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# Foreign Direct Investment in Africa: Performance, Challenges and Responsibilities

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# Abstract

This paper examines the performance, promotion, and prospects for foreign direct investment (FDI) in Africa. Factors such as political and macroeconomic instability, low growth, weak infrastructure, poor governance, inhospitable regulatory environments, and ill-conceived investment promotion strategies, are identified as responsible for the poor FDI record of the region. The paper stresses the need for more trade and investment relations between Africa and Asia. It also argues that countries in the region should pay more attention to the improvement of relations with existing investors and offer them incentives to assist in marketing domestic investment opportunities to potential foreign investors. Finally, the paper argues that the current wave of globalization sweeping through the world has intensified the competition for FDI among developing countries. Consequently, concerted efforts are needed at the national, regional, and international levels in order to attract significant investment flows to Africa and improve the prospects for sustained growth and development.

Keywords: Foreign Direct Investment; Promotion; Africa; Responsibilities
JEL Classification: F21; F23; O55

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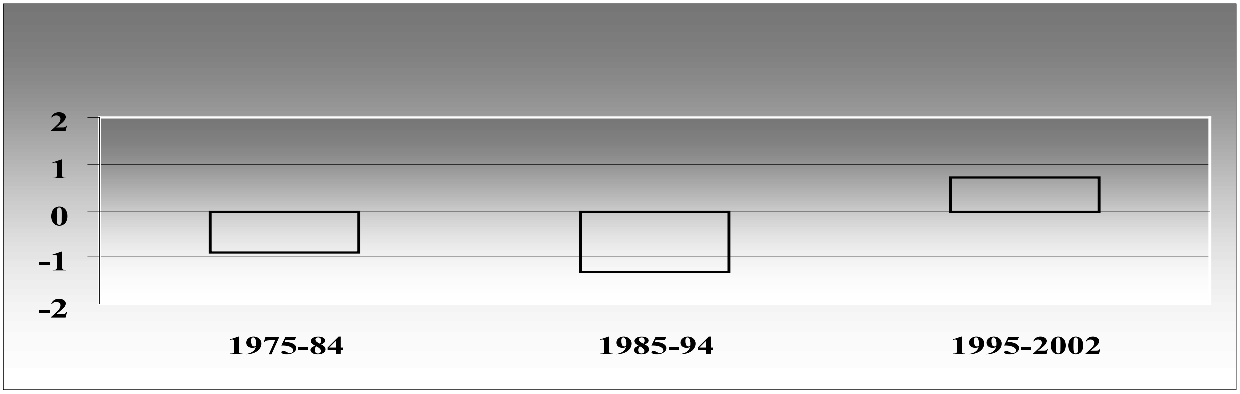
# Introduction

After gaining political independence in the 1960s, African countries—like most developing nations––were very skeptical about the virtues of free trade and investment. Consequently, in the 1970s and 1980s several countries in the region imposed trade restrictions and capital controls as part of a policy of import-substitution industrialization aimed at protecting domestic industries and conserving scarce foreign exchange reserves. There is now substantial evidence that this inward-looking development strategy discouraged trade as well as foreign direct investment (FDI) and had deleterious effects on economic growth and living conditions in the region (Rodrik, 1998).

**Figure 1: Average Growth Rate of Real GDP per capita in Sub-Saharan Africa (%)**




Source: World Bank, World Development Indicators , 2005.

The disappointing economic performance of African countries beginning in the late 1970s up till the mid 1990s, coupled with the globalization of activities in the world economy, has led to a regime shift in favour of outward-looking development strategies. Since the mid-1990s, there has been a relative improvement in economic performance in a number of African countries as a result of the change in policy framework (Fischer et al, 1998). Available data for Sub-Saharan Africa indicate that the average annual growth rate of real GDP per capita which was -0.9% over the period 1975-84 rose to 0.7% in the period 1995-2002 (Figure 1). But the progress made so far is not enough for sustained growth and development in the region. Over the past three decades, Africa's participation in the world economy has declined. The region's share of world exports fell from 5.9% in 1980 to 2.3% in 2003. Its share of world

imports declined from 4.6% to 2.2% over the same period (Table 1).

**Table 1: Distribution of World Trade (1980-2003)**

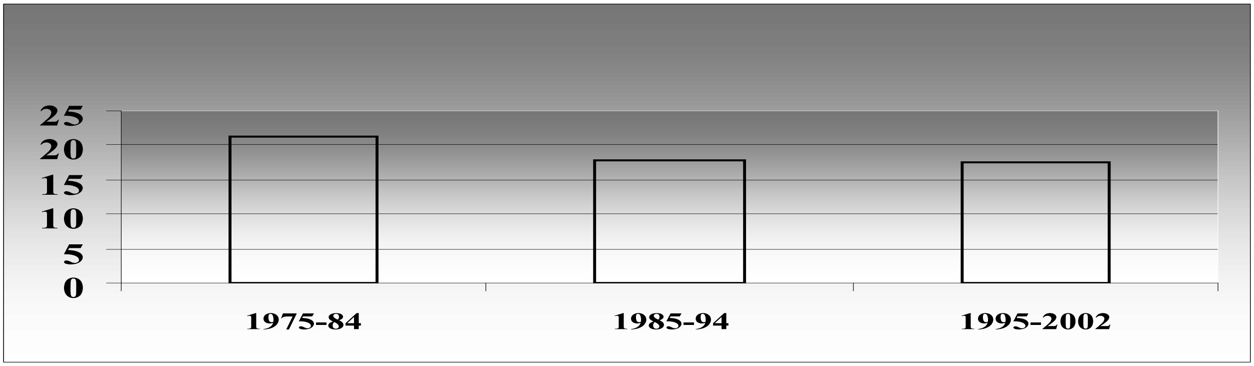
| **Share of World Exports (%)** | | | |
|---|---|---|---|
| **Region/Economic group** | **1980** | **1990** | **2003** |
| Developed Economies | 65.31 | 72.08 | 64.53 |
| Developing Economies | 29.43 | 24.21 | 32.39 |
| South-East Europe and CIS | 5.27 | 3.70 | 3.08 |
| Africa | 5.91 | 3.12 | 2.34 |
| Sub-Saharan Africa | 3.74 | 1.99 | 1.49 |
| Developing Asia | 17.91 | 16.87 | 24.95 |
| Developing America | 5.50 | 4.15 | 5.04 |
| Share of World Imports (%) | | | |
| Region/Economic group | 1980 | 1990 | 2003 |
| Developed Economies | 70.93 | 73.05 | 68.18 |
| Developing Economies | 23.90 | 22.53 | 29.28 |
| South-East Europe and CIS | 5.17 | 4.42 | 2.54 |
| Africa | 4.65 | 2.87 | 2.22 |
| Sub-Saharan Africa | 3.13 | 1.62 | 1.42 |
| Developing Asia | 13.01 | 15.89 | 22.14 |
| Developing America | 6.07 | 3.64 | 4.83 |

Source: UNCTAD Handbook of Statistics, 2004.

Improvements in economic policies are needed to enhance macroeconomic performance and attain the minimum growth rate required to meet the Millennium Development Goals set by the United Nations. An increase in investment is crucial to the attainment of sustained growth and development in the region. This requires the mobilization of both domestic and international financial resources. Given the unpredictability of aid flows, the low share of Africa in world trade, the high volatility of short-term capital flows, and the low savings rate of African countries (Figure 2), the desired increase in investment has to be achieved through an increase in FDI flows, at least in the short-run.[1]

[1] While savings represent about 30 percent of GDP in Asia, in Africa it was below 20 percent over the period 1995-2002. For an analysis of savings in Sub-Saharan Africa see Aryeetey and Udry (2000).

**Figure 2: Gross Domestic Savings in Sub-Saharan Africa (% of GDP)**




Source: World Bank African Development Indicators, 2004.

Until recently, FDI was not fully embraced by African leaders as an essential feature of economic development, reflecting largely fears that it could lead to the loss of political sovereignty, push domestic firms into bankruptcy due to increased competition and, if entry is predominantly in the natural resource sector, accelerate the pace of environmental degradation. Moss, Ramachandran, and Shah (2004) argue that much of African skepticism toward foreign investment is rooted in history, ideology, and the politics of the post-independence period. They also argue that the prevailing attitudes and concerns in the region are due in part to the fact that policymakers in the region are not convinced that the potential benefits of FDI could be fully realized in the region. Clearly, the sector in which a country receives FDI affects the extent to which it could realize its potential benefits. In East Asia, substantial FDI went into the secondary sector thereby contributing to the diversification of the export base and to higher and sustained growth. Africa, on the other hand, receives FDI mostly in the primary sector, and so the benefits to the region have not been as significant as in East Asia. In this regard, a key challenge facing Africa is how to attract more FDI in dynamic products and sectors with high income elasticities of demand.

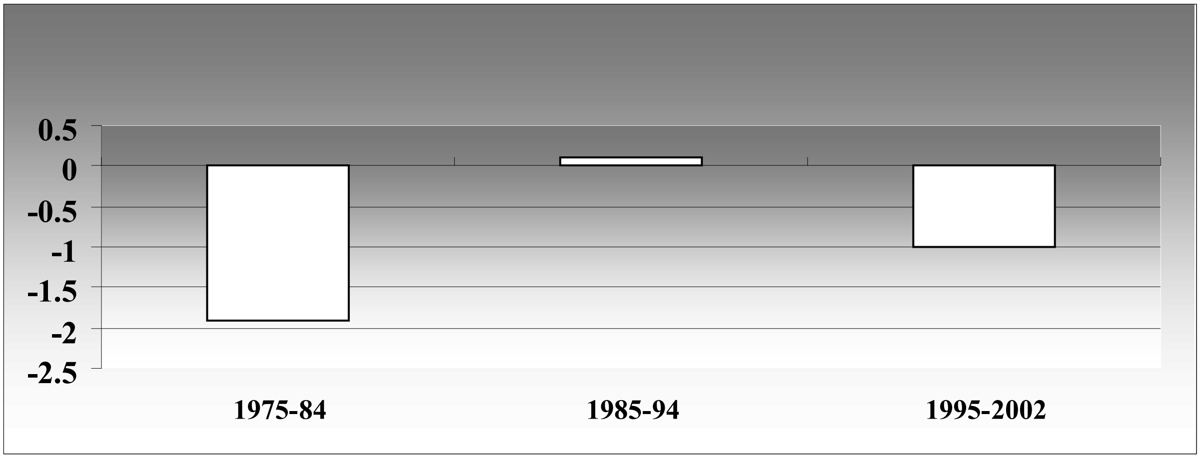
Although most of the concerns of African countries regarding foreign investment are legitimate—for example, there is some evidence that the activities of foreign oil firms in Nigeria have had perverse effects on the local environment (EIA, 2003)—experience has shown that if a host country creates an environment conducive to investment, FDI can play an important role in its development efforts. Its potential benefits include:

- Employment generation and growth: By providing additional capital to a host country, FDI can create new employment opportunities resulting in higher growth. It can also increase employment indirectly through increased linkages with domestic firms. More specifically, the location of a foreign firm in a host country generally leads to the establishment of domestic firms that provide inputs to

it thereby increasing the demand for labour in the economy. Aaron (1999) provides evidence on the positive impact of FDI on employment in developing countries.

- Supplementing domestic savings: African countries have low savings rates thereby making it difficult to finance investment projects needed for accelerated growth and development. Available data indicate that in Sub-Saharan Africa gross domestic savings as a percentage of GDP fell from 21.3% over the period 1975-84 to 17.4% in the period 1995-2002. Furthermore, the gap between domestic savings and investment was -1.9% of GDP over the period 1975-84 and -1.0% of GDP during the period 1995-2002 (see Figure 3). FDI can fill this resource gap between domestic savings and investment requirements.

**Figure 3: Gap between Savings and Investment in Sub-Saharan Africa (% of GDP)**




Source: World Bank African Development Indicators, 2004

- Integration into the global economy: Openness to FDI enhances international trade thereby contributing to the integration of the host-country into the world economy (Morrisset, 2000).
- Raising skills of local manpower: Through training of workers and learning by doing, FDI raises the skills of local manpower thereby increasing their productivity level. The idea that FDI enhances the productivity of the labour force is supported by empirical evidence suggesting that workers in foreign-owned enterprises are more productive than those in domestic-owned enterprises (Harrison, 1996).
- Transfer of modern technologies: Foreign firms typically make significant investments in research and development. Consequently they tend to have superior technology relative to firms in

developing countries. FDI gives developing countries cheap access to new technologies and skills thereby enhancing local technological capabilities and their ability to compete on world markets. Blomstrom and Kokko (1998) provide an interesting survey of the literature on FDI and transfer of technology.

- Enhanced efficiency: Opening up an economy to foreign firms increases the degree of competition in product markets thereby forcing domestic firms to allocate and use resources more efficiently.

There is a small literature dealing with issues related to FDI flows to Africa (see for example, Rogoff and Reinhart, 2003; Akinlo, 2003; Lemi and Asefa, 2003; Bende-Nabande, 2002; Asiedu, 2002; and Schoeman et al, 2000). However, the existing literature focuses on the empirical determinants of FDI to the region, with very little discussion of concrete actions or strategies that could be adopted to promote FDI flows to the region. The present paper attempts to overcome this limitation. It emphasizes a new approach to the promotion of investment to the region that is based on improving relations with existing investors rather than focusing exclusively on costly activities of Investment Promotion Agencies. Furthermore, it identifies clearly what needs to be done at the national, regional, and international level to enhance FDI flows to Africa.

An identification of responsibilities and actions needed at the national, regional, and international level is important for two reasons. The first is that globalization has increased the competition for FDI flows among developing countries. Since Africa is not one of the preferred destinations for investment among foreign investors, it is increasingly being recognized that actions by African countries would have to be complemented by efforts at the regional and international levels in order to improve the prospects for FDI flows to the region (CCFA, 2003). Consequently, it is important to identify the responsibilities that are required at the various levels in order to reverse Africa's dismal FDI record. Second, the New Partnership for Africa's Development (NEPAD) and the G8 "Africa Action Plan" call for a new relationship between African countries and their development partners that is based on shared responsibility for development effectiveness and outcomes (G8, 2002; ECA, 2003; World Bank, 2003). One of the areas in which there is clearly a need for shared responsibility is the attraction of private capital flows to the region. It is therefore important to identify areas of responsibilities at different levels to give African policy makers and their development partners concrete ideas on what they can do to increase FDI flows to the region.

The structure of the rest of the paper is as follows. Section II presents a review of recent FDI trends while section III deals with Africa's investment and trade relations with Asia. Section IV analyses Africa's FDI performance and potential, and section V provides explanations for Africa's poor FDI record. Section VI outlines and examines measures to promote FDI flows to Africa, while section VII deals with prospects for FDI flows to the region. The last section contains some concluding remarks.

# II. Recent Trends in FDI

The rapid advances in technology in the last few decades—especially in transport and communication—have led to tremendous increases in FDI. Global inward FDI flows rose from US$59 billion in 1982 to a peak of US$1,491 billion in 2000. On an annual average basis, FDI inflows increased from 23.1% in the period 1986-90 to 40.2% over the period 1996-2000. Furthermore, FDI outflows rose from 25.7% to 35.7% within the same period (UNCTAD, 2003).

In 2001 FDI flows declined for the first time since 1991, reflecting largely the slowdown in global economic activity as well as the poor performance of stock markets in the major industrial countries. FDI inflows and outflows each fell by 41.0%. In 2002, global FDI inflows dropped by 21% while outflows fell by 9%. The main factors responsible for the further decline include the lower than expected recovery in the global economy, the winding down of privatization in several countries, and the adverse effects of the auditing and accounting scandals in some advanced countries on stock markets. The declining trend in FDI flows continued in 2003 with inflows falling by 18%. Outflows however rose by 3%.

In terms of regional distribution, developed countries account for the bulk of global FDI inflows (Table 2). Until the early 1990s, the share of FDI inflows to developed countries represented more than three quarters of the total flows. Since 1991, the share of developing countries has increased gradually, reaching a peak of 35.3% over the period 1993-98. For the period 2002-03 the share of developing countries is 27%, with Asia accounting for roughly 60% of the inflows to developing countries.

**Table 2: Distribution of World FDI Inflows, 1986-2003 (%)**

| Region | 1986-1990 | 1991-1992 | 1993-1998 | 1999-2000 | 2002-2003 |
|---|---|---|---|---|---|
| Developed countries | 82.4 | 66.5 | 61.2 | 80.0 | 68 |
| Developing countries | 17.5 | 31.2 | 35.3 | 17.9 | 27 |
| Central and Eastern Europe | 0.1 | 2.2 | 3.5 | 2.0 | 5.0 |
| Africa | 1.8 | 2.2 | 1.8 | 0.8 | 2.5 |

Source: World Investment Report, UNCTAD, 2002 and 2004.

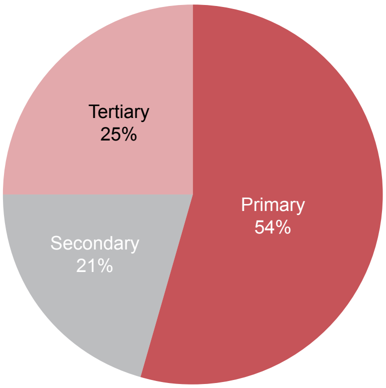
Africa has never been a major recipient of FDI flows and so lags behind other regions of the world.[2] On an

[2] There are two main types of investments made by foreign investors in African countries: greenfield investments, which involve investments in a new establishment; and cross-border merger and acquisition (M&A) of an existing local firm. In general, these investors are driven by the desire to make profit. Therefore, they are often attracted by factors such as the desire to: exploit natural resources (as in Nigeria, Angola, Equatorial Guinea); take advantage of export opportunities created by certain investment locations (as in Lesotho and Swaziland); reap the benefits of domestic investment incentives (Mauritius, Seychelles); and respond to economic policy reforms, especially privatization (as in Mozambique and Uganda).

annual average basis, the region's share of global FDI inflows was 1.8% in the period 1986-90 and 0.8% in the period 1999-2000. A slight improvement was observed in 2001 when inflows to the region rose from US$9 billion in 2000 to US$19 billion in 2001, increasing the region's share of global FDI to 2.3%. It should be noted however that this increase was largely due to two unusual cross-border Mergers and Acquisitions (M&A) in South Africa and Morocco. FDI inflows to the region fell by 40% in 2002 but grew by 28% in 2003. However, on an annual average basis, the share of Africa in global FDI inflows rose to 2.5% over the period 2002-03. Although this represents an improvement, it should be noted that this figure is 24.5 percentage points below the average share for developing countries over the same period (Table 2).

Within the continent, the distribution of FDI flows is uneven. For example, in 2001 the major recipients of flows in the region were South Africa, Morocco, Nigeria, Angola, and Algeria. Furthermore, in 2003, Morocco, Angola, Equatorial Guinea, Nigeria and Sudan accounted for half of the total inflows to the region. The primary sector remains the most important destination for FDI flows into the region, accounting for more than 50% of inflows from major investors to Africa over the period 1996-2000 (Figure 4). Within the primary sector, oil and gas are the most important industries. Since 1999, there has been an increase in inflows into the tertiary (service) sector. In fact in 1999, the tertiary sector attracted more inflows (US$3,108 million) than the primary sector (US$2726 million). In 2000 the primary and tertiary sectors attracted inflows worth US$2,029 and US$1931 million respectively.

**Figure 4: FDI outflows from major investors to Africa, by Sector (1996-2000)**




Source: World Investment Report, UNCTAD, 2002.

# III. Asia, Trade and FDI Flows to Africa

In terms of sources of FDI flows to Africa, the United States, France, the United Kingdom, Germany, and Portugal accounted for most flows to the region from 1996 to 2000. Within the same period, the United States is the most important source of FDI flows into the region, accounting for approximately 37% of inflows from developed countries. This represents a marked-shift from the period 1991-1995 in which the United Kingdom and France were the most important sources of FDI flows to the region (Table 3).

Although developed countries account for over 90% of total outward FDI, Asia is becoming a very important source of FDI in developing countries. The share of developing Asia in total outward FDI stock of developing countries rose from 11% in 1980 to 80% in 2003. A large part of developing Asia's outward FDI stock is however concentrated in Asia. For example, in 2000 about 57% of outward FDI stock from Singapore went to Asia. Similarly Asia accounted for 63% of outward FDI stock from Thailand in 2002.

African countries have serious difficulties attracting FDI flows from Asia. Table 3 shows that based on the absolute value of investments, Japan is the only Asian country among the top 19 sources of FDI flows to Africa over the period 1991-2000. It should be noted however that relative to other developed countries, it is not a major source of FDI flows to Africa. Over the period 1996-2000, its FDI flow to Africa was $340 million compared to $9, 249 and $4, 362 million for the U. S. and France respectively. In 2000, Africa accounted for 0.1% of total outward FDI from Japan. The figure rose to 0.6% in 2001. Since then there has not been any substantial improvements. Japanese investments in Africa are concentrated in two countries: Liberia and South Africa, with the former accounting for most of the investment in the region.

**Table 3: Main Sources of FDI flows to Africa (Millions of Dollars)**

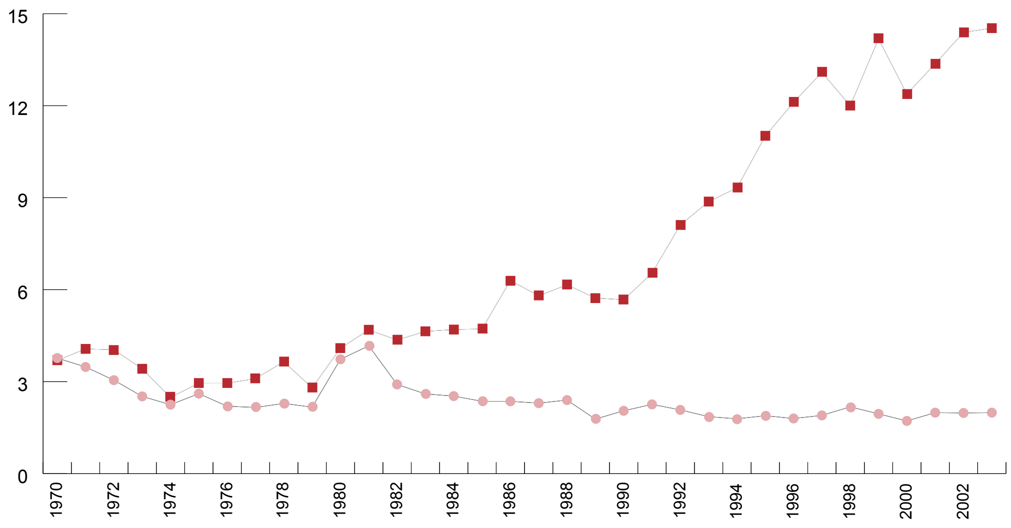
| Country | 1991-1995 | 1996-2000 |
|---|---|---|
| Australia | -33 | -99 |
| Austria | 7 | 221 |
| Belgium | -47 | 242 |
| Canada | 146 | 626 |
| Denmark | 1 | 340 |
| Finland | 3 | 8 |
| France | 2,066 | 4,362 |
| Germany | 402 | 2,475 |
| Italy | 213 | 678 |

| Country | 1991-1995 | 1996-2000 |
|---|---|---|
| Japan | 201 | 340 |
| Netherlands | 297 | 816 |
| New Zealand | - | - |
| Norway | 145 | -148 |
| Portugal | 96 | 1,560 |
| Spain | 50 | 476 |
| Sweden | 4 | 197 |
| Switzerland | 452 | 69 |
| United Kingdom | 2,376 | 3,269 |
| United States | 278 | 9,249 |

Source: World Investment Report, UNCTAD, 2002.

Despite the intra-regional feature of developing Asia's outward FDI stock, the region is becoming increasingly important to Africa's trade. The share of Asia in Africa's total exports rose from about 5% in the 1980s to about 14% in 2002 (Figure 5). In fact if present trends continue, Asia is likely to be the second most important trading partner for Africa within a decade.[3]

**Figure 5: Export Shares of Africa and Asia (%)**




Source: Computed using data in UNCTAD Handbook of Statistics, 2004 (CD-Rom).

[3] Presently, the European Union is Africa's most important trading partner, accounting for about 50% of the region's exports. The second most important export destination for the region is the United States, which accounts for about 17% of the region's exports.

Asian countries have also started to show more interest in investing in Africa. For example, in 2004, China launched the China-Africa Cooperation Forum in Addis Ababa, Ethiopia. It also contributed about $900 million in FDI in the region in the same year (Abraham, 2005). Other Asian countries have also increased their stakes in Africa. For example, India is now the third-largest source of FDI in Uganda and its FDI stocks in Africa in 2002 was $1.9 billion. For Malaysia the figure is $1.6 billion. Relative to the 1990s, the Republic of Korea and Taiwan have also increased their investments to Africa although the value is still relatively insignificant. In 2002, FDI stocks from the Republic of Korea and Taiwan were $407 and $224 million dollars respectively. The sectors and countries that receive the bulk of Asian investment in Africa are:4

- Petroleum (Algeria, Angola, Chad, Equatorial Guinea, Nigeria, Sudan, and Tunisia);
- Apparel and Textile (Botswana, Ghana, Kenya, Lesotho, Madagascar, Mauritius, Mozambique, and Uganda);
- Automobile (South Africa);
- Telecommunications (Ghana, South Africa);
- Food and Drink (Cameroon, Tanzania, and Uganda).

There is a need for African countries to intensify efforts to market their investment opportunities to firms in Asia in order to benefit from the enormous investment resources available in that region.

[4] For more on this see (UNDP, 2004).

# IV. FDI Performance and Potential

Policymakers are often interested in the performance of their economy relative to its potential. Recently UNCTAD computed two indices for assessing economies in terms of FDI inflows: the Inward FDI Performance and Potential Indices. The inward FDI performance index is computed as the ratio of a country's share in global FDI flows to its share in global GDP. For any given country, if the value of the index is one, this means that the country receives FDI consistent with its relative size. If the index is above one, it means that the country attracts more FDI than should be expected given its relative size. Finally, a country with an index below one attracts less FDI than should be expected given its relative size.

**Table 4: Inward FDI Performance Index by Region, 1988-2003**

| Region | 1988-1990 | 2001-2003 |
|---|---|---|
| World | 1.00 | 1.00 |
| Developed countries | 1.03 | 0.92 |
| Developing countries | 0.99 | 1.25 |
| Africa | 0.70 | 1.16 |
| North Africa | 0.85 | 1.00 |
| Sub-Saharan Africa | 0.59 | 1.28 |
| Latin America and Caribbean | 0.90 | 1.42 |
| Asia | 1.09 | 1.19 |
| East and South-East Asia | 1.73 | 1.54 |
| South Asia | 0.11 | 0.37 |
| West Asia | 0.30 | 0.31 |
| Central and Eastern Europe | 1.04 | 1.35 |

Source: World Investment Report, UNCTAD, 2004.

Table 4 shows the values of the performance index for all regions of the world over the periods 1988-90 and 2001-03. The index varies widely between countries. It shows that for the period 1988-90 both developed and developing countries received FDI inflows roughly consistent with their relative size (as measured by their GDP). However, the distribution among the different regions in developing countries varies widely. Countries in Africa and Latin America and the Caribbean received inflows less than their relative size while countries in Asia received more than their relative size. For the period 2001-03, developed countries received FDI inflows less than would be expected given their relative size. The performance index for developed countries over this period was 0.92. Over the same period, developing countries had a performance index of 1.25 and so received inflows more than their relative size. Among

developing countries, Latin America and the Caribbean had an index of 1.42 while Asia and Africa had 1.19 and 1.16 respectively. It is interesting to note that there was a substantial improvement in the index for Sub-Saharan Africa from 0.59 in 1988-90 to 1.28 over the period 2001-03. However, this improvement is due largely to the two unusual cross-border Mergers and Acquisitions in South Africa and Morocco in 2001.

UNCTAD has also computed FDI potential indices for several economies in the world for the period 2000-02. The index is an unweighted average of the normalized values of the following variables: the rate of growth of GDP; per capita GDP; the share of exports in GDP; telephone lines per 1,000 inhabitants; commercial energy use per capita; share of R&D expenditures in gross national income; share of tertiary students in the population; and country risk. Of the 35 African countries included in the sample, only 3––Botswana, Libya, and South Africa—had very high FDI potential, and Botswana was the only country in the region with both high FDI performance and potential. Twelve African countries performed better than would be expected given their potential. The remaining 20 countries were classified as under-performers (Table 5).

**Table 5: Classification of African Countries by Performance and Potential (2000-2002)**

| | **High FDI performance** | **Low FDI performance** |
|---|---|---|
| **High FDI potential** | Front runners | Below potential |
| | Botswana | Libya, South Africa |
| **Low FDI potential** | Above potential | Under-performers |
| | Angola, Congo, Gambia, Mali, Morocco, Mozambique, Namibia, Sudan, Togo, Tunisia, Uganda, Tanzania | Algeria, Benin, Burkina Faso, Cameroon, Dem. Rep. of the Congo, Côte d'Ivoire, Ethiopia, Gabon, Ghana, Guinea, Kenya, Madagascar, Malawi, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, Zambia, Zimbabwe |

Source: World Investment Report, UNCTAD, 2004.

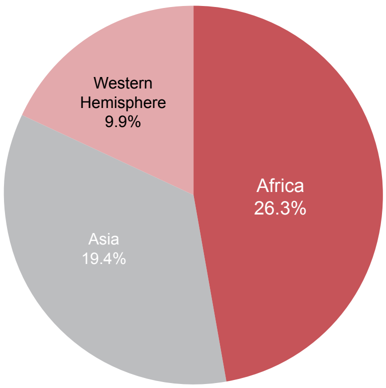
# V. Explaining Africa's Poor FDI Record

Various explanations have been adduced for Africa's poor FDI record. In the empirical literature, the following factors are important determinants of FDI flows to the region.

Uncertainty: One of the reasons why foreign investors are reluctant to invest in Africa, despite its enormous profitable opportunities, is the relatively high degree of uncertainty in the region, which exposes firms to significant risks. Uncertainty in the African region manifests itself in three different ways:

- Political instability: The region is politically unstable because of the high incidence of wars, frequent military interventions in politics, and religious and ethnic conflicts. There is some evidence that the probability of war—a measure of instability—is very high in the region. In a recent study, Rogoff and Reinhart (2003) computed regional susceptibility to war indices for the period 1960-2001. They found that wars are more likely to occur in Africa than in other regions (Figure 6). The regional susceptibility to war index is 26.3% for Africa compared to 19.4% and 9.9% for Asia and the Western Hemisphere respectively. The study also showed that there is a statistically significant negative correlation between FDI and conflicts in Africa. Sachs and Sievers (1998) have also argued that political stability is one of the most important determinants of FDI in Africa.

**Figure 6: Regional Susceptibility to War Index**




- Macroeconomic instability: Instability in macroeconomic variables as evidenced by the high incidence of currency crashes, double digit inflation, and excessive budget deficits, has also limited the regions ability to attract foreign investment. Recent evidence based on African data suggests that countries with high inflation tend to attract less FDI (Onyeiwu and Shrestha, 2004).

- Lack of policy transparency: In several African countries it is often difficult to tell what specific aspects of government policies are. This is due in part to the high frequency of government as well as policy changes in the region and the lack of transparency in macroeconomic policy. The lack of transparency in economic policy is of concern because it increases transaction costs thereby reducing the incentives for foreign investment.

Inhospitable regulatory environment: The lack of a favourable investment climate also contributed to the low FDI trend observed in the region. In the past, domestic investment policies—for example on profit repatriation as well as on entry into some sectors of the economy—were not conducive to the attraction of FDI (Basu and Srinivasan, 2002). Table 6 shows the cost of regulation of entry of new firms in selected countries in Africa and Asia. Clearly the costs of entry, as a percentage of 1997 GDP per capita, are very high in Africa relative to Asia. Within Africa, the costs are higher in Burkina Faso (133.4%), Senegal (99.6%), Nigeria (99.3%), and Tanzania (86.8%).

**Table 6: Comparative Costs of Regulation in Africa and Asia**

| Region/Country | Number of procedures | Time (number of days) | Cost (% of 1997 GDP per capita) |
|---|---|---|---|
| **AFRICA** | | | |
| Zimbabwe | 6 | 59 | 58.5 |
| South Africa | 7 | 30 | 36.7 |
| Nigeria | 7 | 35 | 99.3 |
| Kenya | 8 | 77 | 30.3 |
| Ghana | 11 | 35 | 14.9 |
| Senegal | 11 | 50 | 99.6 |
| Tunisia | 13 | 66 | 42.4 |
| Burkina Faso | 13 | 77 | 133.4 |
| Tanzania | 14 | 77 | 86.8 |

| Region/Country | Number of procedures | Time (number of days) | Cost (% of 1997 GDP per capita) |
|---|---|---|---|
| **ASIA** | | | |
| Malaysia | 6 | 41 | 17.2 |
| Hong Kong | 6 | 41 | 24.7 |
| China | 7 | 111 | 10.7 |
| Sri Lanka | 8 | 31 | 8.6 |
| Pakistan | 8 | 32 | 53.3 |
| Taiwan | 8 | 46 | 0.7 |
| Singapore | 10 | 36 | 12.4 |
| Thailand | 10 | 39 | 10.3 |
| India | 10 | 61 | 12.8 |
| South Korea | 11 | 46 | 15.6 |
| Japan | 11 | 50 | 11.4 |
| Indonesia | 11 | 142 | 29.0 |
| Philippines | 15 | 59 | 10.6 |

Source: Djankov et al (2000)

GDP growth and market size: Relative to several regions of the world, growth rates of real per capita output in Africa are low and domestic markets are quite small. This makes it difficult for foreign firms to exploit economies of scale and so discourages entry. Elbadawi and Mwega (1997), show that economic growth is an important determinant of FDI flows to the region.

Poor infrastructure: The absence of adequate supporting infrastructure: telecommunication; transport; power supply; skilled labour, discourage foreign investment because it increases transaction costs. Furthermore poor infrastructure reduces the productivity of investments thereby discouraging inflows. Asiedu (2002b) and Morrisset (2000) provide evidence that good infrastructure has a positive impact on FDI flows to Africa. However, Onyeiwu and Shrestha (2004) find no evidence that infrastructure has any impact on FDI flows to Africa.

High protectionism: The low integration of Africa into the global economy as well as the high degree of barriers to trade and foreign investment has also been identified as a constraint to boosting FDI to the region. Bhattachrya, Montiel and Sharma (1997) and Morrisset (2000) argue that there is a positive relationship between openness and FDI flows to Africa.

Other factors that account for the low FDI flows to the region but are rarely included in empirical studies—presumably due to data limitations— include:

High dependence on commodities: Several African countries rely on the export of a few primary commodities for foreign exchange earnings. Because the prices of these commodities are highly volatile, they are highly vulnerable to terms of trade shocks, which results in high country risk thereby discouraging foreign investment.[5]

Increased competition: Globalization has led to an increase in competition for FDI among developing countries thereby making it even more difficult for African countries to attract new investment flows. Relative to other regions of the world, Africa is regarded as a high-risk area. Consequently foreign investors are reluctant to make new investments in—or move existing investments to—the region. The intensification of competition due to globalization has made an already bad situation worse. It must be pointed out that the intense competition resulting from trade and financial liberalization puts African countries at a disadvantage because they have failed to take advantage of the globalization process—for example, through deepening economic reforms needed to increase their competitiveness and create a supportive environment for foreign investment.

Corruption and weak governance: Weak law enforcement stemming from corruption and the lack of a credible mechanism for the protection of property rights are possible deterrents to FDI in the region. Foreign investors prefer to make investments in countries with very good legal and judicial systems to guarantee the security of their investments.

Poor and ineffective marketing strategy: In the past, African governments set up agencies to promote foreign investment without taking adequate steps to lift the constraints on foreign direct investment in the region. It is therefore not surprising that investment promotion activities in the region have not been as successful as expected. For example, in Nigeria, FDI promotion in the 1990s was accompanied by increased political risk: frequent and abrupt changes in government; religious and ethnic conflicts; and border disputes. In Ethiopia, until recently, promotion activities went hand in hand with the intensification of war with Eritrea. Similar inconsistencies between government promotion activities and domestic political developments can be found in other African countries but the two examples given here are sufficient to illustrate our point. Apart from the idea that promotion activities in the region started earlier than necessary, there is also the problem that Investment Promotion Agencies (IPA) created by domestic governments were highly bureaucratic, expensive to maintain, and have not been successful in reversing the declining trend in FDI flows to the region.

[5] It should be noted, however, that in the literature, the availability of natural resources has been found to be positively related to FDI flows to the region. See for example Asiedu (2002a), and Onyeiwu and Shrestha (2004).

# VI. Promotion of FDI to Africa

One of the development challenges facing African leaders today is how to attract FDI to the region. A number of efforts have been made in the past to boost FDI flows to the region but they have not had any significant impact. These efforts were unsuccessful because they were ill conceived, did not lift underlying constraints on FDI to the region, and failed to confront the challenges to the attraction of FDI to the region posed by the globalization process.

In designing policies and measures to promote foreign investment and reverse the current dismal FDI trend in Africa, it is important to recognize three facts. First, FDI requires a long-term commitment to the host country, involves very high sunk costs and, in the short run, it is difficult for foreign investors to recoup their initial investments if there is a sudden change in the degree of risk associated with their location. The implication of this short-run irreversibility of FDI is that decisions on entry into a host country are highly sensitive to uncertainty about the investment environment.

Second, foreign investors regard Africa as a high-risk investment region. In addition, economic and political risks are highly contagious due in part to the interdependence of African economies and the globalization of the world economy. The interdependence of African economies affects investors' assessment of risk in individual countries. Because of imperfect information, foreign investors associate the outbreak or occurrence of risk in one country with the likelihood of similar risks in other countries in the region. Consequently, for the most part, they do not differentiate between countries in the region—a phenomenon known as statistical discrimination. This implies that an increase in political instability in one African country will diminish the probability of foreign direct investment flows to that country as well as to other countries in the region. The possibility of statistical discrimination, herding in investment behavior due to contagion, and the absence of adequate instruments for hedging in the region, suggests that complete reliance on a country-specific approach to the reduction of political risk in the region cannot be effective in reducing foreign direct investors' perception of risk in the region. What is needed is a regional approach that recognizes the interdependent nature of African economies and the fact that economic and political risks are contagious.

Finally, the intensity of competition for FDI among developing countries has increased with globalization. Most developing countries have recognized this fact and are taking, or have taken, steps to adapt to the changing external environment. The implication of this increase in competition for FDI is that African countries need to have comprehensive, as opposed to selective, policy reforms if they are to attract significant FDI to the region. In this regard, successful promotion of FDI to the region requires actions at the national, regional, and international level. More specifically, the following measures are needed to promote and attract FDI to Africa.

## Domestic actions

Domestic actions involve actions to be taken by countries in the region: These include image building, domestic regulatory reforms, and marketing of investment opportunities.

Image building: Improving the currently bad image of the continent is key to reversing the dismal FDI trend of the region. This requires an increase in:

- Political stability;
- Macroeconomic stability; and
- The protection of property rights as well as the rule of law.

Supporting existing investors: Improving the investment climate for existing domestic and foreign investors through infrastructure development; provision of services and changes in the regulatory framework—relaxing laws on profit repatriation etc—will encourage them to increase their investments and also attract new investors. In the case of domestic investors, an improvement in the investment climate will also encourage them to keep their wealth in the region and reduce capital flight.

Marketing investment opportunities: Creating awareness of investment opportunities through the use of existing investors and information communication technologies such as the internet. Experience has shown that over-reliance on IPAs for investment promotion has not been very effective in the African region, so there is the need for a shift of emphasis from IPAs to existing investors. This is also relevant because studies have shown that existing investors play a very important role in attracting new investors to new investment locations. For example, in a recent study of foreign direct investor perceptions conducted by the United Nations Industrial Development Organisation (UNIDO) in four African countries—Ethiopia, Uganda, Nigeria, and Tanzania—existing investors were found to be responsible for roughly 50% of foreign investor awareness of domestic investment opportunities (UNIDO, 2002). There is also the need for African countries to adopt a more targeted investment promotion strategy. In other words, they should identify sectors where they have comparative and competitive advantages and then promote FDI into those sectors. This would make investment promotion less costly and more effective.

Diversification of the economy: Several African countries rely on the export of a few primary commodities for foreign exchange earnings. This exposes them to significant terms of trade shocks. Diversification of the economy will enable them to cushion the effects of these shocks and reduce country risk. The reduction in country risk will increase the attractiveness of the economy to FDI in the secondary and tertiary sectors.

Trade liberalization: Openness to trade will signal commitment to outward-looking, market-oriented policies and enhance trading opportunities thereby attracting foreign investors intent on taking advantage of the new trading opportunities.

Privatization: The privatization of inefficient state-owned enterprises will boost foreign investment. African countries have now recognized that the privatization of public corporations is necessary to reduce government fiscal deficits and several countries have instituted privatization programmes. However, progress in the privatization of enterprises has been slow in several countries because of domestic political pressure by powerful interest groups that are against the process.

## Regional actions

Specific actions to be taken at the regional level fall under the following categories: market size; agency of restraint; promoting good governance; and infrastructure development.

Market size: Enhanced regional integration will increase market size in the region and help attract investors currently constrained in part by the small size of domestic markets in the region.

Agency of restraint: The formation of well-functioning regional economic communities and institutions is crucial to conflict prevention and resolution on the continent. The constructive role played by the African Union and the Economic Community of West African States in ending the conflicts in Liberia and Sierra Leone is worthy of emulation (ECA, 2004). Regional integration through the formation of regional groupings can also be used to reduce the incidence of domestic policy reversals and improve the credibility of economic policies in the region. The point here is that in an environment in which national governments have a credibility problem, regional groups can provide an external agency of restraint on domestic policies.

Promoting good governance: The use of a regional surveillance mechanism based on peer pressure will promote good governance and improve the investment climate.

Infrastructure development: Initiating and encouraging more cooperation in infrastructure development projects—for example, in telecommunication, transportation, power generation, and the provision of water—at the regional level. This will increase access to and reduce the cost of provision of these facilities, thereby lowering transactions costs, boosting trade, and increasing the attraction of the region to foreign investors.

## International actions

International actions involve improving market access and assistance in investment promotion as well as in capacity building and infrastructure development.

Improved market access: through the elimination of trade barriers and unfair subsidies on agricultural goods exported by African countries will enhance trading opportunities in the region and create an incentive for foreign investors to invest in the region. Recent evidence indicate that about 40% of the

costs of trade barriers to developing countries are due to restrictions imposed by developed countries (Anderson et. al., 2001). Furthermore, there is evidence that the elimination of trade barriers and unfair subsidies on agricultural goods by the European Union, the United States, Japan, and Canada will increase Sub-Saharan Africa's non-oil exports by 14% and income by 1% (Ianchovichina et. al., 2001).[6]

Some attempts have been made recently by developed nations to improve market access for African countries. These include:

- The African Growth and Opportunity Act (AGOA) introduced by the United States in 2000. The act gives most African countries preferential access to US market for petroleum products, agricultural goods, and manufactures such as textiles. Exports of goods covered by the act from Madagascar, Nigeria, Gabon, South Africa, Lesotho, and Swaziland have already increased as a result of this scheme. While the act gives African nations an advantage over other regions, it does not cover all exports from Africa and so its potential benefits to the region are thus far limited.
- The "Everything-but-Arms" initiative approved by the European Union in February 2001 with the objective of eliminating quotas and duties on all goods, except arms, from 49 least developed countries, most of which are in Africa. Also, Regional Economic Communities in Africa and the European Union (EU) are currently negotiating Economic Partnership Agreements that are intended to give them more reciprocal access to EU markets and pay more attention to development issues.
- The 2004 July Package of the WTO which provides a framework for reduction of trade barriers under the Doha Development Agenda. Some key elements of the package include calls for the elimination of export subsidies at a date to be specified. There are also calls for an end to cotton subsidies and substantial reductions in trade distorting industrial protection as well as agricultural domestic support measures.

Despite the progress made so far, it must be stressed that these initiatives do not go far enough and more needs to be done by the international community to improve market access for African countries in the Doha Round of WTO trade negotiations.

Investment promotion assistance: Since African countries are poor, and investment promotion is costly, governments of developed countries can assist the region in investment promotion through providing accurate information to investors in their countries about the investment environment and opportunities in the region. This type of investment promotion is likely to be more effective than the current approach used by African countries because investors in developed countries take the information received from their governments more seriously than those from developing countries.

Technical assistance: Developed countries can also help improve investment conditions in the region and increase its attraction to foreign investors by providing more technical assistance in areas such as: capacity building, infrastructure development, health and education.

6 By enhancing market access for Africa's exports through reduction of trade barriers, developed countries will increase the likelihood of Africa attracting export-seeking FDI.

# VII. Prospects for FDI Flows to Africa

Despite the dismal FDI record of African countries, there is room for optimism because recent developments in the region in the last few years signal a change in attitude towards more openness to FDI flows. More specifically, we believe that there will be modest improvements in FDI flows to the region in the medium to long term because of the following:

- FDI policies in Africa are improving—profit repatriation is now permitted in most countries, tax incentives are commonplace, there is an increase in the number of industries open to FDI, and privatization and trade liberalization are gaining widespread acceptance in the region. These developments would improve the investment climate.
- There are improvements in telecommunications infrastructure made possible by privatization programmes and this has reduced transactions costs.
- Cessation of hostilities in a number of African countries (for example, Liberia, Sierra Leone, Eritrea, Ethiopia) and an increase in the number of democratic regimes. This would reduce political instability and increase future FDI flows due to lagged effects.
- The 2004 "AGOA Acceleration Act" grants textile producing countries more market access into the United States and so it is likely that we will see more FDI in countries that produce and export textiles. AGOA was originally scheduled to end in 2008 but has recently been extended to 2015.
- Growth forecasts for the region look good. For example, in the 2005 Global Economic Prospects Report, the World Bank expects growth in the region to accelerate in 2005 and 2006. More specifically, the report states that GDP growth will increase from 3.2% in 2004 to 3.7% in 2006. In addition, it indicates that in the long-term per capita income is expected to grow by 1.6% per annum. In general, the favourable growth forecasts for the region are due in part to rising commodity prices, better global economic conditions, and the recent initiative by the G8 to cancel debt owed by a number of severely indebted African countries. These developments are likely to reduce country risk and make the region relatively more conducive to investment.
- Recently, African leaders designed a framework for development in the region—known as the New Partnership for Africa's Development (NEPAD)—that emphasizes the need for macroeconomic stability, good governance, peer review, and political stability in the region. If the principles enshrined in the NEPAD documents are taken seriously and implemented by African leaders, there is the distinct possibility that this may change the quality of economic policy-making in the region and improve the investment climate.

Our optimism regarding prospects for FDI flows to the region is supported by recent surveys of IPAs, International Investment Location Experts, and Transnational Corporations (UNCTAD, 2004). The survey results suggest that prospects for FDI flows to the region in the long term are good. About 92% of IPAs surveyed believe that there would be an increase in FDI flows to the region over the period 2006-

2007. Within the region, the prospects for FDI are best for South Africa, Egypt, Morocco, Nigeria, and Algeria. That said, we believe that countries such as Mozambique, Uganda, Tanzania, Namibia, Mauritius, and Botswana, are also likely to experience an increase in FDI flows because of the relative improvement in their economic policies in the last few years.

The results of the investment surveys also suggest that the preferred mode of investment in Africa is Greenfield investment. About 50% of IPAs indicated that this would be the preferred form of expansion by investors in Africa. This contrasts with the data for developed countries which suggest that the preferred form is mergers and acquisitions.

In addition to natural resources, we believe that the sectors that present the best long-term opportunities for foreign investment in the region are utilities and infrastructure. At the moment, the public sector provides most of these services, but there is growing recognition of the fact that they can be better and more efficiently provided by the private sector. If the current wave of privatization sweeping through the continent continues unabated, there will be an increase in the number of public utilities marked for privatization in several African countries.

Although we are optimistic about the future prospects for FDI in the region, it should be noted that not all countries are likely to attract significant flows in the future. The nature of domestic institutions and economic policies will ultimately determine the set of countries that will have success in the attraction of FDI in the medium-to-long term.

## Concluding remarks

FDI can play an important role in the development efforts of the region. To date, African countries have not been successful in attracting significant FDI flows, reflecting largely the combined effects of political and macroeconomic instability, weak infrastructure, poor governance, inhospitable regulatory environments, intensification of competition for FDI flows due to globalization, and poor marketing strategies. There is the need to reverse the declining FDI trend in the region. This requires concerted efforts at the national, regional, and international level. It also requires a new and more effective approach to investment promotion.

In the past, investment promotion activities in the region were carried out in an environment in which domestic policies were by and large not conducive to foreign investment and so were not successful. An enabling environment has to be created first before marketing investment opportunities to foreign entrepreneurs could be done effectively. The maintenance of a sustained political and macroeconomic policy environment would get the region closer to attaining this objective. Furthermore, the realization of Africa's FDI potentials will also depend on the ability of its leaders to improve the FDI climate and take advantage of the new global interest in the affairs of the region by implementing sound macroeconomic policies, enforcing the rule of law, reducing risks of policy reversals, and improving the provision of infrastructure.

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