

Full Length Research Paper

Can foreign direct investment (FDI) help to promote growth in Africa?

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In the last 2 decades, foreign direct investment (FDI) flows have grown rapidly all over the world. This is because many countries and especially developing countries see FDI as an important element in their strategy for economic development. This paper provides a review of the foreign direct investment economic growth literature in the context of developing countries, and particularly Sub-Saharan Africa. The two main findings are as follows, first, FDI contributes to economic development of host country in two main ways, augmentation of domestic capital and enhancement of efficiency through the transfer of new technology, marketing and managerial skills, innovation and best practices, secondly FDI has both benefits and costs and its impact is determined by the country specific conditions in general and the policy environment in particular in terms of the ability to diversify, the level of absorption capacity, targeting of FDI, and opportunities for linkages between FDI and domestic investment. The findings of the review suggest that FDI is necessary but not a sufficient condition for economic growth.

Key words: Foreign Direct investment, economic growth, diversification, absorption capacity, Sub-Saharan Africa.

INTRODUCTION

In the last two decades, foreign direct investment (FDI) flows have grown rapidly all over the world. This is because many developing countries see FDI as an important element in their strategy for economic development (Ayanwale, 2007). Mergers and acquisitions including private-to-private transactions as well as acquisitions through privatization, which increased significantly in developing countries became an increasingly important vehicle for FDI (Kyaw, 2003). This has led to many countries improving their business climate to attract more FDI. In fact, one of the pillars for launching the new partnership for Africa's development (NEPAD) was to accelerate FDI inflows to the region (Funke and Nsouli, 2003)

In 2006, about 40 African countries introduced 57 new measures affecting FDI, of which 49 encouraged inward FDI (UNCTAD, 2007). The increase in FDI inflows largely reflected relatively high economic growth and strong corporate performance in many parts of the world (UNCTAD, 2008). Reinvested earnings accounted for about 30% of total FDI inflows as a result of increased profits of foreign affiliates, notably in developing countries. In Africa, FDI

inflows increased from \$18 billion in 2004 to \$36 billion in 2006. This was due to increased interest in natural resources, improved prospects for corporate profits and a more favorable business climate. In light of the expected benefits many studies have been conducted, however, the empirical results do not give conclusive evidence of the impact of FDI on the economy of developing countries. For example, while Ndikumana and Verick (2008), Sylwester (2005) and Lumbila (2005) show that FDI has significant positive effect on economic growth, others give evidence to the contrary (Dutt, 1997; Fry, 1993; Hermes and Lensink, 2003). Further, other studies suggest that the effect of FDI on economic growth, depends on whether the country has minimal level of absorptive capacity (in terms of educated workforce, institutional infrastructure and liberalized markets) that allows it to exploit FDI spillovers (Borenztein et al., 1998; Carkovic and Levine, 2002; Le Vu and Suruga, 2005). This study therefore reviews the literature on developing countries in general and Africa in particular, to show how, when and under what conditions FDI impacts positively or negatively on

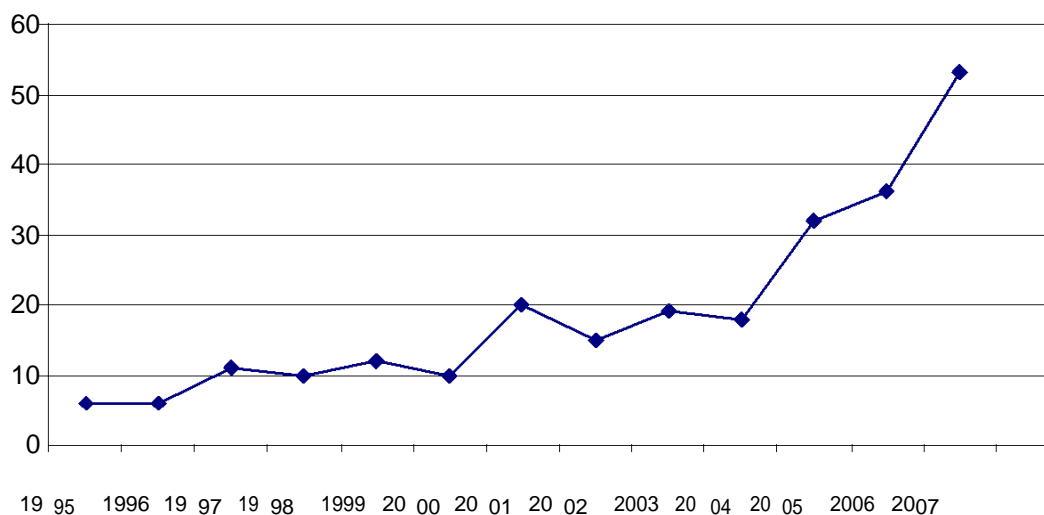


Figure 1. Trend of FDI inflows in US\$ (1995-2007). Source: UNCTAD (2008).

the host country. This review is important because understanding the linkage between FDI and economic growth may be the key to uncovering channels through which FDI stimulates economic performance and consequently, to identify the policy levers that may be activated to maximize both FDI inflows and the gains from FDI.

The rest of the paper is organized as follows, section two gives an overview of FDI inflows in SSA and section three gives a brief discussion of the theoretical and empirical studies on the FDI-growth relationship. Finally, we give policy implications per the findings of the study reviewed, directions for future research and concluding remarks.

Overview of FDI inflows in SSA

FDI inflows to the various regions of the world have grown dramatically in the past 2 decades. The total world FDI inflows, which stood at \$59 billion in 1982, grew dramatically to \$648 billion in 2004 and reached its peak of \$1,833 billion in 2007 (UNCTAD, 2008). In Africa, FDI inflows amounted to \$36 billion in 2006, which was 20% higher than the previous record of \$30 billion in 2005 and twice the 2004 value of \$18 billion and rose to a historic value of \$53 billion in 2007 (UNCTAD, 2008) (Figure 1). The surge was in a large part related to investments in extractive industries, though it rose in various service sectors too.

Despite, the increase in FDI to Africa, this is still less than 3% of global FDI inflows, the African share in global inflows fell from 3.1% to 2.7% and 2.9% in 2005 and 2007 respectively. It is interesting to note, however, that the rate of return on FDI in Africa has been rising since 2000 and it is currently at about 12%, which is the highest in the developing world (Figure 2).

The UNCTAD (2007) report also shows that there was

a shift in the source of FDI, with Asian countries (especially China and India) playing a more active role in the economy of African countries through both Greenfield investments and cross border acquisitions. Of the nearly 442 greenfield investments, 175 were from Asia, 258 from developed economies and less than 10 were from within Africa. The UNCTAD (2005) report shows that most FDI from within Africa comes from South Africa.

4 countries, France, The Netherlands, United Kingdom and US are known to account for about half of the FDI inflows to Africa and half of this goes to Angola, Equatorial Guinea, Nigeria, Sudan and Egypt. On average, since the beginning of 2000, Nigeria remains the largest recipient of FDI to SSA accounting for 16% of the region's stock. By the end of 2007, Africa's total FDI stock stood at \$393 billion, which is an insignificant amount when compared to the \$249 billion FDI that went to South, East, South East and Oceania for only one year (2007).

Sectorally, there was a surge of FDI flows to Africa in the primary sector, mainly oil and gas. In addition, the services sector particularly, transport, storage and communications continued to attract FDI in 2006, however, it grew at a lower rate than the primary sector. Inflows into the manufacturing sector continued to grow at a slower rate in Africa as a whole, but in SSA, no significant manufacturing FDI took place. 2 main issues arise with regard to recent trends of FDI to Africa. First, even though the volume of FDI to Africa has increased substantially since the 1990s, Africa remains largely marginalized in the context of financial globalization. Second, most FDI to Africa is concentrated in the primary sector.

Theoretical literature

There are many models and theories that have been used to explain the effect of FDI on economic growth.

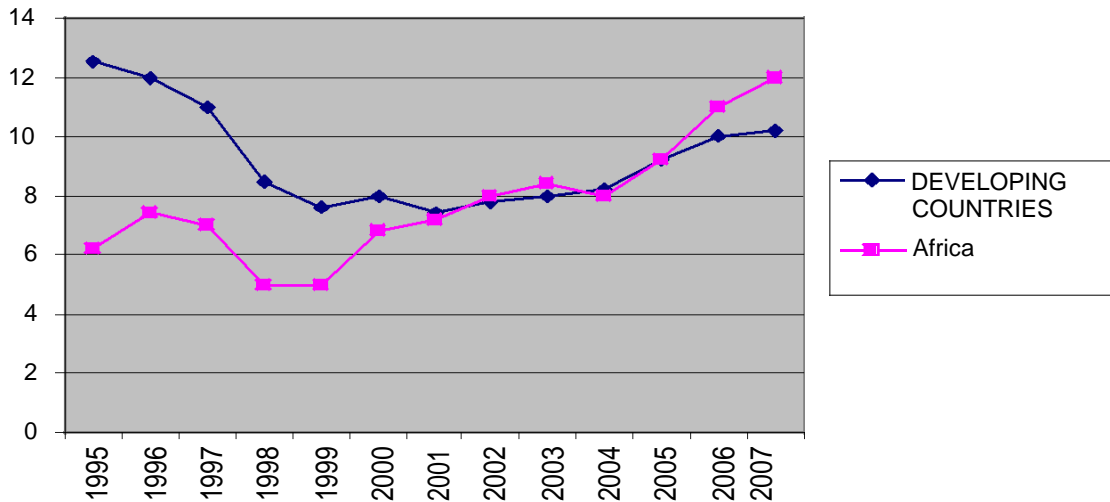


Figure 2. Rate of Return on Foreign Investment (%). Source: UNCTAD (2008).

In this paper, however, we discuss two main perspectives, the development and world systems theory. The development thesis show many ways in which FDI could contribute to the growth in the real income of the host country. First, there is the release from the binding constraint of domestic savings through foreign capital inflow. In this case, FDI augments low domestic savings in the process of capital accumulation. In such situations, FDI serves to stimulate domestic investment and the total investment in the country is enhanced (Ajayi, 2006). Second, FDI produces externalities in the form of technology transfer and spillovers (Carkovic and Levine, 2002). Obviously, by bringing new knowledge and investments in physical infrastructure like roads and factories, foreign investors may help to reduce what Romer (1993) referred to as “idea gaps” and object gaps” between developed and developing countries. From this perspective, FDI may boost the productivity of all firms and not just those receiving FDI. In addition, FDI can improve overall growth by promoting competition in the domestic input market and hence force local firms to become more productive by adopting more efficient methods. Also, the global mobility of capital may limit the ability of governments to pursue bad policies. In summary, FDI may affect economic growth in two main ways, augmentation of domestic investment (adds to the capital stock) and efficiency effects (transfer of technology, marketing and managerial skills).

However, other studies suggest that FDI does not have an independent effect on economic growth. Its effect is dependent on the initial country conditions that allows it to exploit FDI spillovers (Carkovic and Levine, 2002, Lumbila, 2005; Trevino and Upadhyaya, 2003). Trevino and Upadhyaya (2003) find that FDI is more likely to have a positive effect on economic growth in more open economies and Alfaro et al. (2004) argue that the growth enhancing effect of FDI is only possible in countries with developed financial systems. On the other hand, depen-

dependency theorists argue that dependence on foreign investment is expected to have a negative effect on economic growth and the distribution of income. Bornschier and Chase-Dunn (1985) claim that foreign investment creates an industrial structure in which monopoly is predominant leading to what Ajayi (2006) refers to as an enclave economy in which local investors are excluded. As a result, countries that are wholly dependent on FDI will experience stagnation, unemployment and increasing inequality. This is consistent with Rhagavan’s (2000) argument that FDI may have a negative effect on growth, particularly if the inflow of FDI leads to increased monopolization of local industries.

The UNCTAD report (2007) indicates the negative effect of FDI in Africa derives primarily from lack of competition and a distorted regulatory and incentive framework. Tandon (2002) has argued that MNEs are in business to make profit and not for development. Accordingly, dependency theory predicts that FDI inflows may slow growth and produce greater levels of income inequality. The theoretical discussion is therefore not conclusive as to the effect of FDI, however, what is clear is that FDI has both costs and benefits and that FDI is necessary but not a sufficient condition for economic growth.

Empirical literature

The FDI growth empirical literature like the theoretical literature gives ambiguous findings. While Andreas (2006), Ndikumana and Verick (2008) and Lumbila C2005) find that FDI has a positive significant effect on economic growth, others suggest either a nonsignificant or a negative effect of FDI on economic growth (Lougani and Razin 2003; Akinlo, 2004; Ayanwale, 2007; De Mello, 1999). It must be mentioned that many studies have been carried out at the firm, industry and country levels, but in this study, we focus on developing country level studies.

Lumbila (2005) used a panel analysis to study the impact of FDI on economic growth in 47 African countries between 1980 and 2000 and found that FDI exerts a significant positive effect on economic growth. Similarly, Andreas (2006) employed both cross section and panel data on a dataset of 90 countries during the period 1980 - 2002 and report that FDI inflows enhance economic growth in developing countries. In contrast to the studies that find a positive effect of FDI on economic growth, Akinlo (2004) reported that the effect of FDI on the Nigerian economy was not significant, which was supported by a recent study by Ayanwale (2007). Likewise, De Mello (1999) found that FDI had a negative growth effect in non-OECD countries, which he claimed might be due to the fact that FDI reduces total factor productivity growth.

Sectorally, Alfaro (2003) used cross-country data for the period 1981 to 1999 and examined the impact of FDI on growth in the primary, manufacturing and services sectors and showed that the benefits of FDI vary greatly across sectors. FDI in the primary sector tended to have a negative effect on growth, the relationship was positive for the manufacturing sector and ambiguous in the service sector. Equally, Habiyaemye and Ziesemer (2006) in a study of SSA countries found that the overall level of capital investment does not seem to significantly affect economic growth because most of the capital was in the primary sector. From the review of the studies above, two main points can be made. First, FDI can contribute to economic development of host country in two main ways, augmentation of domestic capital and enhancement of efficiency through the transfer of new technology. Second, FDI has both benefits and costs and its impact is determined by the country specific conditions in general and the policy environment in particular in terms of the ability to diversify, the level of absorption capacity, targeting of FDI and opportunities for linkages between FDI and domestic investment (Figure 3). These four factors or barriers, which need to be overcome for a growth enhancing effect of FDI are discussed next.

Policy implications and Conclusions

The review shows that SSA countries have been able to increase the inflow of FDI to the region in recent times; however, the increase has not led to a corresponding positive effect of FDI on economic development. The results of the various studies reviewed provide four main implications in terms of diversification, enhancing the absorptive capacity of local firms, providing opportunities for linkages between domestic and foreign investors and a targeted approach to FDI. These four factors or barriers and how they impact on economic development as shown in Figure 3 are discussed briefly below.

Diversification from primary to manufacturing and services has been touted as one of the major strategies to spur development in Africa where the largest increase in FDI is in new oil exploration and mining activities (UNCTAD, 2007, 2008). Further, spillover effects in mine-

ral extraction is minimal as the technology employed is capital rather than labor intensive. This means that the effect of FDI in Africa to date has been dependent on what the revenues are used for. However, the high levels of governmental corruption in most of the region might limit the positive effect of FDI on economic growth. A solution to this problem according to the UNCTAD report (2007) is to attract FDI into diversified and higher value-added activities. In this regard, one important policy objective should be to reduce the barriers to FDI effectiveness is to build a diversified economy through investment in human capital and infrastructure and productive capacity. Clearly then, the challenge for Africa is how to attract FDI in more dynamic products and sectors with high income elasticity of demand.

The issue of building the human capital and infrastructure is not only important in diversification, but also in being able to make use of the FDI by building absorptive capacity (AC) of the host country. By absorptive capacity, we mean the ability to acquire, internalize, and utilize knowledge developed elsewhere (Habiyaemye and Ziesemer, 2006). Ayanwale (2007), for example, has noted that the low level of education explains the lack of significant impact of FDI on economic growth in Nigeria. The need to build the AC suggests that government policy must promote FDI that augments domestic capacity or investment. It is important to note that even in China and other Asian countries where FDI has been known to be more effective, Keshava (2008) has shown that domestic investment is more effective than FDI in promoting growth. It is of interest to note that the most important recipient of FDI in SSA in the 1990s in terms of GDP (22%) was Lesotho, but economic growth decelerated over the same period. More importantly, FDI flows to Botswana declined but the economy continued to grow (Ajayi, 2006). This is not to suggest that FDI is not needed in the SSA region, but rather that FDI's growth enhancing effect is possible only when it stimulates domestic capacity of the host country's citizens (Carkovic and Levine, 2005; De Mello, 1999; Ndikumana and Verick, 2008). Likewise, Pigato (2000) suggests that in most African countries the capability structures that enhance investment efficiency are those that provide high quality skills, a supplier network that permits specialization and competitive costs, and a suitable physical, scientific, and institutional infrastructure.

Finally, the ability of government to promote policies that enhance the domestic capacity of its citizens suggest that government must target or aim at attracting specific types of FDI that are able to generate spillover effects in the overall economy. Here, the focus must be to employ promotional resources to attract a subset of FDI flows rather than FDI in general. Mwilima (2003) claims that FDI has been more productive in Asia (especially China, Taiwan, and South Korea) than other developing countries because of the targeted approach, which involved screening of investment applications and granting differential incentives to different firms and even prohibited

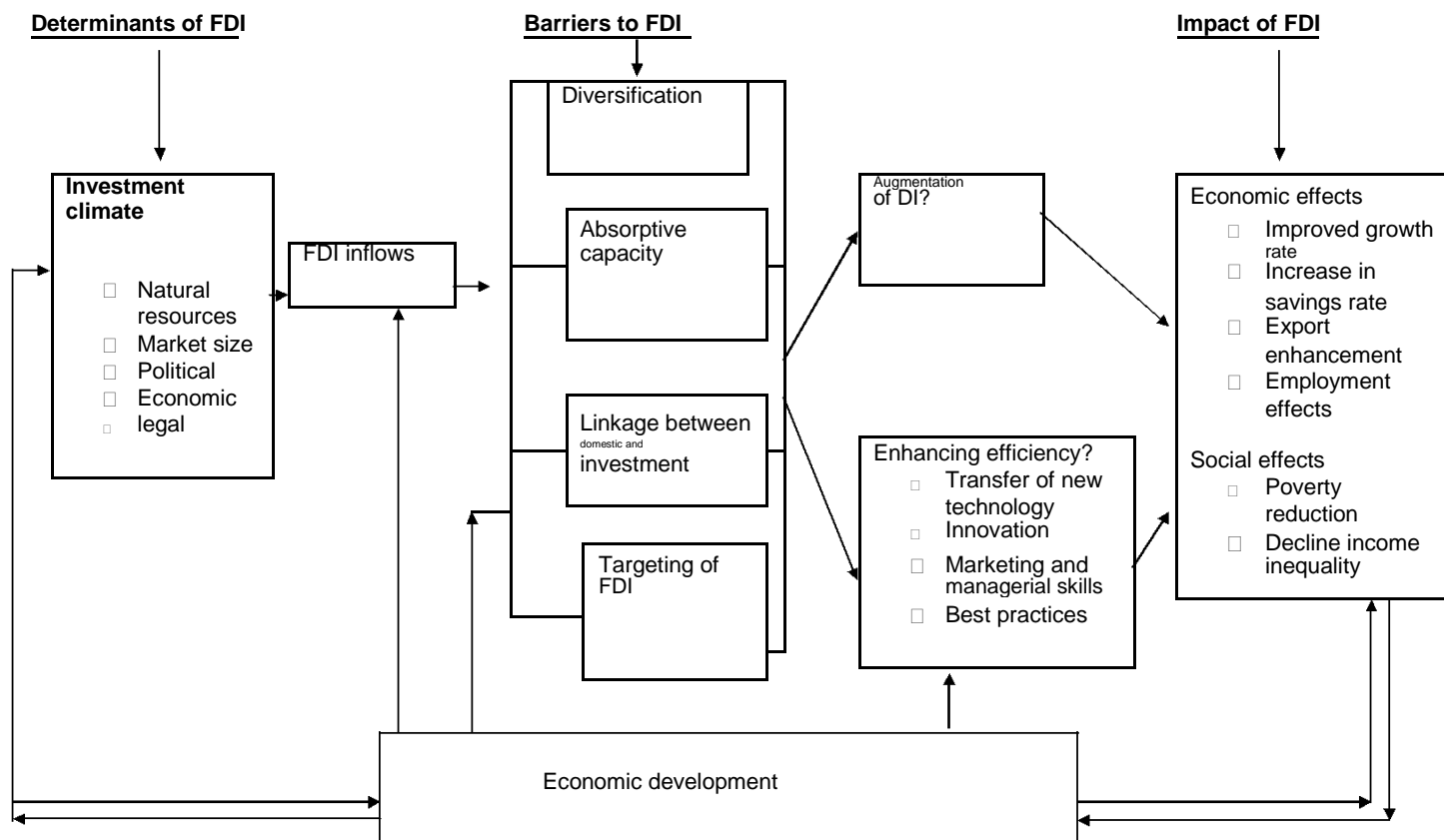


Figure 3. Determinants and impact of FDI on economic growth.

some types of investment. The focus should be on quality FDI, the type of FDI that will significantly boost domestic competitiveness, enhance skills, and invariably leading to both social and economic gains (Figure 3).

Accordingly, we conclude by reiterating the fact that what ever the benefits of FDI, the development process must start from within, through a strong investment in human capital accumulation and a significant increase in infrastructure provision so that a strong basis for a diversified production system can be established; a means to promote technological learning and technology diffusion. Future studies should focus more on empirical studies from a bottom up perspective (country specific studies) as opposed to the many global studies (cross country studies) that have been done on the topic. And even more important, which type of FDI is to be attracted and into which sectors need to be promoted.

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