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# FACTORS AFFECTING THE INVESTMENT CLIMATE IN AFRICA

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# I. INTRODUCTION

1. Over the last ten years the financial position of the developing countries has deteriorated markedly. Their level of indebtedness has almost quadrupled, from $9,000 million in 1955 to an amount probably approaching $35,000 million today. At the same time, interest and repayment charges on existing loans have risen rapidly and are now roughly equal to half the volume of new aid so that the net aid received by developing countries is today half the gross assistance offered.

2. At the same time, there have been significant changes in the types of the financial flows; the proportion contributed by private long-term investment has declined markedly. For example, between 1956 and 1963 private long-term investment from the members of the OECD (that is, the developed world excluding the East European powers) fell from $2,578 million to $1,872 million. There was a substantial rise in 1964 to $2,700 million, but there are indications that the level has declined quite sharply in the last two years.

3. Developing countries benefited from the inflow of private investment from developed countries; indeed, they have probably received more financial assistance in the past two decades than in any previous period and the standard of living of their peoples has risen. Things are getting better; but the improvement has taken place at a rate much slower than the developing world desires or is capable of reaching, given adequate help.

4. The situation in Africa is nearly as grave as in most other regions of the developing world. For one thing, the basic social and economic infrastructure needed for development is probably poorer in tropical Africa than in any other region and no country belonging to it has as yet even remotely approached the stage of internally generated, self-sustaining economic growth. Yet it is in Africa that the decline in the level of direct investment has been most marked, especially since 1964 in which year direct investment from the UK, USA and Germany alone stood at £700 million. The slowdown would be still more marked

if we abstract from the totals of net new direct investments, investment in the exploitation of oil resources of the continent. To take one example, new direct investment in Africa (excluding South Africa) from the UK of £33 million in 1961, has been replaced by a net outflow in the last two years.

## II. THE GAINS FROM DIRECT INVESTMENT

### (a) The gains to the foreign investor

5. It has been frequently emphasized that direct investment by profit-making organizations brings with it a number of additional advantages. The advantages to the developing countries have been widely discussed and will be set out quite shortly later in the paper. However, it is important to acknowledge that direct investment in the developing world also brings advantages to the developed industrial powers as well.

6. The interests of the profit-making organization (whether it be a private firm or a public body such as a nationalized corporation or a state trading organization in the case of the non-capitalist countries) are not always and necessarily identical with those of its own country. Situations where the national need to control the outflow of capital has conflicted with the profit opportunities open to the investors are not unknown.

7. Nevertheless, it is important to stress that, if it is argued that direct investment is particularly valuable as a stimulus to the rapid economic development of the under-developed countries, it must also be accepted that, in a broad sense, it is in the national interest of the developed country as well. In the long run - and often in the short run too - there is a clear benefit from the more efficient use of men and materials in the developing countries made possible by their economic advancement. It is only necessary to examine the history of the massive direct US investment in Western Europe over the last two decades to see the force of this argument. Although this investment has done much to create a number of formidable industrial competitors in areas previously

dominated by the US, it is clear that, far from hindering the overall development of the US economy, this investment has resulted in the growth of the European market which has, in fact, provided a powerful stimulus to the advance of the American economy.

8. When we turn to the individual firm, the advantages of direct investment are more obvious and have been frequently listed. Direct investment in a new market allows it to replicate known techniques, and to spread the results of the very costly research and development already undertaken, over a wider market. Perhaps of equal importance is the fact that the firm is able to maximise the use of the marketing and production know-how it has already gained. Of course, direct investment is often more the result of the 'push' of political or financial pressures than the 'pull' of marketing opportunities.

(b) Gains to the developing countries

9. The gains accruing to the developing countries as a result of direct investment have been set out a number of times. When a firm invests in a country it normally contributes, in addition to the equity or risk capital, a whole complex of skills. As has already been pointed out, it brings production, marketing and administrative skills and access to wide areas of knowledge that are necessary for the creation and successful control of a modern business enterprise.

10. There is one further contribution that any firm which takes an equity stake in an operation in a developing country can make to that country. The distinctive feature of equity participation is that the capital involved is not guaranteed and will be lost if the operation is unsuccessful, and will be rewarded if the operation is successful, not by a given rate of return or yield, but by an unknown level of profit. The knowledge of the firm that any mistakes it makes may cost it dearly alters its attitude and the way in which it runs the enterprise. It is by acting as a seed bed for disseminating the specific skills already mentioned and for creating and developing the general attitude of mind appropriate to the discharge of entrepreneurial function that direct investment can play its most important part in the development of the African economies.

11. The point has been extremely well made in the book International Aid, by I.M.D. Little and J.M. Clifford. On page 223, they comment:

> "We have no doubt that the resources of Africa are such that lack of capital will eventually become the chief impediment to development. But at the present time almost every way of spending money for development, which looks promising, suffers from some non-financial difficulty - lack of either knowledge, or of administrative or other skills."

12. Direct investment brings with it these skills; therein lies its unique value.

## III. THE NATURE OF INVESTMENT DECISION

13. Investors are motivated by the desire to make profits. This is true of all investors, from whatever source. The present value of the profits, and therefore the investment opportunity, is a function of the risk attached to them and the likelihood that they will in fact accrue. Hence, the investment climate in Africa is determined basically by factors which affect the profit expectations of potential investors. Any discussion of the general investment climate must therefore begin with an analysis of the nature of the investment decision.

14. As has already been emphasized, the key point about any investment decision is that it is always taken under conditions of uncertainty. Hence, the only useful way to discuss problems in investment decision-taking is in terms of the ex-ante return, i.e., the yield on the capital at risk as it appears before the event. In respect of the level of new capital inflow, the ex-post return on the capital which has previously been risked is an imperfect and uncertain guide. In simple terms, all investment involves a significant element of gambling. The value of a gamble cannot be known unless both the amount which has to be staked and the odds being offered can be reasonably assessed. Put in another way, the present value of the 'prize' offered by any investment opportunity is determined in part by the expected cash flow which will be returned in the form of profits, and in part by the likelihood of that

cash flow in fact occuring. The smaller the former and the greater the latter, the less will be the present value of the investment opportunity to the investor. In other words, the greater the degree of uncertainty, the greater the yield on the capital at risk needs to be to persuade the investor to undertake the risk. The degree of uncertainty surrounding the investment - the likelihood that it will not be possible to obtain the expected flow of profits, or that if these profits do occur that it will not be possible to repatriate them, or indeed, that the initial capital will be lost - frequently seems to the foreign decision taker so much greater in Africa than in his own country. Hence, an investment with a prospective yield of (say) 20 per cent, in real terms, in a country in Africa probably has the same present value to an investor in Europe, the USA or Japan as an investment with a return of (say) 10 per cent in his own country. But since an increase in the level of uncertainty has the same effect as an increase in the cost of capital to the investor, it also follows that policies specifically designed to reduce that uncertainty would bring down the cost to investors, induce them to expand their investments and thereby benefit the recipient country.

## IV. RISK ELEMENTS IN FOREIGN INVESTMENT

15. Theoretically it is possible to distinguish four kinds of risk in any investment situation. First, there is the general commercial risk: that investment is in the wrong product, or for example, that the oil well is drilled in the wrong spot; that competition may prove to be stronger than expected, or that costs turn out higher than one has foreseen. In short, that the venture will make a loss rather than a profit. There are, in addition, three non-commercial risks which often play a vital role in any non-domestic investment. The first is linked to the possibility that the foreign exchange will simply not be available to enable the investor to repatriate his profits. Similarly, the investor runs the risk of finding that, in his own currency, the value of his profits (and of his original investment) has been substantially reduced by devaluation.

16. The second non-commercial risk can be summed up in the phrase, "the government may change its mind". The tax rules in force at the time that the decision was made may be changed, or the interpretation put on them at that time may prove to have been erroneous. Protective tariffs which were agreed at the time of the investment may subsequently be removed or reduced, and the whole attitude of government may alter. This situation may be extremely rare; nevertheless, the fact is that strangers, unaware of the manners and customs of a particular country, must regard such a change in circumstance as being possible and as posing a real risk to the viability of their project. Finally, there is the classical type of political risk. Governments may change, or in some cases cease to exercise full authority; the assets of the foreign enterprise may be expropriated, or the continuation of the business may be made impossible.

17. The important point, however, is <u>not</u> that there are theoretically a number of different types of risk, but that they all contribute to one general situation of uncertainty. The surveys which have been undertaken over the last few years in order to ascertain which type of risk investors regard as most important, while being extremely valuable from many points of view, can also be misleading. The publication of such survey data may result in a belief that there are a number of separable problems which can be tackled in isolation either by the developing countries or by the main industrial powers. The fact of the matter, however, is that the investor faces not a list of separable types of investment risks, but a total investment climate. Thus he may well be willing to invest, even if he regards it as likely that he will face a lowering of an agreed protective tariff, and fierce international competition in a few years, <u>given that the profits in the intervening period are sufficiently high</u>. Conversely, if he has a great deal of information about the country, and everything points to the likelihood that profits will be remitted and his right to the equity will be respected, the investor will clearly need a much lower profit level to attract him.

18. It is against this background that the probable decline in direct investment in Africa over the last two years must be considered. Of course, a large part of this decline can be traced to the changed conditions in the United States and the United Kingdom. In the case of the United

Kingdom, for example, which at the end of 1964 had a direct investment of £170 million in Africa (excluding South Africa), net direct investment has been the negative sum of -£11 million in 1963/64.

19. While it is true that the overall return on UK investment has not been startlingly good, return averaged 15 per cent over the period 1961/1964, and it is clear that the outflow in the last two years has not been due to the previous poor yield. In any case, however, such average return calculations are almost meaningless. It is true that the return on US direct investment in Africa, for example, was 20 per cent in 1965. However, if the proven and therefore profitable investment in Libyan oil is excluded, the overall return falls to 3 per cent. If, in addition, the fairly long-established investment in Liberia is also excluded, the US direct investment is shown to be $689 million and on this sum a return of 1 per cent was earned. Return is thus frequently highly dependent on the length of time that the investment projects have been operational. Again, changes in the nature of the activity, say, from merchanting to manufacturing, may markedly change the proportion of capital at risk - in this case by altering the proportion of capital recoverable in the short term - without in any way changing the average return.

## V. WHY HAS THE FLOW OF DIRECT INVESTMENT IN AFRICA DECLINED?

20. Whatever the difficulties in estimating the real return, it is clear that the outflow of UK direct capital, which is symptomatic of a change in attitude by direct investors throughout the world, has been the result not of any large-scale disappointment in the result of previous investment, but of three factors. First, the changed conditions in the major industrial countries; second, the decline in political stability in Africa and, third, the rapid fragmentation of the market.

21. Over the last few years a number of important African countries have suffered serious political disturbance, and this, quite naturally, has influenced the investors' attitude to African countries. In addition, a number of important African economies have run into serious balance of

payments problems. However, probably of much greater importance has been the fact that there has been a breakup of a number of substantial markets as the nations have gained their independence and gone their separate ways.

22. An important aspect of the whole problem of investment climate in Africa is the size of the markets in Africa. In 1965 the following 17 African nations, chosen quite at random, had a total national income of under £4.5 thousand million: Kenya, Uganda, Tanzania, Malawi, Zambia, Nigeria, Ghana, Sierra Leone, Gambia, Ivory Coast, Dahomey, Mali, Mauritania, Niger, Senegal, Togo, Upper Volta. In contrast, the Belgian national income in 1965 was £4.7 thousand million. While the development of national economic policies, which unfortunately have frequently resulted in the erection of substantial barriers to trade and the disruption of former trading areas, have probably resulted in some increase in 'protective' or 'defensive' private investment, there is little doubt that this policy will act as a long-term disincentive to the inflow of direct investment.

23. In these extremely small markets it is necessary for most direct investors to insist that they are given a monopoly position; otherwise there is almost no hope that the investment will be viable. However, everyone is aware that the creation of a monopoly position leads to political problems, and indeed, markedly increases the level of political risk associated with the investment. Again, the size of the domestic market makes it highly unlikely that the operation will be large enough to compete successfully in the export market. This means that the investment will necessarily have to depend for its viability on a high protective tariff - and once more, this leads to political problems, the investor is aware of the political danger, and uncertainty and the cost of the investment is raised.

24. Indeed, the smallness of the market often leads to substantial instability in the whole situation. The problem can be illustrated by way of an analogy. It has been shown that in a number of shopping areas

in the United Kingdom and the United States, the introduction of super-markets leads to permanent instability. The total demand in the shopping area is sufficient for, say, one and a half super-markets. One super-market sets up in the area and makes extremely high profits; as a result, a further super-market is attracted, and competes a large proportion of these profits away. The result is that both super-markets do rather badly for a period and, eventually, one of them drops out. The cycle is then repeated. Much the same situation exists in some of the small markets in Africa, where the original investor may well make a very good return; the political pressures to break the monopoly position grow, a further investment is undertaken, but both operations are then found to be unprofitable.

25. To sum up: the fragmentation of the market reduces the attractiveness of Africa as an investment area, and increases the level of uncertainty surrounding investment and therefore its cost to the African countries.

## VI. METHODS OF IMPROVING THE INVESTMENT CLIMATE

26. Obviously an improvement in the investment climate is a prior condition for any increase in the flow of direct investment to the developing world. The problem that must be faced, therefore, is to establish feasible means whereby this improvement can be brought about. In particular it is important to ask how each of the interested parties can contribute to this end. What action can the developed nations, the developing nations, the current and potential investors, and the international agencies take to improve the situation?

27. Over the last few years three lines of approach have been explored. First, machinery for the settlement of investment disputes has been created. Second, the insurance principle has been applied to the underwriting of certain non-commercial risks in a few countries which have set up national guarantee schemes. Finally, a multilateral guarantee scheme under the aegis of the World Bank is now approaching finalization.

## The settlement of disputes

28. On 14 October 1966 a "Convention on the Settlement of Investment Disputes Between States and Nationals of Other States" came into force following ratification by twenty States. It is interesting to note that fifteen of these twenty States were African, and a further five African countries have now signed the Convention but as yet not ratified it. The Convention was first presented in the Spring of 1965 with the stated object of facilitating the settlement of disputes and thereby promoting mutual confidence and a larger flow of private international capital.

29. The machinery for the settlement of disputes has taken the form of an International Centre, controlled by an Administrative Council on which each adhering country is represented. The President of the World Bank acts as Chairman, and there is a permanent Secretary General to head the small secretariat. The Centre itself will not engage in conciliation or arbitration, but will maintain panels of experts from which the disputants may choose. It is important to note, however, that the whole of the machinery is permissive. Those adhering to the Convention are at liberty to use the services of the Centre, should they wish to do so; on the other hand, they can, if they wish, ignore it. However, once a government and a foreign investor have agreed to use the Centre's facilities, they are required to consider any advice given by the conciliator appointed and to comply with any arbitration award made. Moreover, all countries adhering to the Convention are required to recognize an arbitral award as binding and to enforce the financial obligations imposed by the award as if it were a final decision of a domestic court, whether or not they are parties to the dispute.

## National investment insurance schemes

30. At the present time, three of the developed countries (the USA, Germany and Japan) have instituted insurance schemes guaranteeing some part of any loss due to non-commercial causes suffered by their nationals investing overseas. These three schemes resemble each other in that they all normally afford protection in terms of their home currency, they all exclude part of the total cost of the investment from the cover provided,

and there is often provision for the insurance against the loss of some element of earnings as well as against the loss of the original capital. In the case of the USA and Germany, the guarantee scheme is only operative where a bilateral agreement has been signed with a host country.

31. All these schemes simply make use of normal insurance principles. By aggregating risk, they lessen the cost of that risk to the individual taking part in the scheme. Thus, the government guarantees the investor against a loss which might be in the individual case overwhelming, for the payment of a small fee. In the case of the German and Japanese schemes, this fee is reported as being normally just under 1 per cent of the capital insured, while in the case of the USA - where the range of risk covered is usually wider - the fee in most cases seems to be just over 1 per cent of the capital insured.

32. By covering a large part of the non-commercial risk, which many private investors find extremely difficult to evaluate and therefore may overestimate, such schemes allow greater concentration on the commercial risks which the investor frequently has a greater ability to judge. At the present time Denmark, France, the Netherlands and Switzerland are all considering, with varying degrees of urgency, the creation of similar schemes.

Multilateral investment guarantee schemes

33. The International Investment Guarantee Corporation which is at present under discussion takes the same principle of insuring the non-commercial risks in overseas investment one step further. Indeed, in many ways, this scheme is the most hopeful sign that a real improvement in the investment climate (and therefore in the flow of direct investment to the developing countries) is attainable, that has yet appeared. Full details are not as yet available, but the general outline is already clear.

34. The basic proposition is to set up an Investment Guarantee Corporation, which, as was the case of the settlement of disputes machinery, will be under the auspices of the World Bank, to widen the scope of the insurance cover available to investors. The Corporation would organize the insurance of the investment projects, the cover being provided by a system of loss-

sharing guarantees by the home governments of the investors. The activities of the Corporation would be controlled by a board of directors who would represent, in some mutually agreeable proportion, the capital exporting countries and the host countries. There would be a permanent executive to man the Corporation, this executive falling under the control of the World Bank.

35. Under such a scheme, first, a much larger number of countries, and therefore investors, should be able to take advantage of the ability to insure against the non-commercial risks of confiscation, expropriation, restriction on the ability to transfer, and so on, than has otherwise been the case. Second, the permanent executive of the Corporation should in time build up a high level of competence in judging risks and risk situations which would be of immense benefit to all concerned. At the same time, the inclusion of representatives of the host countries in any board of directors might contribute to an improvement in the flow of information between the developing countries and the investors.

36. As time goes on, it is to be hoped that the Corporation will accumulate funds as a result of its income from premiums, and be able to take the initiative in the underwriting of specific projects, though it will almost certainly wish to continue to obtain the agreement of both the capital exporting country and the host country.

37. One provision which has been suggested is that the developing countries should join together and contribute some part of the loss-sharing guarantee necessary to underwrite the insurance cover offered to investors. The sums of money involved might well not be very large, but they would clearly give the developing countries a larger voice in the activities of the Corporation. Furthermore, joint loss-sharing guarantees would encourage the host countries to consider in some detail the real economic viability of any prospective investment in one of the participating countries.

## VII. CONCLUSION

38. There has been some progress both by the developing countries of Africa and the developed, capital exporting countries in the creation of the institutional basis for an improvement in the investment climate. A formal method for the settlement of investment disputes has been adopted. Time will tell how well it will work in practice. The first steps to the setting up of an international insurance scheme have been taken. An attempt is being made to put overseas investment on the same footing as that in the home country of the investor.

39. Yet quite as important as the creation of new institutions is the attitude of mind of all the participants - the developing countries, the developed countries, and the investor. It is vital that any obligations undertaken should be fully and voluntarily honoured, for the ways of reducing the benefit an investor derives from his enterprise are legion and hence not easily legislated against.

40. At the same time, it is vital that foreign investors accept the need to act as "good citizens" of the country in which they invest their money, and to acquire a real understanding of African aspirations.

41. There is a clear ambivalence in the attitude of many governments to foreign investment. Naturally, they would prefer to generate from their own resources most of the capital and expertise they require. They fear the creation of a dual economy, with much of the modern manufacturing sector controlled by expatriates. The foreign investor must recognize these fears.

42. The responsible investor will answer the fears expressed by the African governments by offering African investors a share in the equity of their companies, by training and promoting Africans to senior posts, by using their custom to stimulate the growth of African enterprises - transport undertakings, distributors, garages, component manufacturers, and so on. They will fervently hope that the multiplier effect of their own investment will be principally felt by the African businessman so that while expatriate business may expand, it will represent a smaller share of a rapidly growing cake.

43. In the final analysis, no institutional changes will of themselves create a favourable investment climate. The two most important constituents of such a climate are an expanding basic economy, and a healthy degree of competition. Thus, in many respects, the most important step that could be taken to improve the investment climate would be a greater willingness on the part of the nations of Africa to achieve close economic co-operation. A large prosperous market is a much greater attraction than the existence of investment guarantees; a high level of competition between both expatriate firms and indigenous companies is a greater safeguard than the provision of machinery to settle disputes.