CIIP Competitive Industries and Innovation Program

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Competitiveness and Job Creation Pilot in Ethiopia: Creating Supply Chain Linkages Between Buyers and Suppliers

The World Bank Group-supported Competitiveness and Job Creation (CJC) Project is piloting the first and only program in Ethiopia to facilitate business- to -business (B2B) linkages between Foreign Direct Investment (FDI) firms located within the Bole Lemi Phase-I Industrial Park (BLIP) and domestic SMEs to enhance value addition and develop the local supply chain. This SmartLesson is prepared to capture the lessons so far and inform further dialogue and scale-up of the linkages program nationwide.

BACKGROUND

The International Development Association (IDA) financed the Competitiveness and Job Creation (CJC) Project, a six-year project, which was approved by the World Bank Group Executive Board in May 2014. The development objective of the project is to contribute to job creation by attracting investments and improving competitiveness of enterprises in targeted industrial parks and their linked domestic enterprises. To achieve this objective, the project is comprised of four mutually reinforcing components: (1) support to institutional and regulatory framework and capacity building; (2) support for industrial infrastructure; (3) enhancing industrial parks linkages to the local economy; and (4) project management and monitoring and evaluation.

The linkages program is one of the two subcomponents (skills development and business-to -business linkages) under component (3), which focuses on enhancing linkages with the domestic economy.

What was the market failure?

The assessments and consultations made during the preparation of the CJC Project showed that there were several challenges faced by local firms to link up with the newly emerging FDI. Although the specific challenges vary from value-chain to value-chain, there were some common challenges that hindered the creation of B2B linkages between the local firms and the FDI. The main challenges were:

(i) **Information gap** – firms (both FDI and local SMEs) lacked up-to-date and reliable information on the potential market opportunities;

(ii) **Skills** – most local firms did not have the right skills and technological know-how to meet the requirements of the FDI;

(iii) **Quality and standards** – Many foreign and large firms are not willing to use local supplier and inputs because they do not meet international standards and quality requirements; and

(iv) **Access to finance for SMEs**- hindered the growth and expansion of the businesses.

The B2B linkages program was designed to address these main constraints and to pilot interventions that will inform appropriate policies and programs for a nationwide roll -out of a linkages program.

Box 1: Textile and Garment industry challenges in Ethiopia

An IFC pre-implementation study for its Ethiopia Textile Competitiveness project (approved in July 2016) that assessed the competitiveness of the textile sector in Ethiopia has revealed that International manufacturers' estimates of labor efficiency and productivity levels in Ethiopia generally range from 30% to 45% below estimates for Kenya and Bangladesh.

In addition, the same study has indicated that quality is challenging for local factories which are unaccustomed to the stringent requirements of international buyers. Local producers have difficulty meeting these standards due to lack of experience working with demanding clients, the use of outdated equipment, and the steep learning curve for meeting buyers' precise specifications.

Program design

The objective of the B2Bs linkages program is to enhance the quality, productivity and market access of small and medium enterprises (SMEs) to enable the firms to create business partnerships with FDI firms and contribute to local value addition, technology upgrade, and job creation. The pilot program focused on linking FDI firms located within the Bole Lemi Phase I Industrial Park (IP) (the only operational government owned IP at the time of project design) and local SMEs. The FDI firms located in the Bole Lemi Phase I IP included garment and footwear manufacturers, serving the U.S. and European Union (EU) markets, leveraging the preferential trade agreements under the African Growth Opportunity Act (AGOA) and Everything But Arms (EBA), respectively. The program interventions included:

- Facilitation of interactions among potential buyers and suppliers (through trade shows);
- A Matching Grant Scheme (MGS) to help SMEs address constraints regarding access to finance:[1] it provides up to 60% grant funding to SMEs to address the noted financial gaps that hinders the creation of business partnership with the FDI firms; and

[1] A World Bank study titled "SME Finance in Ethiopia: The Missing Middle" identified that SMEs face significant challenges in accessing finance from the financial sector and that there are not appropriate financial instruments that serve this segment in the market.

- Technical support and follow-up to ensure that the matching grants are being utilized to address the identified challenges within the SME.

Progress to date

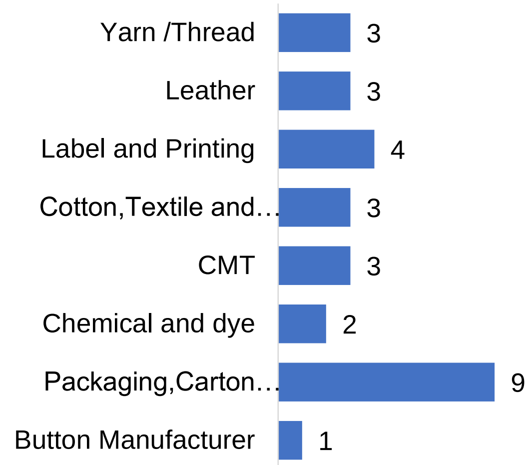
The government, through the Industrial Parks Development Corporation (IPDC), has signed grant agreements with seven SME companies, which are the first batch of beneficiaries for the MGS. Of the seven companies, three will provide packaging materials (cartons and polybags), two will supply leather and leather products and two accessories including buttons and labels.

As the program is the first linkages development program in the country, there is significant learning as well as a lack of clarity on mandates, cumbersome administrative bureaucracies, and information asymmetry. The Lessons Learned outlined in this note reflect the early stage findings and challenges faced so far in initiating and implementing the program.

Lesson 1: Strategic sharing of information, and access to market opportunities, builds stronger business relationships.

The trade shows organized by the project team brought BLIP investors and local suppliers together for the first time and was highly appreciated by both parties. The events attracted manufacturers and buyers who are not currently located within the BLIIP. The events have: 1) provided an opportunity for manufacturers and global buyers to get information on local market opportunities and see the capacities of local suppliers; 2) helped the local suppliers to see new market opportunities and understand the needs and demands of the potential buyers; and 3) helped initiate the first interactions and business networks between potential buyers and sellers, including some manufacturers located in other industrial parks. There have been additional requests and demands to hold similar events.

Figure 1:
Number of Local SMEs at trade show, by product



Lesson 2: Be aware of mismatched business interests of buyers and sellers and the need to manage expectations.

While there is keen interest from both the FDI firms (buyers) and the local SMEs (sellers), there is a mismatch of the business cases from both ends in terms of volume and price. Buyers consider the local companies to be too small with weak capacity to meet their full and "sophisticated" demands. In addition, the potential buyers/ manufacturers in the BLIIP are operating at an average of only 40% of their total capacity, which affects their volume of demand.

Also, local suppliers indicate that the demand (volume) from FDIs firms is too small to make sensible economic benefits and justify the significant production investments needed to meet their requirements and specifications. Suppliers also complain of the very low prices set by buyers for their products even after passing through stringent product specification and due diligence process, especially for products and inputs with more lucrative domestic market. However, the SMEs are eager to engage with the FDI firms to build business relationships with the anticipation of increasing volume and long-term returns and go to the extent of offering to sell at a discounted price.

Furthermore, the limited range of products available in the local market has limited the scope and opportunities to attract more local suppliers to serve the FDIs.

Lesson 3: Actively engage international buyers who have a strong part to play in product specifications

The pilot program interventions were designed to focus predominantly on the manufacturers and local SMEs, and thus did not underscore active engagement with international buyers such as PvH and H&M. One of the lessons from the ongoing interventions is that the buyers have a lot of say in terms of product quality, traceability, sources of inputs, etc. While FDI firms in Bole Lemi I expressed interest to purchase several inputs, they required that the local SMEs were formally nominated by the international buyers.

Box 2: Vertical Integration

Jay Jay is a company in the BLIIP that is exporting clothing to various parts of the world. The company has recently established its own printing and box factory which sells packaging material to its garmenting factory in the BLIP. Jay Jay decided to establish its own box factory because it couldn't locally source the boxes that were hard enough to meet the standards of the company. By establishing its own printing and box factory, Jay Jay has achieved direct control over the quality, price and delivery time of the boxes.

Lesson 4: The program should be owned and led by a government entity that will coordinate with other stakeholders.

The B2B linkage program was initiated in early 2017, three years after it was declared effective in August 2014. The main reason for the delay was the changes in the institutional set-up within the government system, which had affected the implementation arrangements for the CJC Project, and resulted in a lack of ownership of the program. Initially the Ministry of Industry was the implementing agency of the project however this was moved to the Industrial Parks Development Corporation. Moreover, weak implementation capacity and lack of full appreciation of the program benefits by the various stakeholders and decision- makers were also factors that led to implementation delay.

In addition, it has been difficult to coordinate multiple stakeholders to review and make decisions about the program. By the end of May 2017, the first five Linkages Development Plans (LDPs)[2] had been finalized, but none

[2] A linkages development plan is designed for each qualifying firm. It identifies key constraints faced by the firm that limit it from selling goods or services to manufacturers in the BLIP and recommends interventions that will address these constraints with cost estimates.

of them were awarded a grant for over three months, due to challenges getting the Public-Private Steering Committee (PPSC) to meet for final approval. There have been frequent changes in processes and requirements to bring together the technical committee members and the PPSC members to review applications and make approval decisions. This has been exacerbated by cumbersome administrative requirements and weak implementation capacity, which resulted in back-and-forth and constant changes. Consequently, 4 potential suppliers, out of the 22 short-listed qualified suppliers, have withdrawn from the program.

Lesson 5: Support local suppliers to level the playing field

Local suppliers do not always have price advantage when supplying raw materials to FDI firms, while FDI firms tend to have already established business relationships with global suppliers. One of the reasons for the low demand from the FDI firms is the misalignment of incentives for local sourcing. In some instances, locally purchased goods are 30 percent more expensive than imported products.

As a matter of government policy, companies that fully export their products enjoy duty-free imports of raw materials. As the firms in the BLIIP are entirely export oriented, they are importing their raw materials from different parts of the world tax-free. In addition to the incentives, the FDI firms have already established business relationships with global suppliers whom they can trust to deliver with the required volume, time and agreed price. Most of these suppliers also tend to be owned by the manufacturers themselves, which strengthens the business case to import their inputs from their own subsidiary companies abroad.

However, local suppliers who are expected to supply the same accessories to the firms in BLIIP must pay duties when importing the raw materials and inputs they need into Ethiopia. This makes their product price higher and less attractive to the FDI firms who already have alternative sources for their inputs and accessories. The government is putting in place measures to support local suppliers including for instance recognizing any purchase to FDI firms in IPs as indirect exporters.

Lesson 6: Lack of confidence on the part of buyers hinders the development of local business ecosystems.

There seems to be a significant lack of confidence from the buyers regarding the capacity of local companies to meet their quality, price, and delivery time requirements. In addition, most of the FDI firms factor in availability of raw materials and inputs in their decision matrix to set up production in Ethiopia. To benefit from price advantages as well as to serve other industries, the FDI firms tend to prefer vertical integration in the value chain and set up their own supply chain.

This setup effectively reduces technology transfer to local companies, discourage the development of local business ecosystems, and contributes to the creation of a dual economic structure.

Lesson 7: The scope of products and services required in the BLIP is wider than anticipated.

The government's decision to focus only on direct inputs and products has limited the participation and the potential business opportunities for service-providing SMEs, while there was a clear demand and request from the manufacturers. The list of services needed by BLIP firms, other than direct inputs, include recruitment, catering, legal services, etc.

CONCLUSION

Generally, the B2B Linkages program envisions positive impacts such as job creation and multiplier effect in the economy, including local value addition, import substitution, technology transfer, and the creation of competitive industries. These linkages will significantly benefit both the suppliers and buyers at a large scale.

The lessons learned from the Ethiopian experience, under the CJC Project linkages development program, can help draw some conclusions and policy directions to inform high-level policy making and nationwide scale-up of such program.

Summarizing the key lessons

(i) Policy incentives should be aligned to encourage local value addition and economic spillovers. For instance, alignment of import duty incentives and performance- based-smart incentives to reward firms that adopt local content policies and operations can encourage local sourcing by FDI firms. This should be supported by clear institutional mandates and roles among different government agencies that will simplify and facilitate support to the private sector actors.

(ii) The government role as the facilitator is very important in providing more proactive and pragmatic support to ensure simplified and shorter turnaround time when dealing with procedural matters. Understanding that firms work in an increasingly competitive business environment, the program implementation needs to avoid excessive delays in decision making;

(iii) A linkages program should actively engage global buyers in the set-up and implementation of interventions, as the buyers dictate the quality, specifications, traceability and sources of inputs;

(iv) Lastly, for World Bank Group-supported operations that are introducing B2B programs for the first time in Ethiopia through a lending operations, a parallel advisory technical assistance program will be valuable to support the client in building technical knowledge and institutional capacity.

ABOUT THE AUTHORS

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