

## Policy Note

### Ethiopian Automotive Policy in the African Automotive Market

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The GRIPS Development Forum (GDF) has studied Ethiopian automotive assembly policy through firm interviews, international comparative research and MOTI seminars. This note summarizes GDF's analyses and proposals based on the past studies supplemented by additional ideas in light of recent developments.

#### 1. Our past analysis and proposals

Since around 2018, GDF and JICA have discussed the automotive policy with the Ethiopian authorities (MOTI/MIDI, EIC, PMO, MOF, etc.) For this, we have conducted many interviews with Japanese automotive firms in Japan, Ethiopia and third countries; invited the former MITI DG and officials to Japan (June 2018), organized two automotive seminars at MOTI (February 2019 and February 2020); and sent study missions to Kenya (August 2018) and Myanmar (November 2019) where the automotive development stage (SKD) was similar to Ethiopia. Our analyses and proposals prior to the COVID-19 pandemic and the inauguration of AfCFTA were given in the report, "Automotive Industry Promotion in Ethiopia: Key Issues and Policy Recommendations" (revised March 2020). Its main points were as follows.

1. The automotive industry develops in distinct stages from primitive to global leadership. Ethiopia is in the early stage and needs policies that fit that stage.
2. The very first step in automotive development is the restriction of used car imports [Ethiopia recently introduced this policy].
3. CBU, SKD and CKD must be properly defined. Countries have different definitions. Ethiopia needs to define them clearly and transparently in line with global practices.
4. Appropriate incentives must be offered to domestic assembly. Incentives must be clear, simple and not excessive or too little (Kenya gives a good example). The Ethiopian automotive tax and tariff structure is very complex with many categories.
5. Production scale is vital to the automotive industry but Ethiopia's market is still small. To ensure sufficient volume for each firm and model, the number of firm entries must not be too many and priority models should be decided and effectively supported (Thailand and Uzbekistan provide good examples while Vietnam provides a bad example).
6. Presentation of a realistic demand scenario and accompanying policies to support the scenario will reduce the investment risk of automotive firms (in this, Vietnam offers a good example).

7. Ethiopia should concentrate on attracting automotive assembly firms and assisting their growth. When domestic assembly reaches tens of thousands per year, the policy focus should shift to the promotion of industrial human resources and “supporting industries” (domestic component supply) to increase domestic value creation.
8. According to the Japanese automotive firms, the four problems of the Ethiopian market are (i) foreign currency shortage, (ii) used car imports [already corrected], (iii) insufficient incentive, and (iv) small demand. Additional problems are the lack of inter-ministerial coordination, insufficient interaction with businesses, and the definitions of SKD and CKD.

These analyses and proposals are still valid except for 2 (used car restriction) which was already adopted. The remainder of this paper will discuss additional policy issues in light of recent developments<sup>1</sup>.

## 2. Africa’s automotive production and market

Africa is a very small producer of automobiles, the entire continent having less than a 1% share in global automotive production. However, its growth is the highest in the world. According to LMC Automotive, the region’s car market (new vehicles) was a little over 700,000 in 2021 which is expected to double to 1.4 million by 2030. Some countries are dominated by imported used cars but many African governments are beginning to restrict used cars for the purposes of safety, environment and industrial promotion. Ethiopia recently introduced stiff taxes on imported used cars and the average vehicle age is becoming younger. One important question is whether the rising demand for new cars is filled by CBU imports or domestic assembly.

Another feature of the African automotive industry is the concentration of both production and market in a few countries. Large-scale production exists in only two countries: South Africa which has long promoted its automotive sector and Morocco which greatly increased production for the EU market in the 2010s<sup>2</sup>. For these countries, import duty privileges in the US and the EU (AGOA and EBA) are critically important. Apart from the two, African countries that produce automobiles are Algeria, Egypt, Ethiopia, Ghana, Kenya, Nigeria and Tunisia. Their production remains small, low value-added and mainly for the domestic market only. On the market side, South Africa is the only country with an annual domestic market size of a few hundred thousand. Other than this, only Morocco, Algeria and Egypt surpass the market size of 100,000 vehicles. The production and market of automobiles remain small and in an early stage in the

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<sup>1</sup> Apart from GDF research, there are two other automotive studies with a focus on Ethiopia. The African Association of Automotive Manufacturers (AAAM) produced the report, “Automotive Policy and Centre of Excellence Development, Draft Report, Module 1, Ethiopian Automotive Industry and Policy Rationale,” September 2021 (draft, not yet approved by the government?) Meanwhile, JICA published the “Study for the Promotion of the African Automotive Industry: Post COVID 19 Supply Chain and Mobility Reform,” 2022, which includes Ethiopia as one of the focus countries.

<sup>2</sup> South Africa and Morocco occupy 73% and 24%, respectively, of the total CBU export of Africa, dominating the region’s automotive export with a joint share of 97%. Turning to the export of automotive components, Morocco (35%, mostly wire harnesses), South Africa (31%) and Tunisia (24%) are the major exporters. Tunisia does not export finished cars but its export of automotive components is substantial. These are 2020 data extracted from P. Agarwal, A. Black, A. Lemma, V. Mkhabela, and J. Stuart, *The African Continental Free Trade Area and the Automotive Value Chain*, ODI report (2022).

other African countries including Ethiopia.

The salient feature of the global automotive industry is a move toward connectedness, automatic drive, shared services and electric vehicles (CASE). This movement will certainly affect Africa in the long run, but the current African market is likely to be dominated by gasoline or hybrid cars.

### 3. AfCFTA and the Possibility of Intra-regional Production Rearrangement

The African Continental Free Trade Area (AfCFTA), which came into effect in 2021, may greatly change Africa's economic future but its immediate effects may be limited. This is because most African states lack competitive products suitable for intra-regional trade, because the financial and time costs of transport and border crossing remain formidable, and because of the need to harmonize institutions, taxes and standards among member countries. It is unclear whether the AfCFTA's plan to eliminate 90% of the intra-regional tariffs within five years will be realized. Looking far ahead, however, AfCFTA will surely affect African industries and their locational choices *provided that* Africa grows steadily and the infrastructure and institutions necessary for growth are properly installed. In Southeast Asia, the regional cooperative framework (the Association of Southeast Asian Nations or ASEAN) was established in 1967 to cope with the communist threat, but it took more than two decades to create a mechanism to seriously promote economic integration within the region. It is not surprising that the economic impact of AfCFTA will not come very soon.

The free trade area (FTA) is an agreement to reduce or abolish tariffs among its members while keeping the tariffs with non-member countries unchanged. To study its effects, the trade creation effect and the trade diversion effect are often mentioned. The former refers to the occurrence of new trade among member countries due to reduced tariff barriers. The latter is the situation where products previously imported from efficient external producers are now substituted by the imports from less efficient member countries. Economists argue that the former is desirable while the latter is not from the viewpoint of global efficiency. But these are static effects only.

In the real world, an FTA prompts member countries to become new exporters (rather than importers) within the region. To realize this, they may double industrial promotion efforts in each country to become a winner in the new trade game. This policy acceleration is an important dynamic effect of an FTA. Moreover, FDI firms from outside the region may want to enter Africa as local producers rather than exporters (who must pay tariffs) to take advantage of the disappearance of intra-regional tariffs. This has the dynamic effect of stimulating FDI into Africa. These two dynamic effects of FTA, to improve industrial policy in each member country and to attract additional FDI into the region, are both desirable for Africa's industrialization.

One important issue here is the rules of origin. If AfCFTA requires domestic value addition of 40-60% to automotive products, as many FTAs do, SKD and CKD production with wholly imported component kits, in which many African countries engage, does not qualify as African products eligible for regional tariff reduction. It is reported that AAAM recommends more flexible rules of origin for the African automotive

trade. This is a critical issue that needs to be watched.

It is not yet clear whether the first dynamic effect is taking place in Africa. As for the second dynamic effect, we already see some signs of change in the automotive sector. For global automotive firms (sometimes called OEMs) that want to capture Africa's small but growing market of new automobiles, it is crucial to make the right move now. This includes the establishment of a new production site somewhere on the continent, finding good local partners, building an effective network of automotive inspection, service and component supply, having a good relationship with the host government, and enhancing the brand image and consumer recognition.

For this, a global automotive firm may choose more than one country to enter Africa. Even if intra-regional tariffs are removed, Africa still has many business obstacles such as slow logistics and customs procedures, unpredictable policy, political instability, security issues, health hazards, etc. which call for diversifying country risks. A global automotive firm may establish one, two, five or more production sites in Africa. This is decided by each firm after considering the market condition, business climate, trade hindrance, etc. of each candidate country.

Based on published information, Japanese automotive firms are making the following actions in Africa.

Toyota, with a long production experience in Africa, is in a good position to use its Durban plant (direct management, since 1962) in South Africa to respond to AfCFTA by adjusting production volume and models. Toyota also established production sites in Kenya (contract manufacturing, since 1977), Egypt (contract manufacturing, since 2012) and Ghana (contract manufacturing, since 2021). These sites were not prompted by AfCFTA but may also respond to new opportunities created by AfCFTA. Toyota thus has four production sites in Africa, but the number is not likely to accelerate to cover all African countries. If intra-regional tariffs are abolished, there is no economic reason to build a factory in each African country.

Regional FTAs other than AfCFTA also affect the production strategy of FDI firms. Isuzu assembles small- and medium-sized trucks and buses at its Nairobi plant (direct management, since 1975). The current production capacity is 5,500 vehicles per year (one shift) and actual production was 4,200 in 2020. Kenya is the most industrialized member of the East African Community (EAC) and has the capacity to export its manufactured products to other EAC members if regional tariffs are removed and product standards are harmonized. Because EAC negotiation for intra-regional automotive trade remains slow, Kenya's export to other members has not materialized in sufficient volume. But it may expand in the future.

Mitsubishi Motors suspended automotive production in Africa in 2011 (in South Africa) but it re-entered the market in August 2022 to produce the pickup truck L200 in Kenya. This is commissioned manufacturing to AVA which also assembles vehicles of other global automotive makers. Mitsubishi's re-entry may have been partly driven by AfCFTA which offered the future possibility of low or zero tariffs within Africa. Mitsubishi's business plan begins with a test production of 200 vehicles per year with possible expansion in the future (Nikkei Newspaper, July 14, 2022).

From the viewpoint of African governments, it is natural that each country wants to become a regional automotive exporter rather than an importer. In the future, countries that already assemble automobiles as well as those that do not may compete for attracting more automotive FDI and production expansion. Even

if African governments do not compete, global automotive firms will certainly compare the conditions of each country before deciding where to invest in Africa (as they already do). This means that the first dynamic effect of AfCFTA (policy improvement in each country) is the cause and catalyst of the second dynamic effect (an inflow of new automotive FDI) at the country level. When AfCFTA's impact on African automotive trade becomes real and significant, it will likely polarize African countries into automotive winners and losers rather than generating equal opportunity and industrial convergence for all.

#### 4. Domestic production of popular models and importation of others

Another issue in formulating automotive policy is the fact that global automotive makers located in developing countries do not necessarily locally produce all models sold in that country. Users want to choose from as many models as possible, but the production of many models in small quantities increases the financial and time costs of homologation, component imports, production line arrangement, engineer training, etc. The standard way to solve this problem, not just in Africa but globally, is to locally produce the most popular models while importing other models from the firm's production sites abroad.

For example, Toyota Vietnam (direct management, since 1995) produces Camry, Corolla, Vios and Innova (total production was 70,000 vehicles in 2020) but imports Fortuner, Land Cruiser, Yaris and other Toyota cars from Toyota plants in Indonesia, Thailand, etc. Similarly, Suzuki Thilawa (in Myanmar, direct management, since 1998) specializes in the assembly of four models: Carry, Ciaz, Ertiga and Swift (total production was 13,300 vehicles in 2019).

The strategy of combining local assembly and imports is also realistic even in countries where the annual vehicle volume does not yet reach tens of thousands and where SKD and CKD dominate. The government should recognize the models each car maker chooses to produce locally, and offer support and incentives to those models consistently into the future. Shifting incentives across different models or eliminating incentives for existing models will hurt assembly firms that have invested a large sum to mass produce the chosen models within the firm's global strategy. Because most car makers want to sell both domestically assembled cars and imported ones, offering generous import quotas for CBUs will be highly welcomed by local assemblers that achieve sufficient quality and quantity. Needless to say, such privileges must be allocated in sensible amounts (not excessive) with efficiency, transparency and fairness<sup>3</sup>.

It is probable that automotive firms may replace imported models with local assembly when the domestic market grows and demand for imported models becomes sufficiently large. The local assembly is beneficial not only because of tax and tariff incentives but also because it permits quick and extensive customer response which increases the product value. Firms naturally prefer local assembly provided that the volume is sufficiently large for cost reduction. Whether and when a firm switches from import to local assembly is determined by its business strategy which critically depends on the market volume. The

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<sup>3</sup> South Africa provided additional CBU import quotas to automotive assemblers that satisfied a certain production threshold, but this led to the sales of these quotas to other car importers. The privilege of CBU import quotas thus offered should not be negotiable.

nudging and shoving by the government alone will not be enough.

## 5. Issues in attracting and promoting automotive assembly in Ethiopia

At present, Ethiopia is not a preferred destination for global automotive makers or a candidate for a regional car export hub under AfCFTA. The necessary conditions are missing. But some (but not all) of the necessary conditions can—and should—be created through policy effort.

For automotive investors, Ethiopia's merits are a large population, serious policy intention by the government, and the fact that used car restriction is already in place. On the demerit side, the most serious problem is the shortage of foreign currency which affects not only automotive assemblers but all firms operating in Ethiopia. Other problems include the inappropriate incentive structure which does not sufficiently incentivize locally assembled vehicles vis-à-vis CBU imports; poor logistic infrastructure services which lead to high costs, delays and uncertainty in the availability of imported inputs; political instability and security risks; and policy inconsistency and uncertainty. Let us examine some of them in detail.

Motorization (a rapid increase in personal car use) has not started in Ethiopia, but there is considerable demand for motor vehicles by businesses, governments and development partners. Automotive assemblers invest, produce and sell, combining local assembly and CBU imports, in order to capture this existing domestic demand and prepare for future expansion. One problem is that even the existing demand is suppressed (actual demand is less than potential). The main reason again is the shortage of foreign currency which is unique in Ethiopia. Inefficient logistics and the risk of attack on commercial vehicles and construction equipment under the current security situation also contribute to the shrinkage of demand. Ethiopia must remove these unnecessary impediments as a matter of top national priority. This is easier said than done, but without solving these problems (including the problem of foreign currency), the Ethiopian economy cannot move forward.

Within the government, a critical issue is the lack of coordination among ministries, commissions and institutes responsible for automotive policy. The GDF team identified the absence of information exchange and policy discussion among EIC, MOTI/former MIDI and MOF in a document submitted in March 2020 (see section 1). In policy implementation, there are reported cases of administrative difficulties generated by officials who are not well informed about policy intention or the industry's reality. The most recent incident involves the tax penalty imposed on automotive firms for "under-invoicing" automotive components, a charge which firms say is groundless. Administrative hindrances that serve no policy purpose but add greatly to business costs are many, and they should be eliminated by the government with an open, effective and speedy mechanism.

It is also important to study international lessons. The situations in South Africa or Morocco, whose automotive production is large and closely integrated with the US or EU markets, are not transferrable to Ethiopia. On the other hand, there are African countries at a similar stage of automotive development as Ethiopia but have successfully attracted many assembly plants of global car makers such as Kenya, Ghana

and Nigeria. It is imperative to study the attractive aspects of their policies and benchmark them to improve Ethiopian policy. For this, direct interviews with global automotive makers that entered these markets will also be highly useful.

The immediate policy goal for Ethiopia is to move from the situation dominated by CBU imports with little domestic assembly to a situation where a few carefully selected global automotive makers are invited and encouraged to assemble their popular models in Ethiopia, thereby steadily replacing CBU imports by locally assembled models. This will require the following five administrative measures to be implemented as soon as possible. These require a strong political will and adequate knowledge but not large finance or investment. As such, they can be adopted immediately.

1. Revision of incentive structure in favor of local assembly relative to CBU imports
2. Simplification of incentive structure by eliminating unnecessarily detailed vehicle types
3. An effective mechanism to solve inconsistencies and grievances in taxation and customs clearance
4. A review of the surrender requirement and reallocation rules of foreign currency earnings (including the possibility of higher prioritization of manufacturing and especially automotive assembly)
5. A long-term automotive demand forecast and policy commitments consistent with it

These measures touch multiple ministries including the financial and tax authorities such as NBE, MOF and the Ministry of Revenues and the real-sector promoting authorities such as EIC and MOI. New actions cannot be devised by MOI alone, or by any one ministry. Horizontal negotiation among same-level ministries with different mandates is difficult. The solution must be directly instructed by the highest authority, namely, the prime minister, his senior economic advisor, or the Macroeconomic Team.

From the medium- and long-term perspective, the sound development of the automotive sector will additionally require the following five policy measures.

6. Solution of internal war, ethnic conflicts and security
7. An ultimate solution to foreign currency shortage
8. Efficient, fair and e-based customs clearance and logistic service for cost and time reduction (including the Djibouti segment)
9. Quality, safety, environmental and fuel standards and certification based on global practices
10. When the domestic volume reaches a certain level (tens of thousands annually), new policies should be launched to boost domestic value creation (industrial human resources, supporting industries, global networks and divisions of labor, etc.)

In introducing these measures (except 6 which is political), the gap between the policy goal and Ethiopia's reality must be of reasonable size. In setting goals, policy instruments and target years, the government must recognize the strategy and needs of each firm and aim at a level that is both ambitious

and realistic (given sufficient effort). The goal must be higher than reality but not too high (unreachable). The policy usually targets a small group of selected firms rather than all firms. It must be executed transparently and fairly among selected firms. Businesses will not cooperate if they detect unrealistic targets, unwanted policy measures or unfair treatment. Public-private cooperation must be close yet corruption-proof. Superficial contacts or a short QA session at a conference is not enough to extract the true intention of firms. Policy quality will be low if firms do not trust the government and hesitate to provide information or collaborate with it. These were the secrets of the East Asian high-performing economies. Much effort and learning are required to gain such policy capability.

Finally, a few words may be said about the automotive policy report prepared by AAAM (see footnote 1). This report is heavy on situation analysis but much lighter on policy proposals (at least the version we read). Moreover, the report largely reflects the situation in South Africa which may not fit the Ethiopian reality. The report lists nine Thematic Areas<sup>4</sup>. Some of them may not be necessary for Ethiopia and even if they are necessary, the order of prioritization must be considered. Deliberation on country relevance and time sequencing seems missing in the AAAM report. Specifically, the proposals for an industrial park specializing in the automotive sector, highly detailed ADP eligibility (conditions for receiving incentives), submission of a concrete plan to move from SKD to CKD required of all FDI firms, and the official promotion of labor union activities are derived from the South African context but may not match the reality of present-day Ethiopia. On the other hand, the recommendations for necessary laws and executing and monitoring organizations are basic and too obvious to be included in the Thematic Areas.

The prioritization and timeline of policy measures for automotive development in Ethiopia, from immediate to medium- and long-term, which we think are proper are already presented in the two boxes above. Any of these policy actions will require a large amount of learning, discussion and preparation for effective implementation.

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<sup>4</sup> The nine Thematic Areas are (i) incentive and regulatory framework, (ii) market expansion and trade facilitation, (iii) standards and safety including a vehicle marking system, (iv) access to industrial infrastructure, (v) automotive skills and technology upgrading, (vi) supplier development programs, (vii) implementation and coordination arrangements, (viii) labor relations, and (ix) legislative measures. For their evaluation, see Kenichi Ohno, "Comments on Ethiopia's Automotive Policy and Direction," GRIPS, November 18, 2020.