Foreign Direct Investment and Economic Development in Africa

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By

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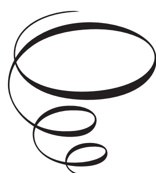

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Preface

Since their independence in the early sixties, many African countries have continued to receive an increasing volume of foreign direct investments (FDI) needed for their development. Unfortunately, the human development and the welfare gains have not followed the pace of foreign investment flows. This can be attributed to many phenomena. In the current book, we review and analyse several features of FDI and their linkages to African countries' economies. The targeted audiences of this book are (1) policy decision makers who want to learn more about the different implications of FDI flows for the development of their country; and (2) researchers interested to conduct further research on FDI linkages and their implications for African countries' development.

The book is structured into six parts. The first part (chapters 1 and 2) defines the concept of FDI and provides a general overview of FDI in Africa. The second part (chapters 3 to 5) identifies and analyses the potential determinants of FDI attractiveness of African countries. The third part (chapters 6 to 9) reviews the literature and studies linkages between FDI and inclusive growth in Africa. The fourth part (chapters 10 to 12) reviews the different agricultural policies in selected developed countries and draws policy recommendations for African countries for the development of their agricultural sector. The fifth part (chapters 13 and 14) reviews the literature and studies

the linkages between FDI, other financial flows and financial market development in Africa. Finally, the sixth part (chapters 15 and 16) studies the role played by FDI in regional integration in Africa.

In each chapter comprised of several sections, we not only provide an overview of the existing literature, but also present stylized facts on each chapter's topic with descriptive statistics and graphs, and later on we perform statistical multivariate analyses to draw sound policy recommendations. The reader will find state of the art analyses on FDI-related topics studied by researchers. Policy makers and development professionals will find in this companion book a useful guide to draw sound policies based on facts and rigorous analyses. Researchers who are interested in conducting research on FDI-related topics will find the necessary references to start with and learn the different analytical tools used by researchers in this field of research. Therefore, as we mentioned above, this is a good companion book for policy makers, development agency professionals and researchers, based on stylized facts and rigorous analytical studies.

We would like to thank students from our respective institutions (Laval University in Canada and ENSEA Abidjan in Côte d'Ivoire) and staff of CESS Institute in Canada, who have contributed as research assistants over the years to the content of this book. In particular, we reserve a special thanks for the following students from Laval University in Canada: Daouda Camara and Eric Ekpinda; to the following students from ENSEA Abidjan in Côte d'Ivoire: Kodzovi Senu Abalo, Aurore Stéphanie Abogne, Honoré A. Agbobly-Atayi, Marc Luc D. Akplogan, Abdoul Aziz A. Amadou, Edjems Stephane Amari, Bassan Bazié, Bitian Djabonou, Bakari Bio A. R. Cyrinus Elegbede, Kouamé Kanga, Jean Stéphane Koffi, Ama Kouao, Adouko Guy Miessan, Yacouba Ouedraogo, Wendingoudi Tidiane Ouedraogo, Audrier Sanou and Kokouvi Tewou; to the following staff of CESS Institute in Canada: Germain Bomisso and Yao Djifa N'Sougan; and to Hugh Dang and Nathan Weatherdon; we thank all of them for their valuable assistance.

Some chapters of this book are from our joint works with colleagues; we thank them for their collaboration, namely, Sylvain Dessy (Laval University in Canada), Isaac Octhere (Carleton University in Canada), Désiré Vencatachellum (African Development Bank in Abidjan, Côte d'Ivoire), and Pierre Yourougou (Syracuse University in the United States). Finally, we extend our gratitude to all our other colleagues, especially, Michel Gendron, Dean of the Faculty of Business

Administration of Laval University in Canada and Koffi N'Guessan, former Director of ENSEA Abidjan, Côte d'Ivoire, for their continual support and financial contribution to the production of this book.

Part I

FDI in Africa: Definition, Characteristics and Trend

CHAPTER 1

FDI: Definition and Concepts

1.1 Introduction

Widely recognized as a growth and development driving force, foreign direct investment (FDI) is seen as an appropriate solution to the lack of resources faced by African economies to sustain the investments and growth necessary to achieve the United Nations' Sustainable Development Goals (SDGs). According to Loots and Kabundi (2012), savings rates in Africa (averaging 9% of GDP) are largely insufficient to fund the minimum level of investment required to achieve the Millennium Development Goals (MDGs) which is 25% of GDP over the long term. So Africa faces a considerable resource gap estimated at 16% of its GDP. This is a reason why external financing (development aid and private capital flows) is timely to support African economies in their development objectives. Among the various existing sources of external financing, particular attention has been paid in recent years to foreign direct investments (FDI), since these capital flows are considered less burdensome (they are not accompanied by austerity measures) and potentially more effective (being generally private by nature).

However, even if it is true that foreign direct investments (FDI) have become of greater interest in recent years because they are widely recognized as driving force of growth and development, the fact remains that the concept is not new. According to Lipsey (2001), the first flows of FDI date back to 2500 BC and began because Sumerian traders expressed the need to have men abroad who would be able to receive, hold and sell the goods they export. Many centuries later (early 17th century), the Virginia Company[1] conducted one of the first flows of FDI in America by establishing a branch. Then, in the middle of the 17th century, multiple FDI was conducted by the families of English, French and Dutch traders who sent their relatives to America and the West Indies to represent their companies. FDI then took off. As Bloomfield noted (quoted by Lipsey (2001)), *"before 1914, the concept of direct investment (in the sense in which it is currently used) was not clearly differentiated from other capital investments in foreign private companies"*. That is why the Organisation for Economic Co-operation and Development (OECD), in collaboration with the International Monetary Fund (IMF), developed a benchmark definition[2] of FDI to serve as an international measurement framework. Today it is widely accepted that *"where adequate general conditions are met, IDI[3] can be a factor of financial stability, promote economic development and improve the welfare of the society"*[4].

In other words, foreign direct investment can be an effective way to help countries deal with unemployment problems and development challenges they face. FDI represent an opportunity for African countries with insufficient savings to finance productive investments. However, for this to be effective, various conditions must be met. The next chapters deal with these conditions. But before these subsequent developments (to be presented later in this volume) on the determinants of FDI and their impact at various levels on African economies, this chapter aims to clarify the concept of FDI while pointing out recent developments.

[1] This is a British company created by King James in 1606.

[2] The latest edition, the fourth, was in 2008.

[3] IDI stands for International Direct Investment

[4] IMF 4th edition of the Benchmark Definition of Foreign Direct Investment, 2008.

1.2 The recent international definition of FDI and its implications

First of all, it should be noted that the term ”International Direct Investment” (abbreviated IDI) is used by the OECD to refer to both foreign direct investment (FDI: investment from abroad) and direct investment abroad. There is thus a clear distinction between IDI and FDI. However, since FDI for a country is a direct investment abroad to another country and vice versa, one can without loss of generality be interested only in FDI and if necessary use the term "FDI outflow" to denote direct investment abroad. In the remainder of this section we will present the definition of direct investment (as defined by OECD).

1.2.1 The recent international definition of FDI

In the 4th edition of the Benchmark Definition (paragraph 11, page 17), OECD defines Direct Investment as follows: *Direct investment is a category of cross-border investment made by a resident in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long-term relationship with the direct investment enterprise to ensure a significant degree of influence by the direct investor in the management of the direct investment enterprise. The "lasting interest" is evidenced when the direct investor owns at least 10% of the voting power of the direct investment enterprise. Direct investment may also allow the direct investor to gain access to the economy of the direct investment enterprise, which it might otherwise be unable to do. The objectives of direct investment are different from those of portfolio investment whereby investors do not generally expect to influence the management of the enterprise.*

1.2.2 Measurement of FDI according to the asset-liability approach and the directional principle

In the 4th edition of Benchmark Definition (Boxes 2.2 and 2.3, pages 29-30), some changes were made to the FDI presentation approaches. The Benchmark Definition recommends two analytical approaches to presenting FDI data: the asset-liability approach which is identical to

balance of payments and international investment position statistics; and, the directional principle which is relevant to analyse the economic impact of FDI in terms of the direction in which it exercises influence or control (FDI inflows/outflows).

The Benchmark Definition stipulates in point 49 the difference between these two types of presentations as follows: "*Partner country or industry allocation is recorded in the directional presentation of FDI statistics as that of the immediate counterparty involved in the investment chain for both inward and outward investments but excluding resident special purpose entities (SPEs) (as opposed to the inclusion of all SPEs under the asset-liability principle described above). A direct investor in country A may wish to invest in country C but may do so through its holding company in country B. This simple example demonstrates how source and destination of investment through indirect routing may distort the data and influence the relevant economic analysis. Also under the directional principle, information for resident SPEs is also shown separately in the core accounts with the full geographic and industry breakdown.*"

To better understand what is included in FDI estimates using one approach or the other, it is important to know precisely the estimation methods of FDI using each approach. The boxes below present FDI estimates using both the asset-liability principle (Box 1) and the directional principle (Box 2).

Box 1. **FDI according to the asset/liability principle**

For the reporting country (RC), FDI is summarised as follows::

ASSETS = Investments by direct investors of the RC in direct investment enterprises abroad

Plus

Reverse investments by direct investment enterprises in the RC in their direct investors abroad

Plus

Investments by fellow enterprises in the RC in other fellow enterprises abroad

LIABILITIES = Investment by direct investors from abroad in direct investment enterprises in the RC

Plus

Reverse investments by direct investment enterprises abroad in their direct investors in the RC

Plus

Investments by fellow enterprises abroad in fellow enterprises in the RC.

Source: OECD, Benchmark Definition of Foreign Direct Investment, Fourth Edition 2008.

Box 2. **FDI according to the directional principle**

For the reporting country (RC), FDI is summarised as follows:
OUTWARD INVESTMENT = Investments by direct investors of the RC in direct investment enterprises abroad

Minus

Reverse investments by direct investment enterprises abroad in their direct investors in the RC

Plus

Investments by resident fellow enterprises in fellow enterprises abroad where the ultimate controlling parent of the resident fellow enterprise is resident in the RC

Minus

Investments by fellow enterprises abroad in resident fellow enterprises where the ultimate controlling parent of the resident fellow enterprise is resident in the RC

INWARD INVESTMENT = Investments by direct investors abroad in direct investment enterprises in the RC

Minus

Reverse investments by direct investment enterprises in the RC in their direct investors abroad

Plus

Investments by fellow enterprises abroad in resident fellow enterprises where the ultimate controlling parent of the resident fellow enterprise is non-resident in the RC

Minus

Investments by resident fellow enterprises in fellow enterprises abroad where the ultimate controlling parent of the resident fellow enterprise is non-resident in the RC.

Source: OECD, Benchmark Definition of Foreign Direct Investment, Fourth Edition 2008.

1.3 The limits of the international measurement framework of FDI

The limits of the international measurement framework of FDI are at two levels: the first is the obsolescence of international criteria for measuring FDI, and the second is the lack of compliance with international rules by all countries.

1.3.1 Limitations of international criteria of FDI measurement

The rapid changes in international trade and innovative financial strategies of firms to reduce their transaction costs soon made obsolete the methods of FDI measurement using the 3rd edition of the Benchmark Definition of FDI developed by the OECD. It is precisely this fact that led to the development of the 4th edition of the revised manual that addresses the shortcomings of the previous edition. We review the limitations of this measurement framework (3rd edition) which is relevant to the extent that some countries might still use it. Indeed, sometimes a long adjustment period is necessary before the universal international application of new methods for FDI measurement.

As part of the mentioned limits, Terrien (2009) highlights various problems related to the implementation of the *principle of the first counterpart country* to identify the origin or destination of FDI flows. Under this principle, the origin or destination of FDI flows is attributed to the country of origin or *immediate* destination of funds. However, multinationals are increasingly using more Special Purpose Entities (SPEs) located in tax havens to achieve their financial operations. Thus, FDI flows from and to countries harbouring SPEs are artificially inflated. The geographical breakdown of FDI is thus deformed and also the breakdown of FDI by industry sector is affected by the over-representation of the activity of SPEs (management of holdings).

In addition, *round tripping* is a type of investment used by multinationals and involves a *round trip* of funds (in whole or in part, directly or not) of an entity affiliated to a non-resident. Yet, according to the methodology defined by the IMF (5th edition of the Balance of Payments Manual), these intercompany loans are recorded as inward or outward FDI flows. We generally expect an overestimation of inward and outward FDI flows due to *round tripping*.

Finally, the principle of the first counterpart country led to record capital in transit (transfers of funds from an affiliated entity to another by passing through several affiliates) in FDI flows. However, the reception of funds by affiliated intermediaries does not necessarily imply holding a stake in these companies nor investment activities, these are simple transfers. Thus, capital in transit also induces dis-

tortion in the geographical breakdown of FDI and the breakdown by sector of activity.

Faced with these multiple problems related to the reliability of FDI statistics, the OECD, in its 4th edition of the Benchmark Definition in 2008, suggests to statisticians in charge of developing these statistics two measures to address them. The first is to isolate the direct investment transactions of resident SPEs. This allows to remove the distorting effect of the breakdown of FDI by geographical region and by business sector due to SPEs. The second measure suggests, for recording intragroup financial operations,[5] that lending and borrowing of resident entities belonging to a resident group with foreign fellow enterprises should be included in direct investment abroad; conversely, loans and borrowings of resident entities belonging to a non-resident group with foreign fellow enterprises must be recorded in direct investment coming from abroad. This measure thus limits the overestimation effect of FDI flows due to intragroup financial transactions.

1.3.2 Divergence between countries in the application of international definition

Despite the existence of an international framework for the measurement of FDI, we note that the application of these rules is not followed uniformly by all countries. The final research report, SIMSDI (Survey of Implementation of Methodological Standards for Direct Investment), produced in a context of cooperation between the IMF and the OECD, supports this assertion. The box below presents the Highlights of the 2001 SIMSDI report.

[5] Note that a group is considered resident from the moment that all companies that constitute it are controlled, directly or indirectly, by the same ultimate investor (usually the parent company of the group) identified as resident

Box 3. **Limitations of the application of international measurement rules of FDI**

Areas where, despite improvements, a majority of countries do not yet follow the international standards:

- Inclusion of activities of indirectly owned direct investment enterprises—the Fully Consolidated System (FCS)
- Use of the current operating performance concept (COPC) to measure direct investment earnings.
- Time of recording FDI income on equity and income on debt
- Recording of reverse investment transactions when the FDI relationship is in one direction only
- Inclusion of data on quasi-corporations involving construction enterprises and mobile equipment
- Valuation of FDI positions (assets and liabilities)

Source: IMF, Foreign Direct Investment Statistics: How Countries Measure FDI, 2001.

1.4 Components of FDI statistics and associated typologies

The FDI statistics are comprised of three basic components: flows, stocks and FDI income (see subsection 1.4.1). In addition, two main typologies of FDI are cited in the literature: by the supply chain logic of FDI and by the form of FDI (see subsection 1.4.2).

1.4.1 Concepts of flows, stocks and FDI income

- **Concept of FDI flow:**

  FDI flows refer to FDI net inflows and outflows for a given period, separately showing outward FDI (acquisitions less disposals / redemptions) and inward FDI (acquisitions less disposals / redemptions) by instrument (equities, loans).

- **Concept of FDI stock:**

  A stock of FDI is the total amount outstanding at a given reference date of the investments made abroad or received from abroad. This is the accumulated FDI available at a given

date. While the concept of FDI stock is simple, it should be noted that the interpretation of a variation of an FDI stock between two periods is not as simple. Indeed, such a variation reflects transaction flows recorded during the interval, currency fluctuations, fluctuations in prices of securities or other adjustments. Although this variation is similar to the FDI flows, it can be somewhat different

- **Concept of FDI income:**

  FDI income is the sum of monetary gains from FDI investments. It comes from two sources:

  a) **Equity investment**: profits of the company during the reference period, corresponding to distributions (dividends) as well as undistributed profits which are treated as profits reinvested in the enterprise.

  b) **Loans**: interest from intercompany loans, trade credits and other forms of loans.

1.4.2 Types of FDI

The main types of FDI can be classified by their supply chain logic and or their form. The classification of FDI according to the supply chain logic was introduced by Markusen (1995). Indeed, this author distinguishes two types of FDI:

- **Horizontal FDI:** This is an FDI with the objective to set up or manage a foreign operation of production of goods and services highly similar to those produced by the firm for its domestic market.

- **Vertical FDI**: This is a FDI with the objective to establish production units used in the production supply chain of a good abroad. The production process is thus distributed, geographically, between different countries.

As for the typology in the form of FDI, it was developed by the OECD in its 4th edition of the Benchmark Definition (2008). This typology led to distinguishing four types of FDI:

- Mergers and acquisitions FDI
- Greenfield investments
- Extension FDI
- Financial restructuring FDI

The following box illustrates the types of operations involved in these types of FDI

Box 4. **Typology of FDIs classified by their form**

Mergers and acquisitions (M&A)	An investor in economy A buys existing shares of a target company in economy B from its shareholders.
	An investor in economy A creates a holding subsidiary B in the economy to buy existing shares of a target company in economy B or C from its shareholders.
Greenfield investment	An investor in country A creates a subsidiary in country B.
	An investor in country A creates a holding subsidiary in country B to establish a sub-subsidiary in country B or C.
Extension investment (to develop a business)	An investor in country A buys shares newly issued by an existing subsidiary in country B to develop its commercial activities.
	An investor from country A buys shares newly issued by a holding subsidiary in country B to buy existing shares of a sub-subsidiary in country B or C in order to develop its commercial activities.
Financial restructuring FDI	An investor from country A buys existing shares issued by an existing subsidiary in country B in order to repay a debt or reduce losses.
	An investor from country A buys shares newly issued by an existing holding subsidiary in country B to subscribe for existing shares issued by an existing sub-subsidiary in country B or C in order to repay a debt or reduce losses.

Source: IMF, “Foreign Direct Investment Statistics: How Countries Measure FDI,” 2001.

In practice, to classify an investment in either category, a questionnaire is applied to companies as part of a periodic survey to determine the characteristics of the investment. Based on their answers, an investment is classified in a specific category.

1.5 Conclusion

In ending this chapter, the following key elements should be emphasized:

- The international measurement framework of FDI is constantly changing due to changes in the economic and business environment and the changing practices of multinational firms.

- The current framework, a fruit of the collaboration between the IMF and the OECD (and recorded in the OECD Benchmark Definition of FDI, 4th edition), certainly reflects recent developments in financial strategies of multinational companies and transformations in international trade but is not thus far fully implemented in all countries. Therefore, differences between the values of FDI flows and stocks between countries may be due, at least in part, to the differences in statistical practices.

- Finally, two main typologies of FDI are noteworthy and may be relevant to fine tune the analyses on FDI: the typology based on the logic of FDI (horizontal versus vertical) and that based on the form of FDI (M&A, greenfield, extension, or financial restructuring).

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