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Foreign Direct Investment and Growth in Africa

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FDI and Economic growth There is now considerable evidence that FDI can affect growth and development by complementing domestic investment and by undertaking trade and transfer of knowledge and technology¹. The importance of FDI is envisioned in the New Partnership for Africa's Development (NEPAD) as it is perceived as a key resource for the translation of the vision of NEPAD for growth and development into reality. This is because Africa, like many other developing regions of the world, needs substantial inflows of external resources in order to fill the saving and foreign exchange gaps and leapfrogs itself to a sustainable growth level in order to eliminate its current level of poverty².

Many developing countries, and Africa in particular, seek FDI in order to accelerate their growth and development efforts. Promoting and attracting FDI has therefore become an important component of the development paradigm and a strategy for developing countries. The role of FDI in Africa as a source of capital has become increasingly important not only because of the belief that it can help bridge the savings-investment gap, but also because it can provide needed resources for the attainment of the Millennium Development Goals (MDGs)³.

This policy brief starts by examining the underlying factors of FDI flows in Africa. This is followed by an assessment of the impact of the recent global crisis on FDI and finally the brief makes some observations on the future trends of FDI.

What determines the flows of FDI? A number of African countries continue to put in place various measures which can attract foreign direct investment to their economies. Some countries have put in place different incentives (sometimes called "sweeteners") to ensure that resources are directed to areas and sectors where they are badly needed to deal with the issues of employment generation and poverty elimination. Indeed, in some cases, there is the risk of racing to the bottom as countries compete for FDI.

Even though Africa has been unable to attract significant amounts of FDI in global terms commensurate to its policy

reform, rates of return on investment and inducement for FDI flows, its global share of 3 percent is nevertheless important⁴. In general, FDI is motivated by both pull and push factors. The push factors, which are external to developing countries, focus mainly on growth and financial market conditions in industrial countries. The pull factors on the other hand are dependent on a host of factors that are determined by a fairly long list of domestic policies and characteristics of host countries. While the push factors determine the totality of available resources, the pull factors determine the allocation of the resources between countries⁵. Many studies have among others emphasized governance failures, problems of policy credibility, macroeconomic policy failures, and poor liberalization policies etc. as deterrents to FDI flows. Factors influencing FDI trends include a conducive macroeconomic policy environment, increased liberalization of markets, large domestic markets, low labor cost, liberal trade regimes, availability of natural resources, good infrastructure, concentration of other investors (agglomeration effects), enforceability of contracts and transparency of the judicial system, availability of "sweetener" policies, business facilitation measures and initiatives by outside bodies to promote investment in Africa⁶. Other factors include investment in human capital, which can bring about an educated labour force, which is crucial in attracting private investment, and improving the efficiency of public institutions.

The empirical results on the determinants of foreign direct investment show two strands of results which are important to Africa. First, the results show that countries in Africa can play major roles in promoting FDI through an appropriate policy framework, and that FDI to Africa is not solely driven by natural resources endowment but also by other factors (see Asiedu, 2006). In the short and medium term, countries can increase their FDI by streamlining their investment regulatory framework, implementing policies which promote macroeconomic stability and improve infrastructure. In the long run, more FDI can be achieved by curbing corruption, developing a more efficient legal framework and reducing political instability (Asiedu, 2003).

¹ There is skepticism in some quarters about the FDI effects on growth and technological spill over as discussed later in this paper.

² In the NEPAD framework, the bulk of the financing will have to come from abroad mainly from official sources, and in particular from foreign direct investment

³ This refers to the MDG goal of reducing poverty by half by the year 2015.

⁴ It has been pointed out many times that there is no need to bemoan the seemingly low share as it is actually consistent with Africa's share of World GDP.

⁵ For a list of domestic policies and characteristics determining the pull factors, See Ajayi (2004).

⁶ See Ajayi (2003)

The Global Economic and financial Crisis and FDI in Africa.

The sub-prime mortgage crisis that began in the United States of America in 2007 affected financial markets and created liquidity in many countries. The crisis eventually resulted into global economic and financial crisis. As a result of the global economic and financial crisis, there have been tighter credit conditions, falling corporate profits, gloomy prospects and uncertainties for global economic growth. Indeed many companies have announced plans to curtail production, lay off workers and cut capital expenditures. All these are expected to have negative effects on FDI. Thus, the channels of transmission of the crisis to FDI flows are reduced access to finance, gloomy prospects and risk aversion.

The crisis has not really bottomed-out even though the global economy is beginning to pull out of a recession; recovery is nevertheless expected to be sluggish⁷. The impacts of the global economic and financial crisis vary widely depending on the region and country. Available evidence shows that the crisis did not have significant impact on FDI flows in 2007⁸. In developing countries, FDI inflows rose by 21 percent to reach a new record level of \$500 billion in 2007 even though between 2005 and 2006, FDI rose by 30.5 percent. In Africa, FDI inflows grew by 21 percent between 2006 and 2007 to \$53 billion in 2007, which to all purposes was a new record. Between 2005 and 2006, FDI inflows in Africa grew by 55.3 percent. What fuelled the inflow of FDI were the booming commodity prices, profitability of investments and improved policy environments. In addition, the flows were supported by a continuing boom in the global commodity markets, Cross-border Mergers and Acquisition (M & A) in the extraction industries and related services. There were also new inbound M & A deals in banking industries. This new trend is an indication of greater diversification away from the traditional sectors mainly oil and gas and other primary commodities.

What are the prospects of FDI flows to Africa ? The future trend of FDI is however uncertain in many respects due mainly to the push factors of FDI mentioned earlier. It is expected that the inflows of FDI will decrease further in 2009 as the crisis in transnational investment expenditures continues to unfold. According to UNCTAD, "the negative impact of the current financial crisis and its economic aftermath on FDI inflows are expected to continue, at least in the short term, and a quick recovery is unlikely"⁹.

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There are primarily three forms of FDI in Africa. These are market seeking, efficiency seeking and resource seeking FDI. These forms will be impacted upon differently. It is expected that in 2009, there will be outright decline in FDI inflows as a result of pull back in efficiency seeking and resource seeking FDI aimed at exporting to advanced countries that are currently depressed. The market seeking FDI which is aimed at servicing local markets with glaring growth prospects, even though still positive, have receded. Unless the economic situation in FDI source countries improves substantially, FDI flows to Africa may be negatively affected with its attendant effects on growth and development.

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⁷ Indeed, it is not expected that the advanced economies as a group will not show sustained pickup in activity till the second half of 2010. For details see IMF World Economic Outlook Update July 8, 2009.

⁸ See UNCTAD, World Investment Report, 2008.

⁹ See UNCTAD Investment brief Number 1, 2009.