



# KOREA COMPASS

TRACING THE IMPACTS OF KOREA'S ENGAGEMENTS AROUND THE WORLD

## OPPORTUNITY AND RISK-MITIGATION IN AFRICA

By Philippe de Pontet and Raymond Gilpin

### A CONTINENT OF OPPORTUNITIES

Following several lost decades of stagnant growth and bad governance after independence in the 1960s, African countries are now resurgent. Whether one looks at gross domestic product (GDP) growth, investment flows, trade, or the process of economic reform, there has been a sea change across much of the continent since 2000, mostly for the better.

In the last five years, only southeastern Asia has outpaced Africa's 5 percent aggregate growth rate. In the future, the International Monetary Fund expects the trend to continue—although with 54 separate countries, of course, there will be a lot of variation around the mean. Foreign direct investment (FDI) is on a rising trajectory in most sectors, including oil, mining, infrastructure, telecommunications, and agriculture, where opportunities still abound despite the remarkable penetration of Chinese and other emerging-market firms. Korean firms are increasingly a part of this story, with a commercial footprint ranging from billion-dollar resource plays in countries like the Democratic Republic of the Congo (DRC) and Angola to medium-sized investments in agriculture, infrastructure, and light manufacturing.

Africa's resurgence is tied in some cases to the rise in commodity prices, but this is a partial explanation at best. More important is the improved macroeconomic policy climate and stabilization of many countries once wracked by civil war or rebel threats. Moreover, at a time when North Africa and the Middle East are roiled by protest, there are few signs that sub-Saharan Africa

will face a similarly destabilizing “African spring.” If anything, political change is coming through democratic channels in reform-minded nations through the mobilization of legitimate opposition parties, not through chaos in the streets.

### THE CHINESE MODEL(S)

The pace and scope of Chinese commercial engagement in Africa since 2000 have been breathtaking. Trade has exploded from about \$15 billion a decade ago to \$120 billion in 2010, over which time Africa has become an important pillar in Chinese energy security, providing one-third of China's oil imports (and a hedge against Middle Eastern instability). FDI flows are also rising sharply, centered on both infrastructure and natural resources, often linked together. Chinese FDI increased from \$1.6 billion in 2005 to \$8.3 billion in 2009, according to the Chinese National Bureau of Statistics. China's most prominent trade partners are also, unsurprisingly, its biggest suppliers of natural resources. Oil-rich Angola and Sudan top the bill, with South Africa in the third spot. The DRC and Zambia, two of the world's fastest-growing copper producers, are also key mining partners. Investment in oil and infrastructure in Nigeria remains relatively modest despite heavy courtship, but this relationship will likely grow exponentially.

### China's Engagement Strategy

Cheap loans—provided by the Export-Import Bank of China and the China Development Bank for industrial and infrastructure projects—have been the most im-

portant financial tool Beijing deploys in Africa. The terms of the loans vary widely, and in some cases, when countries cannot provide adequate financial guarantees to back their commitments, loans are secured with commodities as collateral. The essential bargain, at least in resource-rich countries, has been to link infrastructure development in exchange for resource deals and exports, often structured through resource-backed loans. Apart from oil, other strategic resources actively sought by Chinese firms for future supply security include iron ore, copper, bauxite, cobalt, coal, uranium, and even fertile land for agriculture.

Chinese resources-for-infrastructure projects will remain an effective market entry strategy in Africa's least-developed (and often unstable) countries such as the DRC, Guinea, and Niger, and in pariah states such as Sudan. A similar model can—and already has—worked for Korean firms, albeit on a smaller scale. In other markets, promises of spending on infrastructure may not be sufficient as host governments are increasingly demanding value addition through refining and processing facilities (and downstream investment). Korean consortia that can offer a broad package, including not only expertise in exploration and production but also supporting infrastructure and value addition, will be well placed to succeed in Africa.

Chinese commercial engagement has also included African parastatals in joint ventures in a way that makes host governments feel like real partners in projects. The typical parastatal has 15–30 percent equity in the joint ventures (above the norm with Western multinationals), although often the resource-backed infrastructure loan must be paid back to China first, which over time can cause tensions, as in Angola. Chinese firms allay these tensions in part by offering generous up-front bonus payments, such as the \$350 million bonus that underpinned the \$6 billion agreement with the DRC in 2008.

The engagement strategy does not always rely heavily on spending commitments. Chinese officials have helped their companies make inroads by offering preferential trade access, preferred-destination status for Chinese tourists, timely diplomatic support, technical assistance, agricultural machinery, technology transfers, debt relief, large trade delegations led by senior officials, and the like. The incentives vary some from country to country and generally tap into key priorities of the host government.

## Limits to the Chinese Model

There are limits to the successes of this model, and these limits are also instructive. By far the biggest drawback, at least from the African perspective, has been the reliance on imported Chinese workers in labor-intensive projects. This has created backlashes to Chinese firms in countries such as Zambia and Angola, while putting host governments in a difficult political position with their own constituents. The double-digit unemployment in most of these countries (in some cases the formal sector employs only about 20 percent of the population) makes the presence of thousands of Chinese workers, many of them doing manual labor, highly unpopular. Korean firms would do well to avoid this approach and, instead, hire locally whenever possible, including for executive positions. This is especially the case since many African governments are following Nigeria's lead in implementing strict local-content requirements that insist on local hires and domestic sourcing for critical inputs.

Another common complaint has to do with poor labor conditions and environmental safeguards. Chinese firms have a reputation for paying poorly, fostering inhumane working conditions, and even mistreating employees. This has raised strong opposition from labor unions, which are fairly powerful in countries such as South Africa, Zambia, Guinea, Nigeria, and Ghana, which are all priority destinations for resource-based investment. Chinese mining companies are also seen as poor corporate citizens with regard to the environment, which puts them on a potential collision course with local communities and powerful industries such as tourism.

Chinese firms and diplomats focus on elite-level relationships in the capital to the exclusion of civil-society institutions, including opposition parties. Direct ties to heads of state, ministers, and their domestic business allies can be essential to market entry, but engagement needs to be broadened to other stakeholders. Otherwise this dynamic can expose them to high levels of political risk when there is a change in regime, an ascendant opposition movement, or major political protests. This strategy can also come at a high cost when the host government lacks legitimacy or faces a rebel threat because Chinese firms can be seen as tempting targets and as proxies for the hated government. In 2007, Ethiopian rebels in the restive Ogaden region bombed a Sinopec

oil installation, killing nine Chinese workers, as a proxy target allied with the host government.

Chinese firms have not managed expectations properly in some cases, which has fed the disillusionment. A notable example is Sinopec's decision to walk away from a commitment to refurbish the Lobito refinery in Angola, a major priority of the government. This incident caused relations to cool despite an estimated \$11 billion in resource-backed loans since 2005.

Heavy competition from Chinese imports has alienated the local business community, which finds it difficult to compete. This can cause headwinds for its firms on the ground. Perceptions run deep that cheap Chinese goods, sometimes bolstered by predatory business practices, are flooding the local markets. This can turn the local business community against China and force host governments (as in South Africa) to erect targeted trade barriers that can complicate the bilateral relationship.

There is widespread suspicion, and a fair amount of evidence, that Chinese firms use big bonus payments to secure deals over rivals. Some of this is legitimate but some crosses the border into bribery, essentially reinforcing official corruption in the process. Some Chinese projects benefit communities linked to the ruling elite, but some have marginal developmental or even commercial value. Wuhan Iron and Steel paid the pariah government of Madagascar \$100 million to stave off competitors for the Soalala iron ore concession in 2010. Even if such tactics are technically legal, they practically ensure that host governments will continue to expect or demand special payments and perks over the course of the investment cycle, which can be bad for business over time.

### **Korea's Opportunities**

Korean firms that are uneasy about greenfield investment in certain countries can enter these markets as minority partners with more established investors. Risk-averse Japanese firms have taken this approach in countries such as the DRC and Equatorial Guinea. South Africa is a natural candidate for this type of collaboration, given its large and developed private sector that has already made aggressive forays across the continent. South African companies see mutual advantages in teaming up with foreign firms that can provide the capital and technological know-how to

complement their regional footprint and expertise. Banking sector tie-ups with well-run South African or Nigerian banks can be an innovative way to expand exposure to Africa. The landmark \$5.5 billion acquisition by the Industrial and Commercial Bank of China of a 20 percent stake in South Africa's Standard Bank in February 2008 will help finance projects across the continent for years to come, giving the Chinese bank and companies access to attractive opportunities well beyond South Africa's borders. Likewise, U.S. retail giant Wal-Mart is seeking a majority ownership of South Africa's Shoprite in part because of its presence in 14 other nations on the continent. Some South Korean firms have also followed this approach, such as Korea National Oil Company's acquisition of the Africa-focused junior oil firm Dana Petroleum.

Acquisitions are one way to enter African markets but another promising approach, which can also mitigate risk and improve project sustainability over time is through public-private partnerships.



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## **POTENTIAL FOR PUBLIC-PRIVATE PARTNERSHIPS IN AFRICA**

African countries have recorded impressive economic growth rates over the past decade, in both oil and non-oil economies. According to the 2011 African Economic Outlook report, this trend is likely to continue over the medium term with more African countries expanding economic opportunity, growing trade, reducing poverty, and laying the foundation for self-sustaining development and more effective and accountable governance. However, this would be possible only if recent economic gains are consolidated (principally by sustaining appropriate macroeconomic frameworks, continued policy reform, and economic diversification) and key market imperfections are corrected.

Africa's infrastructure gap is a major market imperfection. Weak infrastructure costs the continent two percentage

points in GDP growth every year, and productivity is reduced by as much as 40 percent. In addition to affecting economic growth, weak infrastructure is costly for Africa's consumers and investors; for example, African consumers pay twice as much for basic services, and strategies to mitigate unavailability and uncertainty cost businesses millions every year. Addressing the continent's infrastructure gap will require an estimated annual investment of \$93 billion over 10 years in order to make a marked difference.

Although African countries are already spending roughly half of the estimated amount and external sources are slowly growing, a \$31 billion funding gap remains. Traditional approaches to filling this gap are both constrained and broadly ineffective. They are constrained because the combined impacts of the global financial crisis and aid fatigue have severely reduced the amount of funds available to support development projects across the African continent. Most donors are more inward looking as domestic economic stresses become paramount. Furthermore, investment flows are becoming much more risk averse. A lot of development assistance is being reprogrammed to focus on humanitarian emergencies (like famine), postconflict assistance, and natural disasters (like earthquakes or floods). Thus, traditional sources of financial assistance and support are drying up. Traditional approaches are also relatively ineffective because they are very government centric and overly bureaucratic. An estimated \$8 billion is wasted each year in infrastructure projects across the African continent. This is partly due to endemic corruption but largely due to the fact that public-sector bureaucrats all over the world are not best equipped to make business decisions or implement commercial projects. If Africa is going to make meaningful progress in addressing its infrastructure gap, it would need to adopt a different strategy, and public-private partnerships (PPPs) offer a promising opportunity. PPPs combine private-sector entrepreneurship, skills, and technology with effective public-sector governance and oversight to deliver goods and services at costs that are affordable for hitherto underserved populations. These arrangements require the private-sector firms to raise project finance, marshal requisite skills and technology, and introduce efficiency-enhancing management techniques on the understanding that the host government will commit to a series of governance and institutional undertakings that will mitigate risks for potential investors.

## Case for PPP in Africa

There are three main reasons why PPPs are particularly suited to contemporary African countries. First, Africa's consistent positive economic growth trajectory of recent years has been underpinned by significant governance reform. African countries are consistently cited as top performers in annual global Doing Business Project reports (a World Bank project), and rankings on the Global Governance Index (through the World Bank Institute) have shown signs of improvement. This suggests that governments in high-performing economies, like Botswana, Ghana, and Tanzania, would be inclined and have the capacity to provide the enabling legislative and institutional frameworks needed for successful PPPs. They are also much more likely to enter the management and concession contracts that PPPs involve. Second, the growing economies have the capacity to attract and effectively absorb large capital inflows, given the degree of risk mitigation that PPPs provide. A number of companies sitting on the fence are therefore likely to take advantage of potentially lucrative contracts. Third, African countries recognize the pressing need to close the infrastructure gap and are already devoting significant domestic resources for this purpose. Given the opportunity to compare the relative benefits of managed investments (which is what PPPs provide) over publicly funded and operated infrastructure projects (which is the option often available to them), many will opt for the predictability and risk-sharing technology transfers and efficiency that PPPs can provide.

External stakeholders, such as the Korean government and Korean companies, could gain a lot from PPP arrangements with African countries. For companies considering infrastructure contracts in Africa, PPPs offer a degree of securitization. Lucrative emerging markets in Africa become less risky and more profitable when governments reduce distortions via predictable and transparent contracting, the provision of clear and enforceable legislative and regulatory guidelines, and a degree of risk sharing (for price volatility or exchange rate exposure, for example). PPPs also offer predictable and naturally growing revenue streams that bode well for longer-term stability.

The investment, operational, and management obligations contained in most PPP arrangements could provide a win-win outcome for both investors and the host countries. Investors would be able to plan much

better and be more comfortable in their operating environments. Additional costs caused by delays, waste, and corruption could be significantly diminished. In addition to the provision of key services like transportation, energy, communication, and water supply, host countries would benefit from skills and technology transfers, employment creation at various points along the value chain, and a more open business climate. Africa's bilateral partners, like the Korean government, could use foreign assistance resources to build capacity to negotiate and manage PPPs in African countries, strengthen regulatory frameworks, and creatively incentivize investment flows into African economies. Such actions will enhance prospects for stability and prosperity as they also help to create markets for Korean firms in Africa's emerging economies.

### **Arrangements for PPP**

PPP arrangements could be either greenfield or improvements in existing facilities. Broadly, they could be either build-operate-transfer (BOT) or build-own-operate (BOO). BOO infrastructure projects would call for the investing companies to be responsible for construction, operation, and maintenance throughout the economic usefulness of the investment. With BOTs, in contrast, the investors operate the project for a predetermined duration, usually sufficient for an adequate return on investment, before transferring the assets to the host government.

In addition to these greenfield initiatives, there are also PPPs that focus on the rehabilitation or expansion of existing facilities. In many cases, these occur within the context of the privatization of state-owned facilities. A number of African countries are already experimenting with PPPs, partly as an alternative to the privatization drive of the 1990s when a broad range of formally state-owned assets were transferred to private firms—with very mixed results. African countries are comfortable with a model of project finance in which they share responsibilities and risks while they ultimately retain some control of the assets. Some examples of recent PPP initiatives in Africa follow.

#### **South Africa-Mozambique- Trans African Concessions**

As part of a subregional initiative to promote integration and trade, South Africa and Mozambique in 1996 embarked on a joint transportation project that would

provide a toll road connecting both countries. Neither postconflict Mozambique nor cash-strapped South Africa could afford the cost or provide the expertise to execute and manage the project. The governments entered a 30-year BOT arrangement with Trans African Concessions to construct and operate the N4 toll road. Financing was provided by a consortium of regional and international financial institutions (20 percent equity and 80 percent debt).

This subregional PPP model has a number of advantages. By including more than one country, it enlarged the potential market and captured the growing and increasingly interconnected trade and migration characteristics. It also helped the investors to minimize demand risks by subsidizing the relatively poorer consumers in Mozambique with marginally higher tolls in more prosperous South Africa. The toll road itself became a catalyst for increased economic activity, which boosted economic output and increased the through-flow of vehicular traffic.

Korean firms wary about the small size of many African economies and relatively weak consumer demand could adopt regional and subregional approaches like this one. Toll roads, electricity generation and distribution plants, and water treatment and provision plants could become even more economically viable if they serve multiple markets. By forging economic integration, such initiatives could become growth poles and could spin off other industries and opportunities along the value chain. Local construction and maintenance capacity, for example, could be greatly enhanced—particularly after sustained engagement with PPP companies. This could ultimately lead to reduced aid dependence, self-sustaining progress, and the emergence of more reliable trading partners across the continent.

#### **Gabon-Vivendi Water**

A second example is Gabon's multiutility PPP run by a consortium led by Vivendi Water from France. Under this 1997 arrangement the consortium (Societe d'Energie et du Gabon) provides water and power to roughly half of the country's population at tariffs that are 17.5 percent less than were charged by the former state-run utilities. The PPP uses a cross subsidization model to finance a plan to expand services to rural areas. Joint costs, both overhead and some operational costs, also help reduce costs and enhance efficiency. This model highlights

the possibilities for creative engagements by Korean companies, which could bundle a range of services to reduce costs, mitigate risks, and enhance the efficiency of services that could be provided.

### **Tanzania-Malaysian Consortium**

Africa's experience with PPPs has not been all positive. The project run by Independent Power Tanzania Limited (IPTL), a Malaysia-led consortium in Tanzania, is an example of how inadequate public-sector management, weak oversight functions, and corruption can derail PPPs. Capacity constraints and inadequate public-sector institutions resulted in minimal due diligence, overly optimistic scenarios, and the adoption of bad pricing models. Government officials allegedly received substantial bribes to look the other way. As a result, the project has operated well below capacity and with excessive cost overruns and high costs to consumers. Consumers' purchasing power from IPTL paid 12 cents a unit, while those purchasing directly from the state-run company paid 7 to 9 cents. More fundamentally, the project failed to recognize that the problem was the distribution network, not power generation—where IPTL focused its investments. Under the PPP arrangements the project became a fiscal burden to the Tanzanian government. The lessons here include the importance of transparency, augmenting public-sector capacity, thorough feasibility studies, and robust market research.

### **EFFECTIVE PPPS**

Research published by the Public-Private Infrastructure Advisory Facility suggests that PPPs are most effective when “they appropriately combine the interests of the two partners—that is, the interests of the government in expanding and improving services for citizens that are sustainable and achieving value for money and the interests of private investors in obtaining a reasonable return on their investment for the risks they are being asked to bear.”

For this to happen in Africa, four broad criteria must be satisfied. First, African governments must have a keen sense of how PPP projects fit into their national development strategies. Linkages among PPP activities (for example, construction), PPP outcomes (such as efficient service delivery and employment generation),

and the government's agenda for improved quality of life for all citizens must be clearly articulated. This is especially important in postconflict or postcrisis countries where reconstruction is an urgent necessity and resource misallocation is more likely. Second, governments should take steps to acquire the skills and resources necessary to prepare and manage PPP projects. This requires upgrading the workforce, augmenting skills, strengthening and providing resources to relevant institutions, and adopting effective management techniques. Most successful African countries have made progress in this area through productive collaborations with bilateral and multilateral partners. Third, African governments should prioritize the development of enabling legislative and regulatory frameworks. The private investors interested in PPPs are looking for competitive and predictable environments. African governments cannot rely on international goodwill to attract appropriate PPP opportunities, and Africa's emerging economies are already instituting necessary reforms. Fourth, programs should be put in place to inform and sensitize all citizens about the challenges, responsibilities, and opportunities presented by PPPs. Communities should also be made aware of delivery and quality targets and be provided with channels and mechanisms for evaluation and feedback.

Although PPPs in Africa are both practically and politically challenging, there is ample evidence that governments are increasingly aware of their potential benefits and are taking steps to facilitate their adoption measures that bolster public-sector capacity, place contracts in the public domain, and demonstrate how improved services with affordable prices could foster sustainable economic development. International investors are recognizing the opportunities for market access and expansion that PPPs present and are employing creative strategies to circumvent inherent commercial, political, and institutional risks in Africa.

### **KOREA AND PPP**

Korean firms are uniquely positioned to contribute substantially in this regard. Although PPPs would not work in every African country, there exists a gradually expanding critical mass of reforming and rapidly growing countries where they could be an effective vehicle for strategic investment. PPP benefits in Africa will go beyond cost-ef-

fective service delivery to include employment creation, local business development, and skills and technology transfers. These are all consistent with Korea's foreign policy objectives in Africa and justify a careful examination of mutually beneficial partnerships in the continent's infrastructure sector.

In recent years, South Korea has lagged behind its neighbors in fostering commercial relationships with African countries. Japan initiated its Tokyo International Conference on African Development (TICAD) in 1993, the first Forum on China-Africa Cooperation (FOCAC) was held in 2000, but the Korea-Africa Forum was only inaugurated in November 2006. The Framework for Korea-Africa Development Cooperation (2009-12), which was annexed to the Declaration of the Second Korea- Africa Forum held in November 2009, mentions infrastructure (section E.i) and PPP (section L.i) but offers few concrete strategies to enhance this important sector. Although Korea-African trade has increased from \$6.4 billion in 2000 to \$13.9 billion in 2009, very little relates to PPPs or Africa's burgeoning infrastructure sector. For example, trade in Korean-registered ships in Liberia accounted for over one-third of trade in 2009. Between 2005 and 2009, Africa accounted for 1.5 percent of Korea's investments, down

from a peak of 2.8 percent in the first half of the 1990s. Infrastructure and construction accounted for 2.8 percent of Korean investments in Africa. Very little is being done to provide incentives for greater investments in the continent as a whole, and the infrastructure sector in particular.

Although China, Brazil and India are making significant progress in African markets, there is clearly room for Korea to promote mutually beneficial commercial engagements in Africa's growing number of emerging markets. Korea's potential advantages could include improved technology, a commitment to green development, demonstrable competence in global infrastructure projects and an adherence to international standards for labor, human rights and the environment.

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