Summary

INVESTMENT AND INNOVATION POLICY REVIEW

ETHIOPIA

1 February 2001

The peace agreement of December 2000 between Ethiopia and Eritrea, which effectively ended the two year conflict between the two neighboring countries, has brought renewed hope that Ethiopia will regain the economic growth momentum that it experienced in the post-1992 liberalization period. Key ingredients for renewed growth are increased investment, both domestic and foreign, improved physical infrastructure, the generation of relevant skills and the development of competitive enterprises through local technological and innovative capacity building.

Domestic investment in Ethiopia has increased rapidly since the introduction of liberal policies in 1992. However, the gap between domestic investment and savings has remained large, thus reinforcing the need for foreign direct investment (FDI) in the development of the economy. Between 1990 and 1997, gross domestic investment as a proportion of GDP rose from 11.9 per cent to 19.1 per cent, while gross domestic savings remained at the same rate. A large part of the increase in investment has come from the private sector whose share increased from 2.5 per cent to 13.1 per cent. Public sector investment increased only marginally, from 6.4 per cent to 7.4 per cent. It would appear, therefore, that if a high level of private investment is to be maintained, concerted efforts should be made to promote domestic savings. At the moment, the savings gap in Ethiopia is met through investments generated from foreign sources, more specifically, bilateral and multilateral development assistance and direct investment.

The Review shows that, although Ethiopia's investment climate has improved greatly in recent years, there are still many aspects of investment policy where improvements are urgently needed. More importantly, Ethiopia does not yet have an FDI promotion strategy nor does it have a clear vision of where it fits in the global investment strategies of transnational corporations (TNCs). Investment policy in Ethiopia currently consists of broad statements of development objectives and an investment code that elaborates the investment framework and the sectoral activities identified by the Government as priority areas. Therefore, the need to develop an investment promotion strategy and a vision of the country's investment objectives and expectations is urgent.

While the focus of the Review is on investment policy, it also gives a special attention, at the request of the Government of Ethiopia, to local technological development and the process of innovation and their implications for investment and competitiveness. The report introduces a broader perspective of the innovation process – one that contrasts with the traditional understanding of innovation as an isolated activity carried out in specialized R&D centres often at a high cost. Although such activities or "inventions" are vital for advancing the frontiers of technology, they do not accurately reflect the reality of innovative process in the current highly competitive environment. Nowadays, innovative activities are aimed at maintaining competitive advantages and tend to be continuous, incremental and take place predominantly at the enterprise level. With liberalization and increasing knowledge-intensity of production, the ability to learn, innovate and adapt to changing market conditions as well as factors such as product quality, flexibility and continuous interactions with customers and suppliers are becoming critical elements for the survival of enterprises both in their home market and abroad. Moreover, these requirements are not confined to high-tech industries or developed countries only but also affect developing countries including the least developed among them. Consequently, policies and strategies designed to attract FDI must be viewed as an integral part of a strategy to build local enterprises and national technological and innovative capability. This principle is the basic approach guiding the investment policy review in Ethiopia.

The Review is structured as follows. Chapter I briefly examines the recent policy changes in Ethiopia and the factors that determine its potential as an attractive location for FDI. Ethiopia is the second most populous country in Africa, endowed with many resources, has an important geographic position -- in short, it is a potentially attractive location for foreign investment. Chapter II reviews the investment policy of Ethiopia and the recent trends in FDI flows, the sectoral and regional distribution and the institutional arrangements for attracting foreign investment. It shows that the liberalization measures undertaken in the post-1992 period have encouraged foreign investment flows into the country. Yet the quantity of FDI that the country received was small compared to other countries in the region, and to Ethiopia's potential. Inflows for 1994-1997, a period of rapid economic growth and private sector development, were merely 0.2 per cent of total FDI flows to sub-Saharan Africa, 5.3 per cent of inflows into Uganda, and 5.4 per cent of those into Tanzania.

At the request of the Government of Ethiopia, the Review has also dealt with selected sectors. Chapter III reviews the country's strategy for agricultural development, more specifically the potential for improving productivity and attracting investment into the sector through technological changes and innovation. Case studies are used to analyze linkages with industry. Indeed, since 1992, the Government of Ethiopia has identified Agricultural-Led Industrial Development (ALID) as the main locus of its overall national development strategy.

Chapter IV evaluates opportunities for investment and innovation in one of the branches of the agro-business sector in which Ethiopia has comparative advantage namely, the leather and leather products industry. The value chains in the production of leather-related goods, the strengths and weaknesses of the leather goods production system in Ethiopia and the policies and institutions supporting the sub-sector are analyzed.

In Chapter V, the potential for enhancing investment and innovation among SMEs in Ethiopia is examined. SMEs make up the largest and the most important segment of industrial sector in Ethiopia.

Finally, Chapter VI presents conclusions and policy recommendations, including those directly relevant to FDI. It emphasizes the need for vision, coupled with a realistic view of the changing global investment climate. The tasks involved include:

- Mapping out the core competencies and assessing the strengths and weaknesses of the economy and the growth opportunities available at the national, local and firm levels;

- Identifying sectors or clusters of activities where competitive advantages already exist and where new ones can be developed; and

- Formulating policies and incentive schemes that target sectors or activities identified as priority investment areas and foster linkages between FDI and local enterprise.

With respect to policy analysis, the Review points out the need to improve business skills at all professional levels, especially within the civil service. The main objective should be to improve the creative energies in the enterprise sector as a whole and to lay the foundations for long-term sustainable development.

The Review also notes the need for Ethiopia's policy analysts to think beyond a specific sector or activity and to relate their policies to the wider national system. In the case of the leather industry, for example, its effective development as a competitive and innovative sector and its attractiveness to FDI will depend on policy intervention at all levels of the value chain, to enhance linkages between producers and supporting institutions.

On investment policy and promotion, the Review recommends that a single agency should have the overall responsibility for investment promotion activities and international negotiations in Ethiopia. Currently, there are public sector agencies that undertake international investment promotion in an ad hoc manner. This could give misleading signals to potential investors. At the present juncture, the Ethiopian Investment Agency (EIA) is the ideal candidate to take overall responsibility for investment promotion and coordinate promotional activities of other agencies. But the EIA must be strengthened and managed as an effective one-stop-shop and single entry point for FDI into Ethiopia, including new projects by existing investors.

The Review recognizes the importance of building a stronger partnership between EIA and foreign investors present in the country. It therefore recommends the establishment of a small International Investment Advisory Council comprising senior executives of private sector international companies operating in Ethiopia. Such a body would advise both the EIA and the Government on investment promotion policies and activities and would provide a contact point for potential investors seeking a private sector perspective on investment opportunities in Ethiopia.