THE HORN ECONOMIC AND SOCIAL POLICY INSTITUTE

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Sustainable Financing for Trade and Investment in the Horn of Africa (HoA) Region

1. Introduction

The fast-growing global interdependence in trade and investment and the ensuing fiercer market competitions have changed the way economic development is pursued and assessed. Identifying and maintaining comparative advantages based on endowments, such as natural resources and specializing along those lines is not sufficient. It has become imperative to create new comparative advantages in trade and investment to adapt them to the changing realities. For the Horn of Africa Region, financing shortfalls for trade and investment is one of the deterrent missing links. The capital deficit spans from necessary physical infrastructure and the financial capital to more profound and grand investments vital to the 21st-century global economy.

Shortages are observed in the domestic saving shortfall to finance investments, the unsustainably high trade and current account deficits, and the increasing external debt levels. With an average regional domestic saving of 12.8 percent of GDP and the investment-to-GDP ratio of 24.2 percent, the domestic resource gap of the region in 2017 stood at about 11 percentage points (AfDB, 2018). The parallels are a 3 percent average deficit for the SSA, and 3 and 2 percent surplus for China and India, respectively (WDI, 2018). The sustained recent decline in commodity prices and the consequent reduction in export earnings have put considerable pressure on the countries' external accounts and foreign reserves. Illicit capital outflows have exacerbated the shortage of hard currency across the region. Therefore, the HoA countries heavily rely on external financing for their financing gaps.

Our overall assessment of trade finance in the Horn is that such finance receives less attention at the operational level than investment finances. Yet, the two are enormously related as success in one often depends on success in the other. Almost all investment projects are in some ways linked to international trade flows; they are an avenue for buying inputs or for selling products or both. For instance, commercial banks in the region are, in principle, open to financing the entire export value chain, from production to aggregation and exporting. Yet, actual financing is predominantly at the high-end of the chain.

Trade misinvoicing has been a core component of illicit financial flows (outflows or inflows) in the Horn region. Illicit flows in Djibouti, Ethiopia, Kenya, and Uganda reaches as high as a 5th of their total trade values[1]. And a recent study by the Global Financial Integrity has put Sudan as a county with widespread illicit financial flows.

2. Investments and its financing in the HoA

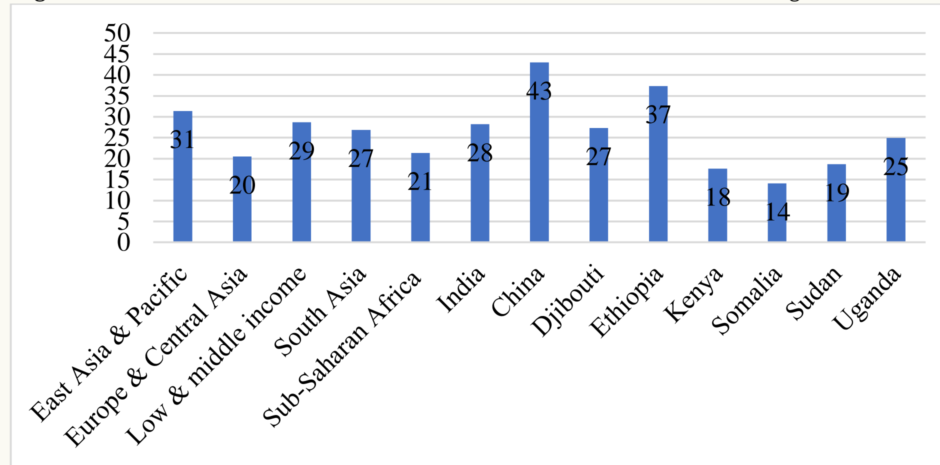
Most countries that invested a large share of their GDP have sustained high growths. In 2010-17, investments in East Asia and the Pacific region (excluding high-income countries) averaged 41 percent of GDP. For the same period, China and India invested 44 and 31 percent of their respective GDP and maintained impressive growths.

With an average investment of only 20 percent of the region's GDP for 2010-17, the Sub-Saharan Africa region is generally under-investing. Within the region, investment as a share of GDP varied substantially; in Ethiopia and Djibouti, gross fixed investments amounted to 38 and 26 percent of GDP in 2017, respectively; Kenya at 18 percent, Sudan at 18.3 percent and Uganda at 23 percent, on

[1] Source: ________________

the other hand, invested moderately. Regarding the region's fragile economies, Somalia invested a low level of 12 percent of GDP during the year, and there was no reliable data for Eritrea and South Sudan.

Figure 1: Gross Investment as Percent of GDP in the HoA and other regions in 2016



Source: World Bank's WDI, 2018

Most of the HoA region investments are financed with external resources, as the region's domestic resource mobilization is far lower, and the question remains on sustainability of such dependence over the long term. In 2016, the HoA countries domestic savings ranged from 8 percent of GDP for Kenya and 22 percent for Ethiopia, except Somalia, which had a large amount of dissaving. On the other hand, the domestic savings of China and the East Asian and Pacific region's averaged around 40 percent of their GDP, and these countries savings fully financed or exceeded their corresponding investments.

3. The savings investment gap challenges in the HoA

The HoA countries except for Sudan have experienced steady and significant financial resource deficits (domestic saving minus gross investment) as a percent of GDP in 2014-17. The high investments drives in Djibouti and Ethiopia led to large deficits as a percent of their GDPs. Sudan is the only resource-surplus country in the region as it has low foreign capital inflows in the form of FDI, ODA, and remittances.

The HoA countries also had experienced balance of payments current account deficits in 2002-17. The current account deficits have been mounting because of the severe dependence of the region's countries on primary commodity exports that have suffered from price volatility and deteriorating terms of trade. In addition, these economies are highly dependent on imports of capital good and manufactured consumer goods alike.

Official foreign reserves are in short supply in most of the countries of the HoA. Consequently, these countries have major constraints on sustaining the import requirements and often face foreign currency shortage and some rationing of access to foreign currencies. In addition, over-valued exchange rates are the norm except for Djibouti, which has the world's oldest currency board arrangement.

Debt accumulation and distrust: Most of the countries of HoA have benefited from the Heavily Indebted Poor Country (HIPC) Debt Relief Initiatives, with the most recent case being that of Somalia in March 2020. The main exception has been Sudan, which has not succeeded in accessing the debt relief initiative, and South Sudan, which is the youngest country and does not qualify for the initiative. Several of the HoA countries have accumulated large amounts of total and external

debts post their initial HIPC relief achievements that are worrisome once again in terms of sustainability.

4. Current and potential sources of finance

The existence of national development banks in most HoA countries and local offices for some Regional Development Banks is an opportunity to obtain domestic solutions and better bridge external finance inflows. There are a lot of potentials to improve the supply of finance within the domestic financial systems. For instance, about $50 billion a year illicit financial outflows from Africa are more than double the Continent's annual ODA inflows. The Aggregate capital flight out of Africa for the period 1970–2010 is estimated at $1.3 trillion, while the continent's debt stock is around $283 billion (AfDB, 2019). In regard to HoA countries, the illicit outflows are at US$[????] million as of [what year??]. Curbing such illicit finance flows alone will significantly improve domestic resource mobilization and, hence, reduce indebtedness.

The ongoing closer cooperation among member states to pool resources for joint implementation of regional infrastructure development initiatives is promising. The major current sources of external financing to the Horn are also promising. In particular, the AfDB has increasingly been active in the HoA region. Since its establishment, the AfDB has financed 526 projects for the HoA countries, and about 60 percent of the projects were initiated after the turn of the millennium.

In addition to the conventional multilateral, bilateral, and regional financing sources, the Horn countries have opened up new and significant financing sources with China and the Gulf states (most notably, Saudi Arabia and the United Arab Emirates). The Gulf States are trading partners for goods and services with all HoA countries and, in particular, with Djibouti, Eritrea, Ethiopia, Somalia, South Sudan, and Sudan.

China has already become a big financer of Africa's development endeavors. In September 2018, at the 7th Forum on China–Africa Cooperation (FOCAC), China pledged $60 billion in financing for Africa (Shinn, 2019). China has disproportionately increased funding in the HoA countries compared to any other sub-region in Africa. With a 34 percent average share for 2000-15, the Horn countries received relatively higher share of Chinese funding than other African regions.

Sovereign bond markets are emerging sources for Africa and the HoA sub-region investment finance. Overall, 20 African countries have raised over $92 billion outstanding Eurobond stocks, including Kenya and Ethiopia with $4.8 billion and $1billion, respectively. South Africa ($18.9bn), Egypt ($18.9), and Nigeria ($11.2bn) lead the continent. At the same time, the stock for other African countries is 5.1 percent of GDP (Cepheus, 2019).

5. Concluding remarks

Trade and investment financing in the HoA portrays promising developments and immense structural challenges. Some of the countries have made economic progress and others are coming out of many years-long political crises; thus, trade and investment financing issues affect them differently. While the former are making existing institutions properly function, the latter are at an early stage of building institutions. Development banks are either nonexistent or functional and in some cases are overly burdened with ambitious and less coordinated lending activities that jeopardize their institution's financial soundness. The existing Development Banks are not adequately resourced and are not well functional.

Countries in the Region face persistent domestic saving shortfalls to finance investments and suffer from unsustainably high trade, balance payment current account deficits, and in some countries, unsustainable debt levels.

The countries heavily rely on external sources for covering their financing gaps. Capital outflows have exacerbated the shortage of hard currency across the Region. Thus, the Region needs to revisit its institutional setup and devise mechanisms to make trade and investment finances accessible and affordable.

From the short-term perspective, the HoA countries should see existing regional potentials. For instance, as much as the public sectors benefited from African Development Bank funding, the private sectors are largely excluded. The exclusion is systematic as the financing policy of the AfDB by design does not directly address retail level lending to private sector actors. But, it has some experience of working with other domestic and regional banks to reach lower-end borrowers. However, IGAD countries have not customized their domestic financial institutions to benefit from such access.

The Region's recent experience in accessing international sovereign bond markets and the favorable credit rating they are getting are encouraging. However, this calls for the countries to be vigilant in maintaining their countries' macroeconomic management and fixing any loopholes for failure. For instance, Kenya and Ethiopia have good standing in the sovereign bond markets, yet their recent mounting debt distress worsens their risk ratings and damages their respective credit ratings.

The collaboration of the IGAD countries with China and the Gulf States to access long-term concessional credits and substantial FDI from the UAE and Saudi Arabia is encouraging. However, caution should be exercised to maintain that they negotiate on terms that are consistent with economic stability and without compromising long-term economic sustainability. There is an obvious concern that the end game of the access to non-concessional of loans should not lead to new difficulties for the HOA countries'.

6. Policy recommendations

Below are some specific policy recommendations for the HoA policy makers and development partners.

- The HoA countries should mobilize enough funds for regional projects by establishing regional institutions like setting up a HoA (IGAD) and associated Investment Funds. Development banks (both multilateral and national) could finance the initial and riskier phases of Greenfield investments. Private capital could step in when project risk level fall (Greenfield investment transitioning to brown-field investment). Development Banks can also free up financial assets by selling them to private sector investors through asset sales programs. Development Banks could join hands in program identifications, information, and data generation by harmonizing their financing structures and standards in their capacity of development and technical assistance interventions. Development Banks should hence assist beneficiary countries in their investment project preparation.
- HoA countries should furher diversify the sources of sustainable external financing. Financing long term and large scale national or regional projects require immense resources for a single financier to bear. Available financial resources are scattered, and a single source often finds it hard to finance such capital intensive national and regional projects. A mechanism to link domestic resources with those from bilateral, multilateral entities may do the job. For instance, the HoA region can capitalize on its key development partners such as the World Bank, the African Development Bank, and China. However, these partners differ in their interests in the region, their capabilities, and their priorities. The question would thus be on how to narrow down such differences and build upon their shared interests.

- Countries should build on augment syndication that have been tried and tested in the HoA, and worked for some projects by pooling resources to finance investment projects jointly. Syndications are often initiated by one party, and others chip in at later stages. Syndication could bring better outcomes when participants work together from the get-go to accommodate participants' interest at the planning stage engaging in blended finance.
- It is possible to mobilize private sector resources by enabling the securitization of investment projects. Individual projects should be formed in a way to allow syndication and securitization possible. For instance, a single project can be restructured into a series of portfolios of assets to suit private institutional investors' credit and liquidity requirements.