

## Policy Brief, March 2018

### The auto industry needs regional integration – can it happen?

#### Industrial Development Think Tank: Policy Briefing Paper 5<sup>1</sup>

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The signing in March 2018 of the agreement to establish an African Continental Free Trade Area (AfCFTA) is a significant step along the road to full regional integration in Africa. Achieving this long standing objective is critical for industrialisation in the continent and is of particular importance to the development of the automotive industry.

Economic growth rates in sub-Saharan Africa (SSA) since 2000 have been impressive, and in some cases even spectacular. Along with the burgeoning middle class, the market for motor vehicles is growing very rapidly albeit from a low base. However, much of this demand is being met by imports because outside of South Africa, production is almost non-existent. In countries such as Nigeria, Ethiopia and Kenya, there is some small scale vehicle assembly with minimal usage of domestically produced parts. But in most of the countries to the north of South Africa, the market is completely dominated by imports of (mainly used) vehicles. Sales of vehicles<sup>2</sup> in SSA (excluding South Africa) amounted to 1.5 million in 2013, having grown by 14% per annum since 2003.<sup>3</sup> With the economic slowdown of the last few years, the rate of sales growth



has declined but the light vehicle market (including South Africa) will be very significant by 2030.

The question then arises as to where these vehicles be produced? Will the continent continue to rely on imports or can it develop its own industry which draws in a number of countries to create competitive regional automotive value chains?

#### **A viable ‘automotive space’**

The automotive industry is scale intensive. Minimum efficient scale in a modern car assembly plant ranges from 60,000 to 150,000 vehicles per annum of a single model. These kinds of volumes are also necessary to provide sufficient scale to justify investments by component suppliers. This creates a major problem given that Africa consists of a large number of (mainly small) economies. In SSA, only South Africa and Nigeria have markets which are presently large enough to provide even a minimal domestic base.

<sup>1</sup> The Industrial Development Think Tank at UJ is housed in the Centre for Competition, Regulation and Economic Development, in conjunction with the SARChi Chair in Industrial Development, and supported by the DTI which is gratefully acknowledged. This paper reflects the views of the authors alone and not of the DTI or any other party.

<sup>2</sup> Including used vehicle imports.

<sup>3</sup> Black, A. and McLennan, T. (2016) ‘The Last Frontier: Prospects and Policies for the Automotive Industry in Africa’, International Journal of Automotive Technology and Management. 16 (2).

In considering the potential for the automotive industry in emerging markets, Humphrey and Oeter<sup>4</sup> use the concept of a viable 'automotive space'. This can take various forms. For instance, China and India comprise large and rapidly growing markets which have sufficient scale in their own right. Producer countries on the periphery of major markets can create a viable automotive space by integrating into these markets. Mexico in relation to NAFTA is one such example, Slovakia and other newer EU member states are another. Morocco provides a more recent case as it has attracted a world scale Renault plant which mainly supplies the EU market. For countries which neither themselves constitute large markets nor adjoin such markets, an automotive space could take the form a regional market where trade agreements grant easy market access to member states and effectively enlarge the market, as per ASEAN and MERCOSUR. Of course, for these emerging production locations to succeed, appropriate trade and industrial policies would be required together with the capacity to upgrade production over time.

### Regional integration is key

Eliminating international trade barriers within Africa is essential if the continent is to develop as a location for large scale automotive investment and production. To illustrate this point, consider a comparison between SSA and India. The total GDP of SSA and India, average per capita income and population size are of the same order of magnitude. Vehicle market size is also similar. The major difference is in production. India produces its own vehicles while Africa is largely import dependent. India is also a significant exporter especially of small cars and motor cycles. In 2013, net automotive exports amounted to \$8.3 billion. SSA on the other hand, is heavily reliant on imports and apart from South Africa, exports very little. As a result, SSA had an automotive trade deficit of \$16.3 billion in 2013.

There are, of course, limitations to this rather simplistic comparison but the key difference is that India has an integrated single market that is protected by a high, common external tariff complemented by other supportive policies. As a result, it has developed a competitive automotive industry together with a strong, integrated supply chain.

### Regional automotive value chains in Africa?

This example illustrates that internal free trade, coupled with some protection from imports creates the *potential* for the emergence of competitive regional automotive value chains in Africa. To date they have not developed to any significant extent. This is in contrast to other developing regions such as south-east Asia, where regional automotive value chains are well established, for instance in the Association of South East Asian Nations (ASEAN) group of countries.<sup>5</sup> The only significant automotive trade within SSA consists of exports from South Africa to other countries. Rapid growth in the rest of the region together with closer regional integration arrangements mean that the continental market is second only to the European Union as a destination for South Africa's automotive exports. But this is one way trade. In 2016, South Africa's automotive exports to the rest of Africa were R31.3 billion with the Southern African Development Community (SADC) accounting for 87% of this amount.<sup>6</sup> On the other hand, South Africa imported only R2.6 billion of automotive products from the rest of the continent.

Regional integration is making slow but steady progress in SSA and the widely accepted central objective is to improve the prospects for industrialisation by expanding the regional market. The five main overlapping trade agreements, the Southern African Customs Union (SACU), the Southern African Development Community (SADC), the East African Community (EAC), the Common Market for East and Southern Africa (COMESA) and the Economic Community of West African States (ECOWAS) are well established and offer a degree of favourable market access amongst member states. The Tripartite Free Trade Area (TFTA) including SADC, COMESA and the EAC was launched in 2015. This is now culminating in AfCFTA, which will potentially bring together 55 countries with a population of 1.2 billion people and a combined GDP of \$3.4 trillion.<sup>7</sup>

But there is a long way to go in converting these overarching agreements into actual free regional trade. The biggest obstacle to integration of the automotive industry within the region is the costs of trade diversion, which are particularly high given the large presence of low priced, second hand cars in most national markets.

<sup>4</sup> Humphrey, J. and Oeter, A. (2000) 'Motor industry policies in emerging markets: Globalisation and the promotion of domestic industry'. In J. Humphrey, Y. Lecler, Y. and M. Salerno (eds.) *Global Strategies and Local Realities: The Auto Industry in Emerging Markets*, London, MacMillan.

<sup>5</sup> Kobayashi, H. Jin, Y. and Schroeder, M. (2015) 'ASEAN economic community and the regional automotive industry: Impact of ASEAN economic integration on two types of automotive production in Southeast Asia', *International Journal of Automotive Technology and Management*, 15(3).

<sup>6</sup> Automotive Industry Export Council (2017), *South African Automotive Export Manual 2017*.

<sup>7</sup> See Tralac 'African Continental Free Trade Area (AfCFTA) Legal Texts and Policy Documents' Available at <https://www.tralac.org/resources/by-region/cfta.html>

For automotive industrialisation to develop on a regional basis, there would have to be major limitations placed on the import of used cars. But why, for instance, would Mozambicans want to buy cars made in South Africa, or Ugandans purchase cars assembled in Kenya when they have the option of cheap, imported second hand cars from Japan?

There is an argument that the smaller economies could be drawn into the regional value chain as suppliers of major components for cars, which are assembled in South Africa (or Kenya). To some extent this is what has happened in MERCOSUR and ASEAN, where the automotive industry played a leading role in driving regional integration. In ASEAN, in particular, there has developed a degree of specialisation and complementation involving Thailand, Malaysia, Indonesia and the Philippines. But there is an important distinction with SADC and with SSA more generally. The aforementioned ASEAN countries are all medium to large sized markets and all have a history of automotive production. The small southern African automotive cluster is already spread across three major locations (Gauteng, Durban and the Eastern Cape) all of which are in South Africa. It is difficult to envisage the emergence of many more such clusters in the southern African region. Even Lesotho with its central location with respect to the major car producing regions in South Africa struggles to attract parts makers to invest in the country given the extremely demanding quality and delivery reliability standards that exist in the automotive sector. Perhaps there is scope for automotive industry cooperation between the larger economies in their respective regions, for example, Nigeria, Kenya and South Africa. But distances and especially transport costs are high between these countries.

Regional integration is essential for Africa to develop a significant automotive industry. But the obstacles are very considerable. The political geography of the continent and the tendency of the industry to cluster in a few locations which in turn develop key agglomeration advantages means that many smaller countries would miss out on attracting investments. It will therefore be difficult for the automotive sector to drive regional integration independently of a broader integration process that develops regional value chains in a range of sectors within the context of a larger common market.