Foreign Direct Investment and Restructuring in the Automotive Industry in Central and East Europe*. Working Paper No. 53, SSEES, University College London, 2015

166 ITC, TradeMap, 2016

2.3.1.7 Infrastructure and the cost of trade

The Czech government, alongside FDI, complimented investment by spending billions (US$) on infrastructure, specifically focussing on roads and railways, to ensure that the large capacity requirements of Multi-national companies can be met. The availability and the high quality of Czech infrastructure, has also been fundamental to the successful distribution of large quantities of production to neighbouring EU countries.

Alongside this is the efficiency of especially railway transport, which on average only requires a 30min waiting time at the border, and at the Austrian border there is no waiting time, compared to Romania and Slovakia which on average have a 140min waiting time at their border.167 As illustrated in figure below, the Czech Republic has a comprehensive reach in road and rail transport to all the major cities in neighbouring countries, especially Germany.

Figure 27: Czech Republic's road and motorway network

Source: Road and Motorway Directorate of the Czech Republic, 2016

The attractiveness of the Czech Republic's efficiency is further highlighted by its high ranking and rating in the Trading Across Borders indicators. Where they received a perfect score of 100, above the OECD high income average of 93.33 and the German score of 91.77.

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[167] European Parliament, *The Results and Efficiency of Railway Infrastructure Financing within the European Union*, 2015

Table 15: Summary of export and import time and cost for trading across borders in Czech Republic

	CZECH REPUBLIC	OECD HIGH-INCOME
Time to export: border compliance (hours)	0	15
Cost to export: Border compliance (USD)	0	160
Time to export: Documentary compliance (hours)	1	5
Cost to export: Documentary compliance (USD)	0	36
Time to import: border compliance (hours)	0	9
Cost to import: Border compliance (USD)	0	123
Time to import: Documentary compliance (hours)	1	4
Cost to import: Documentary compliance (USD)	0	25

Source: Doing Business Database, 2016

Furthermore, they also perform exceptionally well in the time and cost of trading across borders. Compared to other OECD high income countries they, the time to export by border compliance is on average 15 hours, where the Czech Republic takes 0 hours, the same is found for the cost of exporting (illustrated in the table), the OECD high-income average is $160, and the Czech Republic is $0. Considering that the same is true for imports, the Czech Republic is also well-placed to form part of a Global Value chain, where specialised parts and equipment can be distributed from and to the Czech Republic with great efficiency.

2.4 Central & South America

2.4.1 Costa Rica

- Over the decades Costa Rica has made a tremendous leap forward, in the development of the knowledge- and technology-driven economy.
- This change was driven by multinationals deciding to invest and establish manufacturing plants in the country.
- Exports of electronics equipment went from nothing in the 90's to peak at 34% of total exports by 2001. They remained above 20% of total exports in 2015.

2.4.1.1 Critical success factors

- Costa Rica's political institutions and educated labour force, alongside the free-zone regime benefits.
- Geographical location and proximity to the US market
- Macro-economic stability, fiscal incentives and the ease of doing business
- Quality, productivity and cost of labour

2.4.1.2 Country context

Costa Rica is a small coastal country, with a population of a little over 4-million, located in Central America. Costa Rica scores relatively well on indicators such as Institutions, Infrastructure and has low levels of corruption. Trade arrangements are a positive and cost of transport indicators are slightly above average. The private sector also benefits from investment in human capital. However, they still experience constraints in financial market development and the macro economic environment.

Table 16: Costa Rica governance and competitiveness indicators

GOVERNANCE INDICATORS	
Institutions (out of 140) *	49
Infrastructure (out of 140) *	71
Macroeconomic Environment (out of 140) *	94
Corruption Perception Index (out of 168) **	40
COMPETITIVENESS INDICATORS	
Openness to Trade (out of 138) ~	20
Foreign Market Access/Trade Preferences (out of 138) ~	16
Cost to Export_1 (US$ per container) ***	1020
Cost to Export_2 (Border Compliance US$) ***	347
Logistics Performance Index (out of 160) ^	89
Financial Market Development (out of 140) *	85
Labour Market Efficiency (out of 140) *	70
Health and Primary Education (out of 140) *	55

* World Economic Forum's Global Competitiveness Index assesses the competitiveness landscape of economies, providing insight into the drivers of their productivity and prosperity (2015 data).
** Transparency International: Each year countries are scored on how corrupt their public sector is seen to be (2015 data).
*** World Bank's Doing Business Indicators focuses on regulations and regulatory processes involved in setting up and operating a business ($/container, 2014 data/$ border compliance 2015).
~ World Economic Forum's Enabling Trade Index assesses institutions, policies, infrastructures and services that facilitate trade in goods across borders (2014 data).
^ World Bank's Logistics Performance Index is an interactive benchmarking tool created to help countries identify the challenges and opportunities they face in their performance on trade logistics (2016 data).

In terms of doing business Costa Rica ranks in the top 60 in the world, significantly higher than the Latin America and Caribbean average. With the most competitive doing business indicators being Getting electricity, Getting credit and Trading across borders.[168]

2.4.1.3 Background

Throughout the 1970s and 1980s, Costa Rica was suffering from declining competitiveness in the clothing industry, previously a leading export industry, and significant falls in banana and coffee prices, also key export sectors. In response, Costa Rica's national development strategy targeted FDI driven diversification in the technology sector[169]. They focussed on

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168 World Bank, *Doing Business: Costa Rica Economy Profile*, 2016

169 World Bank, *The Impact of Intel in Costa Rica: Nine Years After the Decision to Invest*, 2006

sectors showing steady growth, rather than exponential, which included the medical devices industry and call centres170.

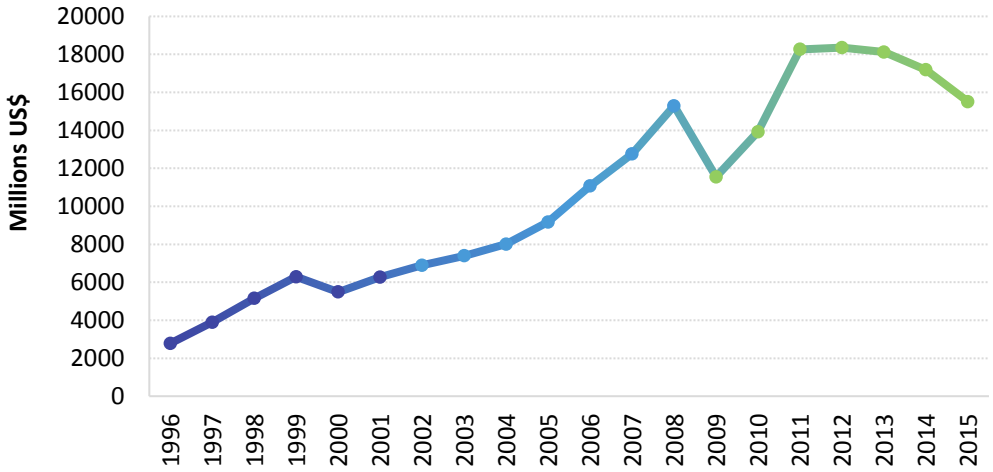
Intel, the catalyst for growth – economic impact

Intel's investment decision was the catalyst for a realignment of Costa Rica's competitive platform as an investment location. Great emphasis has been placed on FDI as along with its liberalisation process, with specific focus on the advanced manufacturing and services activities, being the cornerstone of its development activities. Given that Costa Rica's small size, FDI flows in IT-enabled services was for efficiency-seeking and not market-seeking.171

Intel decided that it would construct a new $300-million assembly and test plant in 1997. This seemed like an unlikely match before the decision, but Costa Rica identified a close fit with Intel through meticulous research, and then also demonstrated that the country's investment climate will adapt to meet their projects requirements.

Accomplished only by the direct involvement of the highest level of government in a short timeframe, against a highly competitive list of competing nations, Costa Rica worked resourcefully and with great urgency to enhance technical education, incentives law, regulation and infrastructure, ensuring a complimentary environment for the sector. 172

Figure 28: Costa Rica total electronics and machinery exports (1996-2015)



Source: ITC TradeMap, 2016

Exports and imports grew significantly, especially in 1997-1998. Exports as a proportion of GDP grew from 33.2% in 1997 to 43.5% in 1999.173 Exports continue to grow strongly.

2.4.1.4 Comparative advantage

Costa Rica had a pro-active response to developing their human capital base, ensuring that they have close to a 100% adult literacy rate. Also ensuring that a high number of the population has a working knowledge of English, through the introduction of the foreign language instruction in primary schools since 1994, showing an internationalisation

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170 OECD, *Attracting Knowledge-Intensive FDI to Costa Rica: Challenges and Policy Options*, 2012

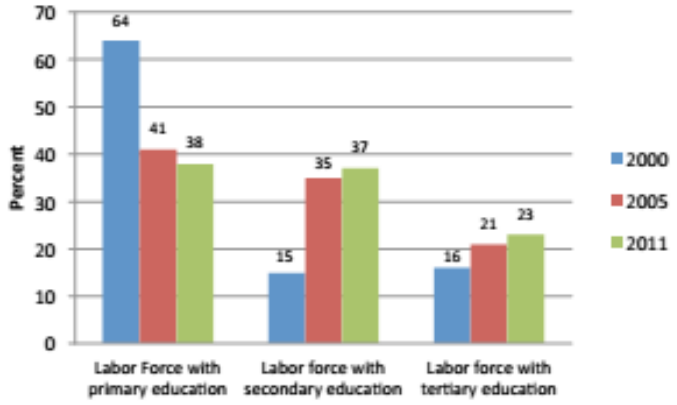
171 Harvard University Center for International Development, *Intel: A Case Study of Foreign Direct Investment in Central America*, 2000

172 *Ibid.*

173 Harvard University Center for International Development, *Intel: A Case Study of Foreign Direct Investment in Central America*, 2000

mindset. They also ensured stability in labour relations through their social democratic model, build on strong institutions developed in the past. 174

Figure 29: Costa Rica education levels (%) of labour force



Source: World Bank, World Development Indicator

Costa Rica managed to increase the enrolment in engineering fields, as the number of students at the Technology Institute grew from 577 (1997) to 874 (2000). Subsequently, the proportion of tertiary education has consistently grown.175

Hourly wages in Costa Rica (in 2007) ranged from $1.80 to $4.11 (including fringe benefits), which compares favourably to other Latin American. Compared to Asian manufacturing countries, however, they fair worse. This could be compensated for by telecommunications, constant and reliable electricity, and high labour productivity.176

Table 17: Comparison of relative gross wages (2002)

COUNTRY	LABOURER		PROFESSIONALS		MANAGEMENT	
	General	Skilled	Junior	Senior	Middle	Middle
India	32	36	27	30	30	41
Philippines	44	47	34	38	36	4
Malaysia	60	64	47	52	49	66
China	50	58	47	56	58	85
Malaysia	60	64	47	52	49	66
China	50	58	47	56	58	85
Costa Rica	100	100	100	100	100	100
Chile	118	113	87	97	93	114
Mexico	169	137	101	107	97	136
Panama	119	181	116	128	99	123

174 Andrés Rodríguez-Clare, *Costa Rica's Development Strategy based on Human Capital and Technology: how it got there, the impact of Intel, and lessons for other countries*, February 2001

175 Felipe Larrain B., Luis F. Lopez-Calva, and Andres Rodriguez-Clare, *Intel: A Case Study of Foreign Direct Investment in Central America*, Center for International Development at Harvard University, 2000

176 Jose Cordero and Eva Paus, *Foreign Investment and Economic Development in Costa Rica: The Unrealized Potential*, April 2008

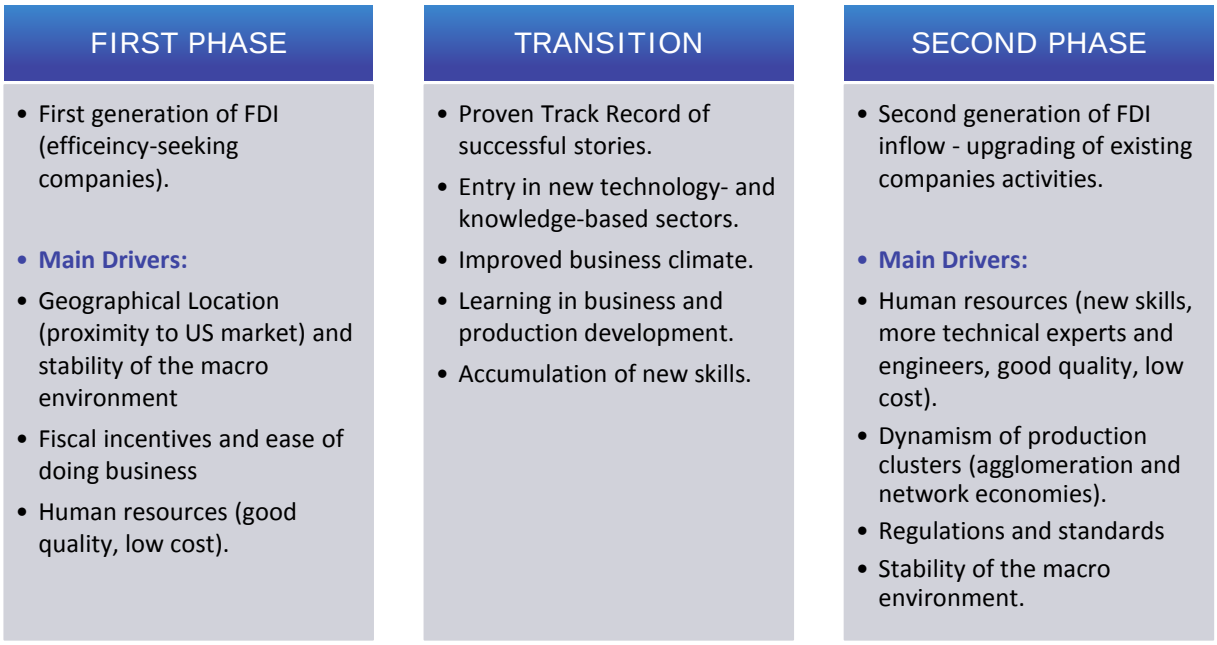
Singapore	174	173	120	123	109	136
Ireland	333	288	173	161	121	137
US	306	292	194	192	164	197

Source: CINDE, http://www.cinde.org/eng-recursohumano.shtml

2.4.1.5 Intel's decision making

Costa Rica's political institutions and educated labour force, alongside the free-zone regime benefits where a key determinant in Intel's investment decision. Intel executives also valued the fact that they would have more bargaining power in a smaller country, than in a larger country like Mexico. And the fact that Mexico, with both Federal and State governments, represented double risk of policy changes.177

Figure 30: Changing drivers for FDI attraction – first and second generation of FDI in Costa Rica



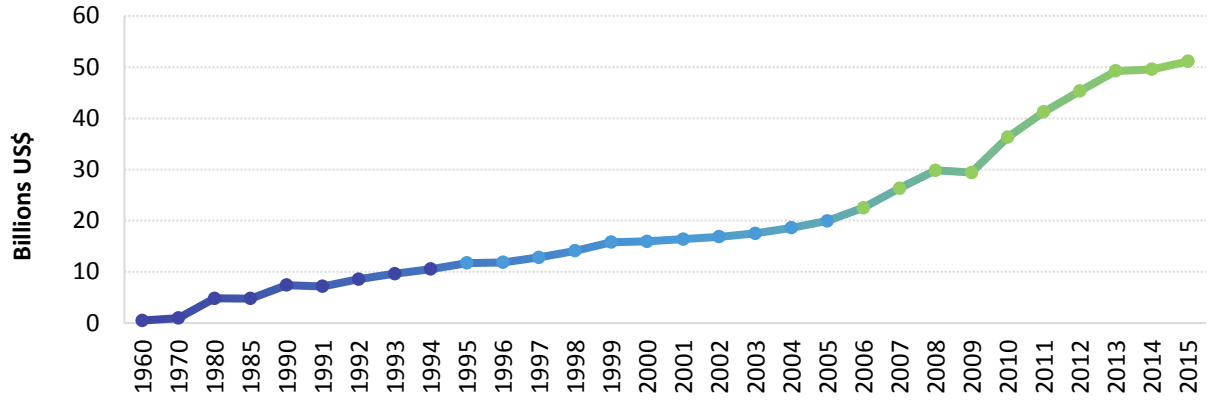
Source: OECD, 2012

A long-standing democracy and stable macroeconomic environment

Another factor in Intel's decision was stability. Costa Rica is one of the most stable democracies in Latin America, with the last interruption dated back to the civil war in 1948. Since then, the country has continuously respected democratic rule. After the 1960s the economy was reliant on the agricultural sector, critical for employment, exports and fiscal revenue, they started a state-led industrialisation programme, with the objective of reducing its reliance on primary products. After the 1981-82 recession, they decided to open to the international economy, to increase the share of FDI. As illustrated in Figure 31 (below), Costa Rica has managed to maintain a stable macroeconomic environment, with strong rebounds after the two financial crises.

177 Felipe Larrain B., Luis F. Lopez-Calva, and Andres Rodriguez, Clare, *op. cit.*

Figure 31: Costa Rica's GDP (1960-2014)



Source: World Bank Database, 2016

Geographical location and proximity to the US market

The strategic location, as a bridge between the US and Latin America, as well as access to the Pacific and Atlantic Ocean, has also contributed to the attractiveness of Costa Rica. The proximity to the US cuts the delivery time for exported goods, and it is strategic for nearshoring IT-enabled services, especially considering the similar time zones.178

Access to electricity

Costa Rica also ranks high in the ease of getting electricity (23rd out of 189 countries). Compared to other Latin American countries they also rank higher than Mexico, Colombia, and Chile.

2.4.1.6 Activist Policy

The Intel Costa Rica campus was set up outside the current industrial parks, in that point of time, because its size exceeded the limitations of these parks. Thus, Costa Rica's Free Trade Law was revised to include the Intel Costa Rica Campus. Intel could then receive the standard Costa Rican investment incentives, including:

- "100% exemption on import duties on raw materials, components and capital goods
- 100% exemption on taxes on profits for eight years, and 50% on the following four years
- 100% exemption on export taxes, local sales and excise taxes, and taxes on profit repatriation
- 100% exemption on municipal and capital taxes no restrictions on capital repatriation or foreign currency management.
- Fully expedited on-site customs clearance
- Ability to sell to exporters within Costa Rica
- Ability to sell up to 40% in the local market with exemption from sales tax."179

Focussing on technology clusters - Develop a strategy to establish service and supply networks for priority sectors.

The promotion activities from 1996-1998 focussed on the electronics sector, establishing and consolidating Intel, and thereafter, attracting more high-tech companies and

178 Jose Cordero and Eva Paus, *Foreign Investment and Economic Development in Costa Rica: The Unrealized Potential*, Working Group on Development and Environment in the Americas, 2008

179 Spar, Debora, *Attracting high technology investment: Intel's Costa Rica plant*. Foreign Investment Advisory Service, Occasional Paper 11, 1998.

strengthening the industry around it. In 1998, Coalición Costarricense de Iniciativas para el Desarrollo (CINDE) focused on the support industry, in order to reinforce the cluster further by bringing in suppliers, and did this for all the large investors established in the country. The local supplier base was seen as a way to increase economic impact through the multiplier effect, also anchoring foreign investors through more substantial and proximate supplier relations. This was achieved through the Provee programme launched in 2000, creating viable links between domestic suppliers and multi nationals. 180

2.4.1.7 Future

In addition to lowering the fiscal deficit to more sustainable levels, a much stronger policy framework is needed. Greater exchange rate flexibility is an important component in this transition. And in addition to this stronger cross-border banking supervision is needed to deal with spill over risks rising due to the interconnectedness within the region.

Costa Rica still needs to focus on structural reforms in order to start boosting productivity and improving competitiveness. Such as actions to lower energy costs, ease red tape and upgrading physical infrastructure. Also, the promotion of high quality (inclusive) education and enhanced childhood care, could raise the participation of women in the labour force.181

2.4.2 Argentina

- Argentina has historically been classified as a middle-income country.
- Argentina is rich in natural resources and is a leading exporter of beef, soybean, and sunflower seeds.
- While Argentina has good natural conditions for wine production, wine was mainly consumed locally until 1990. By focusing on high-quality wine production, Argentina's world wine exports grew from 16% (1995) to 39% (2008).
- The number of countries to which Argentina sold its wines increased from 45 in 1993 to 115 by 2008, indicating a significant growth in new market entry.
- Exports registered a compound annual growth rate of 30.1% in value and 22.3% in volume from 2002 to 2008.

2.4.2.1 Critical success factors

- Western Argentina has all the correct natural conditions for growing good grapes.
- In 1990, the new government opened the country to foreign investment, international best practices, and talent. The cost of market entry was also low compared to overseas markets, coupled with low input costs.
- In America, wine became popular in the 1970/80s and they would ultimately become the largest wine consuming nation by 2010. Argentina's export strategy targeted this market.
- Changing tastes in the wine industry resulted in Malbec becoming a favourite in the growing American market.
- The 2002 Argentine market collapse resulted in the peso devaluing, thus offering good quality wine at low cost.

2.4.2.2 Country context

Argentina has a population of 43-million people and with a GDP of $548-billion, it is one of the largest economies in Latin America. Argentina is rich in natural resources and it is

180 World Bank, *The Impact of Intel in Costa Rica: Nine Years After the Decision to Invest*, 2006

181 Mario Garza, *Restoring Costa Rica's Fiscal Health*, 2015

a leading food producer with large-scale agricultural and livestock industries. It is a leading exporter of beef, soybean, sunflower seeds.

Table 18: Argentina governance and competitiveness indicators

GOVERNANCE INDICATORS	
Institutions (out of 140) *	135
Infrastructure (out of 140) *	87
Macroeconomic Environment (out of 140) *	114
Corruption Perception Index (out of 168) **	107
COMPETITIVENESS INDICATORS	
Openness to Trade (out of 138) ~	90
Foreign Market Access/Trade Preferences (out of 138) ~	44
Cost to Export_1 (US$ per container) ***	1770
Cost to Export_2 (Border Compliance US$) ***	150
Logistics Performance Index (out of 160) ^	66
Financial Market Development (out of 140) *	132
Labour Market Efficiency (out of 140) *	139
Health and Primary Education (out of 140) *	68

* World Economic Forum's Global Competitiveness Index assesses the competitiveness landscape of economies, providing insight into the drivers of their productivity and prosperity (2015 data).
** Transparency International: Each year countries are scored on how corrupt their public sector is seen to be (2015 data).
*** World Bank's Doing Business Indicators focuses on regulations and regulatory processes involved in setting up and operating a business ($/container, 2014 data/$ border compliance 2015).
~ World Economic Forum's Enabling Trade Index assesses institutions, policies, infrastructures and services that facilitate trade in goods across borders (2014 data).
^ World Bank's Logistics Performance Index is an interactive benchmarking tool created to help countries identify the challenges and opportunities they face in their performance on trade logistics (2016 data).

Business leaders consider the high levels of inflation and foreign currency regulations to be the two most problematic factors for doing business in Argentina. The low level of financial market development means that securing credit is challenging. The country also faces an institutional crisis as it is one of the worst performers on the WEFs institutions ranking. As of 2014 the cost to import and export to/from Argentina was more than any other country in the study set. However, the new prime minister has targeted reducing cost to trade and has already made positive changes.

The development of Argentina's wine industry is the merging of the old world with the new. Up until the 1980s the wine world was fairly antiquated. It was a difficult industry for new wines to break into, the prices paid were typically set by the local wine merchants, and both wine reviewers and consumers had very little say. The industry was also dominated by a few select wines, and wealthy international wine drinkers drank French wines largely from Bordeaux wineries182.

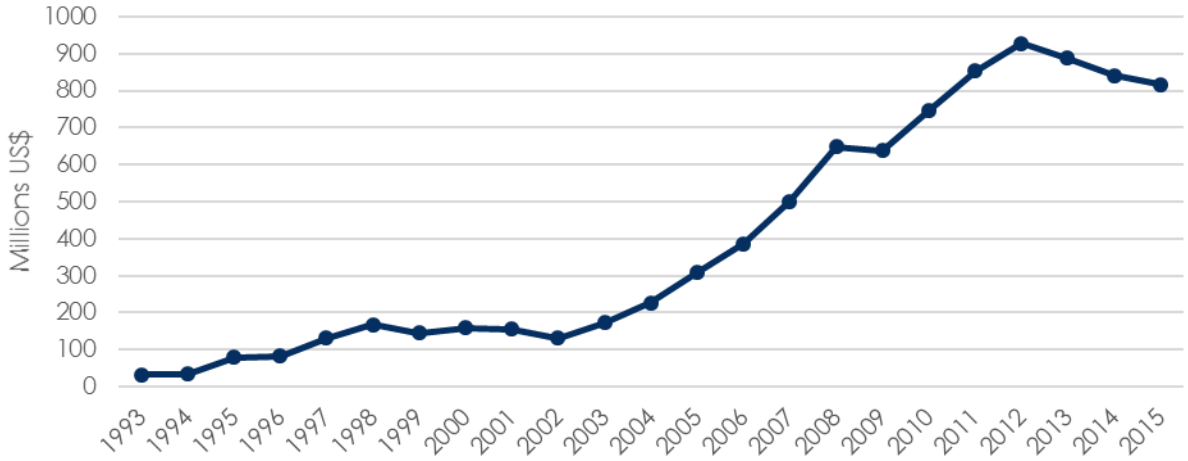
182 Mount. I., 2013. *The Vineyard at the End of the World: Maverick Winemakers and the Rebirth of Malbec*. W. W. Norton

However, the industry started changing when wine became popular in the 1970/80s in America where the average consumer was much less interested in traditional French chateau ranking and more interested in good quantity and quality. The popularity of wine was such that in 2010 the United States passed France and became the biggest wine consumer in the world. This trend resulted in the industry having to design new ways of marketing and selling their products. What followed was new growth in the wine industry from previously below the radar countries like South Africa, New Zealand, Chile and Australia. This showed a trend of seeking out good quality and low cost deals over fame resulting in France losing some market dominance.

In this new development Argentina was unique in that it is a New World country but it has an Old World wine culture with wine playing an important role. But historically, wine in Argentina was more about quantity than quality and they consumed 90 percent of what they produced. Argentina was a essentially a big producer of low-quality table wines for local consumption.

Given the growth in the industry Argentina is now the fifth largest wine producer in the world, following Spain, France, Italy and the United States. Exports registered a compound annual growth rate of 30.1% in value and 22.3 percent in volume from 2002-2008. A report from Wine Business Monthly (May, 2009) shows that U.S. imports of Argentinian wine have risen dramatically in recent years, from 2.6-million cases in 2006 to 4.3-million in 2008. The total value of Argentinian wine in the U.S. rose from $75-million to $146-million in this period. Malbec's share of Argentinian wine exports increased from 35% to 48% over 2006-2008 measured by volume and from 44% to 55% measured by dollar value183.

Figure 32: Argentinian wine exports (1993-2015)



Source: Comtrade

This has positioned Argentina as the seventh largest exporter in the world and, during that period, the fastest growing export country. Argentina's largest export is the United States, accounting for 29.2% of sales, followed by Canada (10.4%) and the United Kingdom (9.3%).

2.4.2.3 Comparative advantage

Western Argentina has all the correct natural conditions for growing good grapes. Dry conditions give the vines good health in terms of fighting cryptogamic diseases (fungi, bacteria and virus). There are many good regions to produce wine in Argentina and the climatic and soil differences in regions result in the same variety tasting differently.

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183 Veseth. M., 2009. *Wine, Recession and Argentina.* The Wine Economist

Mendoza is the leading wine producer in Argentina. Mendoza province offers the best combination of climate, soil and infrastructure, making it the most important wine territory in Argentina. Argentina's wine production areas range from the northern province of Salta to the southern region known as Patagonia (i.e., the provinces of Neuquén, Rio Negro, and Chubut). This 4,800-mile-long strip (2,400km) of irrigated desert along the Andes Range has proved to be highly suitable for growing grapes of different varieties.

The success story of Argentina's wine exports is also synonymous with the story of Malbec. Malbec is Argentina's signature wine and comprises half of all wine exports. In 2010 Decanter magazine published a report on Argentinian Malbec that featured the largest tasting in their history, a record 255 wines. Four of them received five stars, the highest designation. At the International Wine Challenge, the world's biggest wine competition, Argentina has won ten gold medals for its wine – with several bestowed on the Malbec blends. It has also won several awards at other prestigious wine events.

Argentina relies on favourable natural conditions for their wine production, as well as highly competitive production factors, such as cheap labour, low cost inputs, and an abundance of land.184 The table below provides a summary of the favourable conditions Argentina enjoys:

Table 19: Argentina's favourable conditions for wine production

CATEGORY	FAVOURABLE CONDITION(S)
Geography	Very high average altitude of vineyards 2,700 ft. (intense sunlight, cold nights, dry mountain air)
Climate	Intense light (adds flavour) Abundant water High plains with cool climate Well-defined winters, hot summers Little rain (but abundant melting snow from the Andes allows irrigation when required) Ample sunshine Few diseases No much wind, except Patagonia No hail, except Mendoza
Land	Abundant and cheap land (approx. $16,000 per hectare)
Raw materials	Little use of pesticides 50% of vines are more than 25 years old Mainly flood irrigation Mainly engrafted vines
Labour	Low unskilled labour costs Easily available manpower

184 EC, Study on the competitiveness of European wines, 2014

2.4.2.4 Value Chains and FDI

Due to these perfect growing conditions and the change in trends in the wine industry Argentina's west became a magnet for any foreign or local wine merchant who had capital to invest. In the 1990s winemakers invested $1.5-billion in the Argentine wine industry. $1-billion was from foreign investment. Investments originated from countries such as France, Italy and Spain. This resulted in a professionalization of the industry, creating a new variety of highly-qualified agricultural engineers, sommeliers, oenologists, and wine technicians185. The arrival of foreign wine makers resulted in great improvements in quality. They introduced modern techniques such as yield control, fermentation, temperature control and the use of oak barrels.

The price of land in Mendoza has now significantly increased. The price of the best land in Mendoza has increased from about $135,000/ha in 2007 to $180,000/ha in 2013/14. However, this still represents good value as an equivalent piece of land in California's Napa Valley will cost much more than double.

The foreign direct investment and an injection of overseas talent, techniques, and innovation caused the wine sector to boom after the 2002 financial collapse and the devaluation of the peso. The build-up to the 2002 collapse was also important. President Carlos Menem became president of Argentina in 1989 and his regime (which lasted through the 90s until 1999), while very corrupt, opened the economy to foreign direct investment that renewed many industries, including the wine industry. This is evident in that many important Argentinian producers have international connections. For example, Bodega Colome is owned by Donald Hess of Switzerland, who also owns The Hess Collection in the United States. Achaval Ferrer is a joint venture with a Montalcino winemaking family. Bordeaux wine investors are players in Diamandes and Clos de los Siete. O Fournier's owner is Spanish. Cheval des Andes is a joint venture of Moët Hennessy's Terrazas de los Andes and St-Emilion's Cheval Blanc. Bodega Norton is owned by the Swarovski family of Austria186.

The processes of supplying wine to international markets was a combined process of having natural abundance, coupled with trade liberalisation and market openings that was characteristic of Argentina's policy in the 1990s187.

Argentina's success was also a combination of important factors on both the demand and supply side: having good products, the right products at the right time and favourable economic policies. Argentina has also done well in choosing good distribution channels. For example, the Alamos brand (which is a leading export brand in the United States) is imported and distributed in the States by the Gallo Company. Gallo has a large and efficient distribution network and formidable marketing abilities. The wines presented good value and rapidly improving quality. The U.S. wine market was growing and consumers were turning away from Merlot and later Syrah/Shiraz, creating an opportunity for Malbec188. And as mentioned previously, some of the most important brands established effective distribution partnerships, which enabled them to lead Argentina into the market and firmly establish the category189.

Distribution into the States was an important contributing factor to Argentina's success. Wine consumption in Argentina is on a downward trend partially due to increased consumption of beer and soft drinks. However, the economic crisis of 2002 made matters worse for the domestic market. Argentine producers had no choice but to export to survive. The United States market was a prime target given their growth in wine consumption.

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185 ProsperAr, 2009. Invest in Argentina – Investment Opportunities.

186 Veseth. M., 2010. *Secrets of Argentina's Export Success.* The Wine Economist

187 Steve Stein, American Association of Wine Economists, Working Paper No. 21, 2008

188 Veseth. M., 2016. *Will Argentina Wine Export Growth Return in 2016?* The Wine Economist.
Veseth. M., 2016. *Whatever Happened to Argentina's Wine Boom?* The Wine Economist.

189 *Ibid.*

These factors resulted in a transformation of the wine industry. The growth of the industry coupled with strong exports to the United States positioned Argentina as a key global player.

2.4.2.5 Activist government intervention

Following the "Mendoza-San Juan Agreement"- the main goal was to foster the diversification of the national grape and wine industry - the Corporacion Vitivinicola Argentina was established to manage and coordinate the implementation of the Wine Strategic Plan 2020.190

Private public partnership

Once the Argentine economy stabilised and liberalised in the 1990s, many wineries upgraded their machinery and began undertaking experiments. Two of the top exporters in this sector were companies owned by international investors. One of these wineries, Norton, began its transformation in 1989 when it was bought by an Austrian investor. A Special Fund was created for the promotion of Argentine wines in the UK and USA markets.191

The Corporacion Vitivinicola Argentina plan includes three main goals:

- Position Argentinian wines in export markets, with a focus on the Northern Hemisphere. This was implemented through the Wines of Argentina body. They are responsible for communicating actions and promoting in different locations across the world. This body and their activities are financed firstly by members which are wineries, and secondly, the public sectors in charge of promotions.
- Expand the presence of Latin American markets and boost sales domestically.
- Support small- and medium-sized producers to integrate into the wine value chain. This was aimed to ensure the upgrade of production, technology and organisational processes, through investment in capital inputs and technical assistance. To further support this objective, an agreement was made with the Inter-American Development Bank to finance the integration of small and medium wine grape producers.

2.4.2.6 Technology

Technology has also played a role in the modernisation and growth of the wine sector in Argentina and has helped make poor quality wine a thing of Argentina's past. Yields per hectare have also risen significantly during the 90s due to using modern techniques. For example, a machine, made by Pellenc, a French firm, will harvest 20 tonnes of grapes in one day: enough to make 18,000 bottles of wine, and a harvest that would otherwise require 40 workers. Other technologies include optical sorting whereby cameras and image-processing software is used to separate and discard low-quality products.

Pellenc released a machine in 2007 that separates grapes by using optics that filters grapes according to shape, size and colour thus selecting only perfect berries. Other advances have been made in storage and transportation. Technology has vastly improved the quality of low end wines and more prestigious producers are becoming open to the use of technology in winemaking.

2.4.2.7 Macroeconomic factors

The financial collapse also played a role in the unprecedented growth of the wine sector. The 2002 devaluation of the peso resulted in Argentina and its products being very cheap

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190 Euan Fleming, Stuart Mounter, Bligh Grant, Garry Griffith, & Renato Villano, *The New World challenge: Performance trends in wine production in major wine-exporting countries in the 2000s and their implications for the Australian wine industry*, 2014

191 *Ibid.*

for foreigners and profitable for producers and contributed to Argentina's competitiveness on the export market.

The wine industry has also managed to survive the fatal factors that have prevented other industries from growing. The lack of credit and volatility make it difficult to grow business in Argentine. The wine sector has managed to survive due to the low cost of land and manages the issue of no access to long term credit by reinvesting profits and accessing FDI.

2.4.2.8 Argentina now

In recent years the strength of Argentina's wine industry's growth has come to a stop. Exports to the United Stated have tapered off at 13.2-million cases overall with meagre growth rates of less than 1 percent. The current export environment is one of export volume being up overall, but revenues are down because of falling unit prices and steep competition. Impact Databank statistics show that Argentina wine shipments to the US market peaked in 2010-11 in terms of volume after a decade of rapid growth. Volume in 2014 was modestly down from that peak, but lower than any year since 2009. The boom seems to have faded and growth in the U.S. market remains flat.

The slowdown of Argentine exports is also due to a shift in taste in the American market. "Red Blends" are the fastest growing red wine category possibly at the expense of Malbec sales.

The situation for individual brands depends very much on price point and margin. Constellation's Marcus James was the market leader in 2009 with 425 thousand cases in the U.S. market compared with Alamos with 75 thousand cases192. The situation has now changed and the more premium brands have outperformed due to double-digit inflation in Argentina and unreasonable export taxes eating away at the margins of value brands. These economic factors have been so severe that the margins on value brands have been squeezed so tightly (or even negatively) that a number of Argentinian producers have gone out of business.

Alamos, which sells at a premium price point, has plateaued at 900 thousand cases in 2014. Marcus James, selling at a much lower price point, has slumped to just 180 thousand cases193. What this indicates is that the $10 plus market in the United States is growing and that Argentine wines are doing well in this segment. However, the level of competition in this segment is growing and there is also the growing trend of Red Blends.

Argentina has faced exceptionally difficult economic conditions over the past ten years. The economic policies of President Fernandez de Kirchner have not been good for exports. Her presidency has resulted in significant inflation which has had the knock on effect of pushing up wages and the production costs of producing wine. The government's monetary policy has also kept the exchange rate at artificially strong levels which reduces export margins. Strict capital controls have also been implemented making it difficult and expensive for companies to import technology and winemaking supplies from overseas markets.

The most significant economic factors that have slowed growth in the wine industry include export rights payments; value added tax (IVA) returns; and the National Viticultural Institute's (INV) enforcement of wine volume bookkeeping rules.

The export rights results in Argentines paying 5 percent of the value of exports to government for the right to export. This 5 percent plus 1 percent is meant to be returned to the exporter as soon as the invoice has been paid. However, due to shortage of funds in government reserves they have significantly delayed these payments and as a result of

192 Veseth. M., 2016. *op. cit.*

193 Veseth. M., 2016. *op. cit.*

significant inflation if these amounts ever get paid back in pesos they will be worthless compared to the original dollar value that was invoiced.

The same outcome is visible with IVA returns in that value added tax (21%) should be paid back to the winery if the finished product is exported. This is not happening due to government's lack of funds. The INV enforcement has also become corrupted and wineries are being fined for miner technicalities. Taken together, these costs are rapidly eroding wineries' ability to continue day to day business. Inflation has also had severely negative consequences. The high levels of inflation have completely eroded payment terms with suppliers making it impossible to secure credit.

On a positive note Argentina had a change of government in December 2015. The new President Mauricio Macri has already made a number of significant changes and has promised to end the policies that have crippled the economy. President Macri has already removed export taxes on a number of important industries such as wine and has allowed the peso to fall from its artificially high level. The removal of the export tax has potentially supplied the wine industry with a $50-million windfall. The combined impact of these two changes improved the country's international competitive positioning by 50% almost overnight. Although these measures have already helped the wine export industry, the domestic economy has been affected by rising inflation due to higher import costs. The full impact of these decisions will only be felt in 2017 as most export book orders for 2016 are based on 2015 prices.

2.4.2.9 Future challenges

The current hope for Argentina is that the new polices find traction and they can weather inflation. Argentina should continue to target the American market with a focus on the $10 and above price point as this market segment has been identified as having the highest growth and margin opportunities.

In the past, a significant portion of Argentina's growth in wine exports was in the value wine segment. A report by Rabobank (2016)194 cautioned that with the improvement in competitiveness and pricing flexibility, Argentina should carefully manage its value wine segment pricing to avoid undermining the long-term premium positioning of the brand and the overall category. The report stated that excessive pricing moves may result in windfall profits today but could create difficulties in the long run.

There is also the need to diversify exports beyond just Malbec. Argentina is home to a number of great wines. Diversification is needed to protect against the risk of changes in taste.

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194 Rabobank, 2016. *Argentine Wine's New Lease on Life.* Food & Agribusiness Research and Advisory