United Nations TD/B/EX(57)/3

United Nations Conference on Trade and Development

Distr.: General
17 April 2013

Original: English

Trade and Development Board
Fifty-seventh executive session
26–28 June 2013
Item 2 of the provisional agenda
Activities undertaken by UNCTAD in support of Africa

Strengthening linkages between domestic and foreign direct investment in Africa

Note by the UNCTAD secretariat

Executive summary

Investment is an important driver of growth in both developed and developing countries. There has been a significant increase in domestic investment in Africa over the past two decades. However, despite consistent growth and international support through overseas development assistance (ODA), most countries on the continent still see a wide gap between investment requirements and domestic resource availability. Foreign direct investment (FDI) can play an important role in bridging this gap. But Africa accounts for a very low share of global FDI flows (2.8 per cent) and, more importantly, FDI flows to the continent are concentrated in a few countries and largely in the extractive sector. The latter has reinforced Africa’s dependence on commodity exports and the vulnerability of African countries to external demand and speculation-driven commodity price movements. Moreover, to date, there is no evidence to indicate that FDI in Africa is contributing to economic diversification through backward and forward linkages. Under such circumstances, the tendency of FDI to reinforce enclave-type development – with external integration gaining more importance over the internal integration of the local economy – is a real concern. Against this background, this note questions the automatic efficiency gain assumptions implicit in the design of FDI policies in many African countries. It is misleading to assume that attracting FDI per se will automatically generate opportunities for technology transfer, linkages with domestic enterprises and opportunities for diversification into more dynamic activities. Experience from successful countries show that the contribution of FDI to host country development tends to be greater in countries where the domestic enterprise sector is dynamic and well developed. In this respect, therefore, FDI is a lag rather than a leading variable in the development process. As a result, policies towards FDI should be designed as a complementary component of a wider and more integrated development strategy needed to raise growth, create jobs, build productive capacity and foster a dynamic and vibrant domestic private sector.

Introduction

1. Domestic investment is both a driver and an engine of growth in developed and developing countries. It is necessary to sustain growth, create employment and lay the foundation for poverty reduction. Over the past decade there has been a rapid increase in Africa's needs for resources to finance the development of infrastructure and productive capacity, but domestic investment has not grown fast enough to match these needs. As a result, there is a wide and growing gap between Africa's investment requirements and domestic resource availability. The decision made by African leaders, during the Summit of the African Union in January 2012, to fast-track the establishment of a continental free trade area with a view to boosting intra-African trade has also made the need for more domestic investment not only urgent but imperative. An expansion of intra-African trade requires investments in infrastructure and in building productive capacity for trade. Therefore, if African governments wish to enhance the likelihood of achieving the objective of boosting intra-African trade, they have to intensify efforts to increase domestic investment.

2. FDI can play a supportive role in closing Africa's financing gap. Indeed, in the face of inadequate domestic investment to finance long-term development in Africa, attracting FDI has assumed a prominent place in the strategies of many countries in the continent. In addition, the experience of some fast-growing East Asian economies has strengthened the belief that attracting FDI is key to bridging the resource gap of low-income countries and avoiding further build-up of debt while directly tackling the causes of poverty.

3. The benefits expected from attracting and hosting FDI hinge on a number of implicit assumptions. The first is that FDI has the potential to contribute to growth through complementing domestic investment as well as transfer of skills, management expertise and technology. In this scenario, the activities of foreign enterprises are expected to generate spillover to the local economy through competition, imitation, labour turnover and vertical linkages. The second assumption is that additions to capital stock from attracting FDI will be tied down in production activities with investments in new plants and equipment, thereby forcing the foreign investor into long-term commitments and giving policymakers some degree of reciprocal bargaining power once such investments are in place. Another assumption is that FDI will crowd in domestic investment and that, therefore, attracting FDI is an effective policy tool for stimulating local investment.

4. There is no conclusive evidence to support that these underlying assumptions apply in the case of African countries. The linkages observed tend to be limited and present only in isolated cases. UNCTAD studies also show that most new FDI going to African countries in recent years has been attracted through opportunities in extractive industries, the services sector and mergers and acquisitions, rather than through greenfield investments. Furthermore, the decline in FDI flows into Africa in the wake of the global financial and economic crisis also suggests that FDI tends to follow growth and has a tendency to be footloose when economies begin to face difficulties.

5. Nevertheless, because of their need to narrow the financing gap, most countries in Africa continue to intensify their efforts to attract more FDI. But Africa currently attracts a relatively small share of global FDI and, more importantly, most FDI that goes to the continent is concentrated in a few countries, primarily the large and resource-rich economies (Anyanwu, 2012). Recent data indicate that Africa currently accounts for about 6 per cent of total FDI flows to developing countries (UNCTAD, 2013). Therefore, even when compared with other developing countries, Africa remains a marginal player in attracting global FDI. The attraction of Africa's natural resources accounts for the bulk of

FDI flows and for the uneven distribution of FDI in the continent. This fact also explains why, despite impressive growth trends, African countries have not made very effective use of FDI to support development, as evidenced by the fact that FDI has generated few linkages in African economies, and has not led to significant technology transfer as expected. One of the reasons for the low share in global FDI flows for Africa and the limited impact of FDI in the continent is the approach adopted by African countries in seeking and promoting FDI, which focuses more on providing generous incentives and less on creating a domestic environment conducive to entrepreneurship and business in general. The experience of the past few decades has shown that the most effective way to attract market-seeking or efficiency-seeking FDI is to have a dynamic and growing private sector and a policy environment attractive to both domestic and foreign investors. There is, therefore, a need for African countries to rethink their investment promotion strategy to ensure that it yields maximum benefits to the continent.

6. Against this backdrop, this note would argue that FDI is a complement to domestic investment rather than a substitute for it, and efforts to attract foreign investment, therefore, must not overshadow those aimed at boosting domestic investment through public sector interventions and higher domestic savings. Indeed, the primary objective of Governments should be to develop a vibrant and growing domestic enterprise sector supported by domestic investment. In the long-term, this process by itself is the best strategy for attracting FDI, as foreign investment tends to be strongly attracted to countries that have achieved sustained rates of economic growth and where the domestic private sector is sophisticated and large enough to supply quality products and become an effective partner to foreign enterprises.

7. The remainder of the note is organized into four chapters. Chapter II highlights recent trends in domestic and foreign direct investment flows to Africa. Chapter III identifies the mechanisms through which domestic investment can catalyse FDI flows and provides empirical evidence on this relationship based on results from surveys of African countries. Chapter IV discusses some measures required to create or strengthen linkages between domestic investment and FDI, while chapter V highlights issues for discussion.

I. Trends in domestic and foreign direct investment to Africa

8. Over the past decade there has been a significant increase in domestic investment in Africa both in monetary terms and as a percentage of gross domestic product (GDP) (table 1). In 2010 domestic investment in Africa was about $353 billion compared to $100 billion in 2000. Furthermore, the share of domestic investment in GDP rose from about 17 per cent in 2000 to 21 per cent in 2010. While the increase in domestic investment in Africa is significant, it is worth noting that the share of investment in GDP in Africa is well below the investment share of other developing regions, in particular developing countries in Asia, where the share was about 35 per cent in 2010. In this regard, there is a need for African countries to increase their investment ratios to the levels observed in rapidly growing emerging developing countries to enhance prospects for sustained economic growth.

Table 1
Gross fixed capital formation across selected groups

Economy	*Measure*	*1970*	*1980*	*2000*	*2007*	*2010*
Africa	in billion $	17.7	110.6	100	261.9	353.2
	% of GDP	19.43	25.47	16.67	19.58	20.65
Developing countries	in billion $	37.2	190.1	397.4	757.2	983.4

Economy	*Measure*	*1970*	*1980*	*2000*	*2007*	*2010*
in America						
	% of GDP	21.41	25.12	18.63	20.14	19.64
Developing countries in Asia	in billion $	55.8	336.2	1 135.3	3 040	4 773.8
	% of GDP	19.35	24.53	26.52	30.55	34.64

Source: UNCTAD database.

9. With regard to trends in FDI inflows, in 2011 Africa received $42.7 billion representing 2.8 per cent of global FDI inflows and 2.3 per cent of Africa's gross domestic product (UNCTAD, 2012a). Africa's share of FDI flows to developing countries fell from 9 per cent in 2008 to 6 per cent in 2011. Table 2 shows that the amount of FDI inflows to Africa in 2011 represents a major decline compared to the 2008 figure of $57.8 billion. In fact since the onset of the global economic and financial in 2008, FDI inflows to Africa have been on the decline (UNCTAD, 2012a). However, when FDI flows are disaggregated by subregion, important differences emerge between North Africa and sub-Saharan Africa in terms of recent trends in FDI inflows. For example, while FDI inflows into North Africa declined significantly in 2011 because of political instability in Egypt and Libya, inflows into sub-Saharan Africa actually increased from $29 billion in 2010 to $37 billion in 2011. Nevertheless, the increase in inflows into sub-Saharan Africa was not enough to offset the decline in inflows to North Africa resulting in a decrease in inflows into Africa.

10. One of the stylized facts associated with FDI flows to Africa is that they are highly concentrated in a few countries, mostly resource-rich or large African countries, while smaller and resource-poor countries have been largely unable to attract significant FDI inflows. For example, three countries (Algeria, Nigeria and South Africa) accounted for about 41 per cent of FDI flows to Africa in 2011. In this context, one of the challenges facing African countries is how to reduce the geographic and the sectoral concentration of FDI flows in order to maximize the developmental impact of FDI. Although FDI flows to Africa go mostly to the extractive sector, there are indications that a sectoral shift is occurring particularly into services. In fact, data on greenfield projects over the past three years indicate that the relative importance of the primary sector is declining (UNCTAD, 2012a).

Table 2
Inward foreign direct investment flows across selected groups

Year	*Measure*	*World*	*Developing economies*	*Africa*
1980	in billion $	54.1	7.5	0.4
	% of global FDI	100.00	13.83	0.74
	% of GDP	0.46	0.29	0.09
1990	in billion $	207.5	34.9	2.8
	% of global FDI	100.00	16.80	1.37
	% of GDP	0.93	0.89	0.57
2008	in billion $	1 790.7	650	57.8
	% of global FDI	100.00	36.30	3.23
	% of GDP	2.92	3.70	3.68
2011	in billion $	1 524.4	684.4	42.7

Year	Measure	World	Developing economies	Africa
	% of global FDI	100.00	44.90	2.80
	% of GDP	2.19	2.87	2.26

Source: UNCTAD database.

II. The link between domestic investment and foreign direct investment

11. The approach that most African countries have adopted in seeking and promoting FDI over the past decades stems in part from the assumption that FDI will crowd in or stimulate domestic investment in a host country (Al-Sadig, 2013; Mileva, 2008; Bosworth and Collins, 1999). While there are valid theoretical grounds for this view, it ignores recent research findings indicating that domestic investment in itself is an important determinant of FDI flows. In other words, the relationship between domestic investment and FDI is in general bidirectional (Lautier and Moreaub, 2012).

12. There are several reasons why domestic investment can catalyse FDI flows in developing countries. Domestic investors tend to have better knowledge of the investment climate and so their action is a signal to foreign investors on the state of the economy. Consequently, in an environment where there is information asymmetry between domestic and foreign investors, domestic investment will drive foreign investment. Another reason why domestic investment could affect foreign investment is that factors that stimulate domestic investment also affect FDI. For example, public investments in infrastructure lower transaction costs and increase the return on private investment as well as FDI. The two-way relationship between FDI and domestic investment has different implications for investment promotion. If domestic investment is a driver of FDI, then the best way to attract FDI is to give priority to the promotion of domestic investment rather than offering special and generous incentives to foreign investors. This, of course, is not to suggest that incentives should not be given at all for FDI. On the contrary, there are some investments that African countries cannot undertake without the involvement of FDI. Therefore, providing incentives and building institutions to attract targeted FDI is an essential component of a national investment policy and strategy. However, a policy approach that focuses on providing special incentives and support to FDI in the hope that it drives domestic investment is erroneous.

13. Several empirical studies have been conducted on the relationship between domestic investment and FDI using evidence from African countries. For example, Ndikumana and Verick (2008) examined the nexus between FDI and domestic investment in Africa and have found evidence of a two-way relationship between both variables. Their empirical results indicate that domestic investment stimulates FDI, although there is also evidence that FDI has a positive effect on domestic investment. Nevertheless, with the exception of resource-rich countries where FDI tends to be attracted regardless of the state of domestic investment, the evidence shows that FDI flows tend to be steady and their sectoral spread more even in countries where domestic investment and the enterprise sector are growing fast. These findings suggest that the tendency observed in Africa, where the focus of investment policy is on offering generous incentives to attract FDI, needs rethinking. Policies should also pay more attention to promoting domestic investment as an important channel for stimulating FDI.

14. Evidence based on investment survey data has also yielded some striking findings on the FDI-domestic investment nexus. For example, the United Nations Industrial Development Organization (UNIDO; 2011) provides evidence indicating that while

transnational corporations in Africa have a negative effect on domestic firms operating in a given sector, they do have a positive impact on growth and productivity of domestic firms in other sectors. The fact that FDI can have both positive and negative effects in a host economy implies that reaping the benefits is not automatic. Furthermore, the impact will vary across countries and will depend largely on the structure of the host economy, its level of development and the nature of domestic economic policies (UNCTAD, 2005). Therefore, as African countries ratchet up efforts to attract FDI they have to find ways to maximize the benefits and minimize the risks. Creating a domestic environment conducive to domestic investment and private sector development is one way to attract FDI while limiting some of its risks.

III. Policy options for strengthening linkages between domestic investment and foreign direct investment

15. It is evident that recent export expansion from Africa was due to a large extent to increased foreign investment in the extractive sector, tourism and other export-oriented activities. In this context, the external integration of African economies through FDI has advanced much further and faster than internal integration, hence the slow progress in structural transformation and development of productive capacities. In fact, as the UNCTAD *Economic Development in Africa Report 2012*, subtitled *"Structural Transformation and Sustainable Development in Africa"* shows, the rapid increase in commodity exports from Africa during the 2000s was accompanied by a reversal of progress made during the 1980s and 1990s towards the production and export of manufactured products. The share of manufacturing in Africa's GDP fell from 15 per cent in 1990 to 10 per cent in 2008 (UNCTAD and UNIDO, 2011). The most significant decline was observed in Western Africa, where it fell from 13 to 5 per cent over the same period. Substantial deindustrialization was also observed in the other subregions of Africa. For example, in Eastern Africa the share of manufacturing in output fell from 13 per cent in 1990 to about 10 per cent in 2008, and in Central Africa it fell from 11 to 6 per cent over the same period. In Northern Africa it fell from about 13 to 11 per cent, and in Southern Africa it fell from 23 to 18 per cent (UNCTAD and UNIDO, 2011). The declining share of manufacturing in Africa's output is of concern because historically manufacturing has been the main engine of high, rapid and sustained economic growth (UNCTAD and UNIDO, 2011). Furthermore, manufacturing is critical for absorbing the millions of young Africans who will be joining the labour market in the coming years. Already, 40 per cent of Africa's population resides in urban areas, and this number is projected to rise to about 60 per cent by 2050. Taking these considerations on board means rethinking the investment policy approach and moving the policy debate on investment away from the singular focus on FDI attraction towards a more balanced, pragmatic and strategic perspective on how FDI can fit into the development agenda in ways that bring about not only faster and sustained growth but also stimulate domestic investment and links with domestic enterprises to promote structural and technological change.

16. There are several policy measures that African countries need to adopt to create and strengthen linkages between domestic investment and FDI. For example, they need to promote entrepreneurship in order to boost domestic investment and also create more dynamic enterprises that can meet the requirements of highly competitive domestic and international markets. This will send a positive signal to foreign investors about the state of the economy. As noted above, boosting the domestic private sector has become particularly important in the light of recent evidence that domestic investment stimulates FDI in Africa. The provision of economic incentives to domestic firms, sharing of market information, provision of business services, infrastructure development, maintaining of peace and security, reduction of policy uncertainty, better access to finance and reduction of trade

costs are some examples of areas where policy action is needed to promote entrepreneurship in Africa. UNCTAD provides a policy framework and implementation guidelines for promoting entrepreneurship in developing countries and economies in transition (see UNCTAD, 2012b).

17. The promotion of joint ventures between domestic and foreign investors will also enhance technology and skill transfer and strengthen the impact of FDI in the domestic economy. Recent investment surveys of African countries indicate that foreign joint ventures are larger, employ more workers in the host economy and are more productive than wholly-owned foreign firms (UNIDO, 2011). Therefore the promotion of joint ventures will yield mutually beneficial outcomes to both foreign investors and the host economy, and should be encouraged and supported.

18. African governments can also use targeted economic incentives and policies to encourage foreign investors to source inputs locally, thereby enhancing linkages between domestic and foreign investment. UNCTAD has initiated two programmes which are specifically aimed at promoting linkages between foreign and domestic firms in selected developing countries, including in Africa, and creating the potential for domestic enterprises to participate in global value chains. The first of these initiatives is the UNCTAD *Entrepreneurship Policy Framework and Implementation Guidance*. The Framework includes six clearly defined actions that Governments should undertake in order to develop entrepreneurship and create dynamic local enterprises. These actions are: (a) formulating entrepreneurship strategies, (b) optimizing the regulatory environment, (c) enhancing entrepreneurship education and skill development, (d) facilitating technology exchanges and innovation, (e) improving access to finance and (f) promoting networking and awareness. The Framework aims at supporting policymakers in the design of policies, targeted measures and institutions to promote entrepreneurship. While cautioning that one size does not fit all, it suggests policy options and actions in priority areas that have a direct impact on the development of entrepreneurial capacity. The Framework also features a user guide, a step-by-step approach to developing entrepreneurship policy and a set of indicators to measure progress.

19. The second initiative is the Business Linkages Programme, which is implemented as part of UNCTAD’s Empretec network to promote entrepreneurship and small and medium-sized enterprise upgrading. It has been operational since 2005 and its primary objectives are to identify policy measures that Governments need to introduce in order to encourage business linkages; assess the needs of foreign enterprises in terms of inputs and the potential for local sourcing; assist small and medium-sized enterprises to become “partnership ready” (through the Empretec programme); and make the programme sustainable through empowering national partner institutions. The Business Linkages Programme has expanded to nine countries: Argentina, Brazil, the Dominican Republic, Mozambique, Peru, Uganda, the United Republic of Tanzania, Viet Nam and Zambia. Current business linkages projects include several sectors, e.g. the automotive industry, agribusiness, mining, telecommunications and tourism.

IV. Conclusion and issues for discussion

20. The fact that FDI can play a constructive role in the economic development of African countries by transferring capital, skills and know-how is not in doubt. Indeed, it has already been a critical factor in the development of Africa’s extractive as well as other industries. The key issue for African policymakers is not, therefore, whether FDI can bring benefits, but how the gains and costs from hosting FDI can best be managed to complement the wider set of measures needed to strengthen domestic investment and the private sector and in such a way that internal integration is deepened. This will require policymakers to

ask a different set of questions from those raised by efforts aimed simply at attracting FDI by providing generous incentives, regardless of whether FDI generates spillovers and linkages that benefit domestic firms. Avoidance of such hard questions in favour of easy recipes for incentive-based promotion in the hope of attracting FDI will neither achieve economic development goals nor will it lead to long-term and sustained inflow of FDI. As already noted above, in the long-term, the best strategy for attracting and maximizing the benefits from FDI is to develop a dynamic and vibrant domestic private sector.

21. Questions for consideration during the panel discussion:

(a) What are the key factors inhibiting linkages between domestic enterprises and foreign enterprises operating in Africa?

(b) How can African countries make better use of FDI to support development of their productive capacities?

(c) Does the level of development of domestic enterprises influence FDI flows and their impact?

(d) What are the policy measures needed to reduce the geographical and sectoral concentration of FDI in Africa?

References

Anyanwu J (2012). Why does foreign direct investment go where it goes? New evidence from African countries. *Annals of Economics and Finance*. 13(2):425–462.

Al-Sadig A (2013). Outward foreign direct investment and domestic investment: The case of developing countries. International Monetary Fund Working Paper WP/13/52. February.

Bosworth B and Collins S (1999). Capital flows to developing countries: Implications for saving and investment. *Brookings Papers on Economic Activity*. 1:143–169.

Lautier M and Moreaub F (2012). Domestic investment and FDI in developing countries: The missing link. *Journal of Economic Development*. 37(3):1–23.

Mileva E (2008). The impact of capital flows on domestic investment in transition economies. European Central Bank Working Paper No. 871. February.

Ndikumana L and Verick S (2008). The linkages between FDI and domestic investment: unravelling the developmental impact of foreign investment in sub-Saharan Africa. *Development Policy Review*. 26(6):713–726.

UNCTAD (2005). *Economic Development in Africa: Rethinking the Role of Foreign Direct Investment*. New York and Geneva.

UNCTAD (2012a). *World Investment Report 2012: Towards a New Generation of Investment Policies*. New York and Geneva.

UNCTAD (2012b). *Entrepreneurship Policy Framework and Implementation Guidance*. New York and Geneva.

UNCTAD (2013). Global Investment Trends Monitor No. 11. 23 January.

UNCTAD and UNIDO (2011). *The Economic Development in Africa in Africa Report 2011: Fostering Industrial Development in Africa in the New Global Environment*. New York and Geneva.

UNIDO (2011). *Africa Investor Report 2011: Towards Evidence-based Investment Promotion Strategies*. Vienna.