The Economic Future of Somalia

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Somalia stands at a crossroads.

Down one road the current economic status quo will prevail, leading to anemic growth, high levels of informality (90%), unemployment (47 percent, 75 per cent for the youth) and lack of diversification and specialization. Down the other road, a new economic policy and investment framework could accelerate economic growth and employment, allowing Somalia to capitalize on its unique strategic position and undoubted natural and human resources potential.

I have been working in Somalia since 1993, and happened to be in Mogadishu the day the Black Hawk was shot down by Mohamed Farrah Aidid's militia. Sitting in Mogadishu at the time, following the collapse of Siad Barre's government in 1991, it was clear that history had been very unkind to Somalia since the so-called Golden Days of the Land of Punt. In that period, Somalia was a significant trade partner with Egypt, plying lucrative trade routes connecting with merchant classes from Parthian Persia to Phoenicia, and from Ptolemic Egypt to Greece and the Roman Empire.

Since 1993, the citizens of Somalia have struggled to re-establish the core functions of an effective state, though in recent years substantial progress has been made. International cooperation partners have re-balanced external support to balance structural development finance with humanitarian support. With Government revenue's now rising year-on-year, the next decade will be absolutely critical to changing the course of history for the better.

This short article does not discuss macro-fiscal issues, which are important, but related to the real and wider economies.

Why is the Somali Economy Important?

Anyone who understands state-building knows that revenue collection is a pre-condition for any state, as it seeks to coopt the periphery and mobilize legitimacy through the provision of growth, employment and health enabling services. Once the social contract breaks down, as it did, citizens take up arms to defend themselves, precisely because the state has failed to do so.

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Building good governance and maintaining law and order costs money! As it is difficult to tax the informal and illegal economies, the Government has few options but to control the formal economy, or to catch airways flyover taxes of customs duties. While VAT and GSM taxes provide a solution for taxing the informal economy, tax administration requires considerable capacities; which in turn are related to the ability to mobilize resources. This is a vicious cycle, though well-targeted external aid can be deployed to build core revenue capacities, and this process has now started in earnest.

Without a strong formal economy or a taxable informal economy, Government will not have the fiscal resources necessary to deliver public goods; including building trade and value chain infrastructure. As a result, all efforts must be linked to maximizing investment returns to growth, revenues and jobs.

What is the current Structure of the Somalia Economy?

The Somalia economy has still not been well documented, through recent research undertaken by Hayaan Institute for Research and Policy, USAID and the World Bank provides considerable insight into the current structure of Gross Domestic Product (GDP). The International Monetary Fund (IMF) and the World Bank estimate Somalia's GDP at about US$5.7 billion in current dollar terms in 2014, though given the scarcity of hard economic data and porous borders which undermines recordation of informal economy flows, the economy is likely to be 20-50% bigger than these estimates. Having lived in Afghanistan for many years, preparing the early economic updates with Bill Byrd, as the Government's capacity to collect data increased, new markets and trade flows were finally documented.

In Somalia for example, there has traditionally been considerable illegal fishing, and as a result, the fishing maritime economy is likely to be very badly reflected in GDP; which of course does not include the illegal, combat or coping economies. So what is known of the current structure of GDP?

- ***Private Consumption and Imports***: According to the World Bank 2015 Economic Update, '*Household consumption, financed by remittances, was equivalent to more than 100 percent of Somalia's nominal GDP in 2014, with food and beverages accounting for about 60 percent of the total*.' (World Bank, 2105). Net investments only accounted for 8% of GDP and exports 14%.

- ***Remittances***: Given the size of the Somali Diaspora, remittances have been estimated anywhere from US$1.2 to US$2.0 billion, equivalent to 23–38 percent of GDP. Of course, the financial crisis in 2008 and 2009 affected remittances considerably, and as a result, global economic conditions considerably determine the value of remittances to GDP. Evidence from the2013 Somaliland Household Survey shows that 31 percent of urban households and 16 percent of rural households received remittances (World Bank, 2015)

- ***Livestock***: The entire world knows that livestock is the backbone of the Somali rural economy; and it represents the largest sector. Export data collected by the

FAO-managed Food Security and Nutrition Analysis Unit (FSNAU shows that in 2014 some 5 million livestock were exported to the Gulf States. This included 4.6 million goats and sheep, 340,000 cattle and 77,000; valued conservatively at around US$360 million.

- ***Agriculture and fisheries***: While Somalia is often thought about at largely drought-ridden and dependent on rain-fed agriculture and flood recession agriculture, the reality is that the size and potential of the agricultural sector is largely unknown, and often poorly documented. Similarly, with the collapse of the Somali Coast Guard the extremely high level of illegal fishing not only deprives the economy and communities of wealth creation, it also deprives the government of important revenues. Modest investment in modernizing local fishing, including establishment of cold storage chains and SPS certification, would yield considerable wealth creation.

- ***Financial Markets***: The Central Bank recognizes only 50 financial institutions operating in Somalia, and in addition to handling remittances, trade finance is also provided, the commercial banking sector is transitioning from an un-regulated sector to one that is fully in line with the 2012 Financial Institutions Act. Traditional money transfer businesses are in decline. Lowering the costs of finance and increase access are critical to spurn the emergence of a dynamic small to medium enterprise sector, and to smooth household consumption.

- ***Telecommunications and Media***: In recent years telecommunications have taken off considerably, and this has been linked to money payments also. The expansion of the sector – which now includes over 2o companies – also provides opportunities for taxing users – as Afghanistan has just done; to broaden the tax base. TV, radio, newspapers and online news are all expanding rapidly. Law Firm Hogan Lovells reported the following characteristics:

    - Somalia has the lowest international call rates in Africa and one of the cheapest in the world (CIA World factbook, 2012);
    - 34% of adults in Somalia use mobile money (World Bank, 2012) though this will have increased substantially;
    - US$1.6 billion in money remittances were handled annually (CIA World factbook, 2012), though again this is assumed to have increased;
    - Somali's online Dahabshiil is one of the largest money transfer companies in Africa, operating in 155 countries (The Guardian, July 2012)

- ***Imports***: Without an industrial base Somalia remains heavily dependent on imports. Again, according to the World Bank, trading partner countries show that imports reached $3.3 billion in 2013 and are projected to reach $3.7 billion in 2015. Support for import substitution in key areas of the economy will not only improve the balance of trade (Somalia ran a trade deficit of 39% in 2012), it will also boost the local economy and create employment at home. Options for this are discussed below.

- ***Precious Stones and Minerals***: Somalia also has not inconsiderable mineral deposits, among which precious and semi precious stones and oil and gas are known. With international commodity prices currently in free fall, and with significant divestiture underway in relation to oil, it would be decades (if at all) that oil deposits will be tapped. The size of the precious and semi-precious stone economy is unknown.

- ***Other***: Somalia is traditionally known for both Frankincense and Myrrh, among other gums and spices, and though these markets are small, they are growing. If well managed, latent potential can be exploited, though sustainability must been heavily considered. In addition, Somalia also exports charcoal, bananas, sugar, sorghum and corn among other items. Khat is also widely traded, and has allowed considerable fixed capital contributions to the economy to be made, as Opium has also done in parts of Afghanistan. An estimated 10 million people globally consume Khat, of which Somalia is a considerable supplier. Airlines are a growth driver also, though market distortions also exist.

The structure of the Somali economy is therefore very much in transition, though low levels of foreign direct investment, lack of specialization and limited diversification all affect both economic and social outcomes. That said, coming from an extremely low base, and with a high intellectual Somalia Diaspora increasingly looking to play a greater role in Somalia's future, the next 10-20 years could be historic, if the right investment framework is established, and enabling systems put in place.

What is the preferred economic policy and investment strategy?

I am a former government economist, but since 2008, but I also the owner of multiple businesses. As a result, any economic growth policy must balance public and private capabilities, and it must work in a targeted and systematic way to establish business models that can be replicated and scaled. Moreover, the private sector is generally more concerned about balancing risks and rewards and operating in an economy where the legal framework protects investors. Foreign companies will only look for sweetheart deals here, unless they can invest long term within an enabling framework.

Outside of domestic consumption, Somalia has always had a fairly traditional economy, reflective of largely un-processed primary products and low value added processes. The structure of the economy directly reflects rational risk seeking behavior and the results of weak state regulatory capacities, and as a result the future of the Somali economy must be considered rather bright. Moreover, as times change and functional restructuring of state authorities progresses, the chances of political settlement sooner rather than later might for once be on the cards; though support from AMISOM will be critical over the longer term.

A critical observation here related to what is referred to as the 'triple transition'. This means, that security and law and order are only possible once political settlement has been reached, and full economic development is only possible once security and rule of law are established. However, it is clear, that if the entire population of Somalia is sufficiently vested in the formal and informal legal economy, the chances of peace and stability increase massively. Resource scarcity and competition are drivers of instability and predation.

In the future it is important to create and foster mutual dependencies between sectors and with the wider region, though increasing access to power and financial markets will be key drivers in the value addition transition. On the economic side, this means establishing an evidence-based economic policy and investment framework, to include both traditional and un-traditional models of investment financing. One of the many lessons we have learned in countries from Egypt to Afghanistan and from Ethiopia to the United Arab Emirates is to identify a financing modal and modalities that work well even in a difficult context.

It seems logical to focus any economic growth policy and growth strategy on:

- ***Enhancing value from existing sources of growth*** (i.e. product certification, market network development, removing informational asymmetries; remove binding constraints such as the cost or finance or access to rural electrification);

- ***Expanding poorly managed sub-sectors and emerging niche markets***, in particular those that can be scaled by changing the investment approach, value0addition structure, and financing modality (i.e. power, gemstones, incense etc.). Improving processing, packing, branding, bulking and aggregation and certification here are key. If the state cannot provide certification, private companies can.

- ***Developing and fostering new economies and markets***, among which the services sector, finance and insurance industries, independent power producers, linking education to skills demanded by the market etc. A clear policy on the primacy of small to medium enterprise growth is critical to board based growth.

- ***Public Private Partnerships are key to the re-defining the state and leveraging the power of the private sector***, and these can be carefully deployed into sectors beyond water and sanitation. For this to happen, the Government can increase engagement with the following international agencies, around which bankable investment can be routinely developed:

    - ***The Private Infrastructure Development Group (PIDG)*** mobilizes private sector investment to assist developing countries in providing infrastructure vital to boosting their economic growth, and combating poverty;

    - ***The Public-Private Infrastructure Advisory Facility (PPIAF)*** is a multi-donor trust fund providing technical assistance to governments in developing countries in support of the enabling environment conducive to private investment. This includes the necessary policies, laws, regulations, institutions, and government capacity. PPIAF also supports governments to develop specific infrastructure projects with private sector participation;

- ***World Bank Global Infrastructure Facility (GIF)***: The newly established GIF is focused on expanding the universe of infrastructure projects that have the potential to mobilize private investment, through support across the project preparation and transaction process, to include infrastructure investments in power, transport, water and sanitation.

- ***Changing the model of community development****,* to one that is not project driven but rather driven by establishing / strengthening informal institutions and their linkages to markets. In Pakistan for example, Nestle spent 10 years investing in communities, building milk cooperatives, and establishing community cold storage systems, allowing them to set price guarantees for producers but also to aggregate product to urban domestic markets. Community development must not be blind to real market opportunities, and farmers learning and resources centers (as piloted in Central Asia) can bring the private sector and producers together.

- ***Lowering transaction costs and building trade, transit, storage and other essential infrastructure*** is critical to lowering the transaction costs for both imported and exported goods. Economic isolation, like gender and social exclusion, must be rapidly overcome, not only undermines competitiveness, it undermines social and capital mobility, both of which are key to change.

- ***Urbanization***, given that the Somali population is set to double over the next tree decades, will guarantee that municipalities are in fact the most important governance unit in the country. Municipalities can become the drivers of urban renewal and small scale industrial processing, if leaders and managers at this level of government are trained to develop and deploy new investment models, as advocated by The Hague Process for example.

- ***Special Economic Zones*** and Multi-Modal Inland Ports are going to be critical, both to securing an enabling investment environment for domestic and foreign investment, but also to assist in the process of formalization. Major ports such as Bosaso, which has a new international runway to be served by Gulf and other carriers, provides great opportunity for grouping anchor, ancillary and spin-off investments, the impact of which can be profound. Similarly, along major corridors into Ethiopia and Kenya, multi modal inland ports can be developed (many are emerging in Pakistan, India, Turkey and Central Asia) as trade and transit hubs, with spins offs for processing and packaging. Given the that poorly conceived and badly implemented SEZ's can be disastrous, partnering with countries such as the UAE which has considerable capacity in this area should be considered. They would be based in airports, ports and along trade corridors.

Given the potential financing risks that many investments take - resulting from overly optimistic financial flows, higher construction and running costs as well as interest and currency risks – capacity for assessing the Net Present Value, Internal Rate of Return and other analysis is needed, based on feasibility studies and transaction advisory support. A PPP unit could be established and training in all three jurisdictions, around which core skills can be developed in this area. Guidelines alone will do little, as the basis for the concession (if that is the model) will require strong competencies, and the African Development Bank and IFC can support such an approach.

Diversification and Specialization are Key to Sustained Growth

Diversification of the economy will happen under the write conditions, and once a decision has been taken to encourage growth in potential sub-sectors, perhaps using hybrid investment modalities. External aid has not enhanced growth prospects considerably since 1991, though this is beginning to chance. Diversification is also necessary to broaden the benefits of growth, and to allow small to medium enterprises to bloom, which is critical to improving per capita earnings.

In certain parts of the economy such as telecoms and banking, specialization is expected, However, there is also considerably scope for specialization in fisheries, agriculture, packaging, exports, gemstones and other sectors, including services, where a business focus production on a limited products or services in order to gain greater degrees of productive efficiency. Little work has been done on these two areas, though new firms are being established every year and through price discovery and other mechanisms, specializations are slowly beginning to emerge.

A Call fore Innovative Funding Modalities

There are a range of financing and investment mechanisms that have not been significant drivers of Somalia's growth in recent years, undermining the potential of the private sector to be the primary driver of growth and employment. While general improvements to the business environment have been made, the existence of a weak institutional environment means that new financing and investment mechanisms must emerge to ring-fence project finances and draw down the risk – setting the stage for Special Purpose Vehicles (SPVs) to be established. Project investment criteria, which will need to reflect the specific nature of any public and private investment, must be broadly as follows:

- Must be bankable (i.e. able to attract financier);
- Must have demonstrable impact on growth in trade, transit or extractives;
- Must have proper Project Management and Governance Arrangements in place;
- Must encourage private equity participation / private sector development;
- Must have sufficient cash-flows and positive NPV and Internal Rate of Return above the opportunity cost of capital;
- Should be implemented in 12-24 months;
- Must be politically feasible; and,
- Must have a clear risk management and mitigation plan.

New financing and investment mechanisms provide an opportunity for the Government and the private sector to move away from a heavily aid-dependent approach, though establishing viable models that can be replicated will take both effort and time Sample generic models are outlined below:

- ***Build-and-Transfer (BT)***: A contractual arrangement whereby the Private Party undertakes the financing and construction of an infrastructure project and after its completion hands it over to the Government Agency. The Government Agency will reimburse the total project investment, on the basis of an agreed schedule. This arrangement may be employed in the construction of any infrastructure project, including critical facilities, which for security or strategic reasons must be operated directly by the Government Agency.

- ***Build-Lease-and-Transfer (BLT)***: A contractual arrangement whereby the Private Party undertakes the financing and construction of an infrastructure project and upon its completion hands it over to the Government Agency on a lease arrangement for a fixed period, after the expiration of which ownership of the project is automatically transferred to the Government Agency.

- ***Build-Operate-and-Transfer (BOT)***: A contractual arrangement whereby the Private Party undertakes the financing and construction of an infrastructure project, and the operation and maintenance thereof. The Private Party operates the facility over a fixed term during which it is allowed to collect from project users appropriate tariffs, tolls, fees, rentals, or charges not exceeding those proposed in the bid or negotiated and incorporated in the PPP agreement, to enable the Private Party to recover its investment and operating and maintenance expenses for the project. The Private Party transfers the facility to the Government Agency at the end of the fixed term that shall be specified in the PPP agreement. This shall include a supply-and-operate situation, which is a contractual arrangement whereby the supplier of equipment and machinery for an infrastructure project operates it, in the process providing technology transfer and training of the nominated individuals of the Government Agency.

- ***Build-Own-and-Operate (BOO)***: A contractual arrangement whereby the Private Party is authorized to finance, construct, own, operate, and maintain an infrastructure project, from which the Private Party is allowed to recover its investment and operating and maintenance expenses by collecting user levies from project users. The Private Party owns the project and may choose to assign its operation and maintenance to a project operator. The transfer of the project to the Government Agency is not envisioned in this arrangement. However, the Government Agency may terminate its obligations after the specified time period.

- ***Build-Own-Operate-Transfer (BOOT)***: A contractual arrangement similar to the BOT agreement, except that the Private Party owns the infrastructure project during the fixed term before its transfer to the Government Agency.

- ***Build-Transfer-and-Operate (BTO)***: A contractual arrangement whereby the Government Agency contracts out an infrastructure project to the Private Party to construct it on a turn-key basis, assuming cost overruns, delays, and specified performance risks. Once the project is commissioned, the Private Party is given the right to operate the facility and collect user levies under the PPP agreement. The title of the project always vests in the Government Agency in this arrangement.

- ***Contract-Add-and-Operate (CAO)***: A contractual arrangement whereby the Private Party expands an existing infrastructure facility, which it leases from the Government Agency. The Private Party operates the expanded project and collects user levies, to recover the investment over an agreed period. There may or may not be a transfer arrangement with regard to the added facility provided by the Private Party.

- ***Rehabilitate-Operate-and-Transfer (ROT)***: A contractual arrangement whereby an existing infrastructure facility is handed over to the Private Party to refurbish, operate, and maintain it for a specified period, during which the Private Party collects user levies to recover its investment and operation and maintenance expenses. At the expiration of this period, the facility is returned to the Government Agency. The term is also used to describe the purchase of an existing facility from abroad, importing, refurbishing, constructing, and operating it.

- ***Concession Agreement***: A contractual arrangement whereby the Government Agency entrusts the operation and management of an infrastructure project to the Private Party for an agreed period on payment of specified consideration. The Government Agency may charge the user levies and collect the same either itself or entrust the collection for consideration to any person who shall pay the same to the Government Agency.

- ***Management Contract (MC)***: A contractual arrangement whereby the Government Agency entrusts the operation and management of an infrastructure project to the Private Party for an agreed period on payment of specified consideration. The Government Agency may charge the user levies and collect the same either itself or entrust the collection for consideration to any person who shall pay the same to the Government Agency.

<u>What Does the Future Have in Store for Somalia?</u>

Outside of the political domain, the future of the Somalia depends very heavily on accelerating growth and employment. For this to happen, new investment modalities must be developed, moving away from aid dependency and private flows from the diaspora alone. Under the right conditions, and coming from a very low base, the rates of return in Somalia must be many times higher than they are in more advanced economies, for a given investment. Urbanization and population growth mean that annual rates of GDP growth must be in the 5-7% range for the next two decades, and this can be done, but it requires strong policies and hybrid modalities. None of this is complex, but it must be done.

With considerable maritime resources, and with sufficient sunshine to export energy across the entire region, re-branding Somalia as a business destination is the first step toward ushering a renaissance for the new Somalia.

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