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PEGNet Policy Brief

Policy instruments for FDI promotion in Africa

Saskia Mösle, Frauke Steglich

KEY POINTS

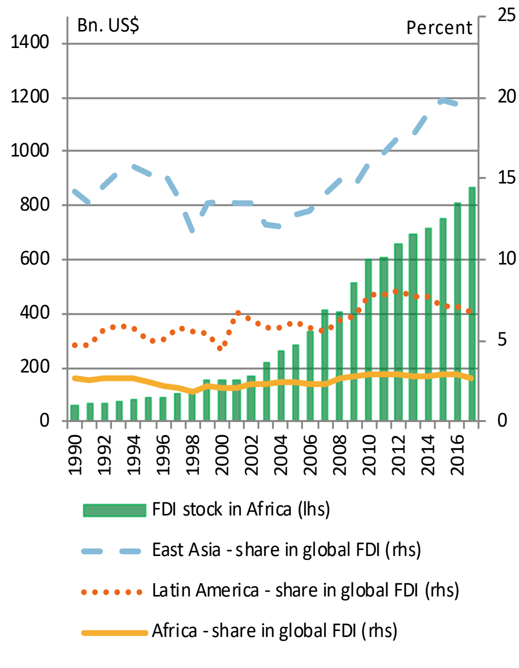
- Foreign Direct Investment (FDI) in Africa continues to be low: Only 3 percent of global FDI stocks and 1 percent of German FDI is located in Africa.
- On the upside, German FDI is more concentrated in manufacturing compared to FDI of major sending countries which is dominated by the commodities sector.
- Several policy instruments can contribute to higher investment in developing countries. They include investment promotion agencies and special economic zones on the part of the recipient countries, and investment guarantees as well as a network of chambers of commerce abroad on the part of the investor countries.
- Strengthening institutions in African countries remains the most important measure to attract FDI.

Global foreign direct investment (FDI)[1] has increased substantially over the past decades and so has FDI in Africa. The value of the total stock of FDI on the continent has risen almost 15-fold since 1990 to under 900 billion US dollars in 2018 (Figure 1). However, Africa's share in the global stock of FDI fluctuated between 2 and 3 percent over the same period even though its share in the world population rose markedly. Also compared with other developing regions, the relative importance of the continent as a recipient of FDI remains low. For example, East Asia accounted for just under one fifth of global FDI in 2017, compared to 15 percent in 1990. Latin America's share has since risen from 5 to 7 percent.

Increasing FDI flows to Africa could stimulate its economic development through access to international markets, human capital and technology. For example, Alfaro et al. (2004) show that FDI has a positive impact on overall economic growth in the recipient country. Görg and Strobl (2005) show that companies in Ghana with managers who have gained experience from multinational companies have higher productivity growth than other comparable companies. Bwalya (2006) analyses enterprise data for Zambia and finds that domestic suppliers increase their productivity growth as a result of additional FDI. Thus, FDI can contribute to technological development, industrial upgrading and diversification, and economic growth of the recipient countries.

There are concrete policy options available to promote FDI to Africa. Political and economic conditions in potential host countries of FDI, including the quality of institutions, transport infrastructure, and human capital, are crucial for the location decision of investors. However, the attractiveness of many African countries as a destination for international investment still lags behind in comparison with other developing regions.[2] In addition to national-wide reforms aimed at improving the overall business climate, both investor and potential host countries can implement specific economic policy measures to increase FDI flows to developing countries.

Figure 1: Inward FDI stocks in Africa and the shares of developing regions in global FDI



Source: Own visualization based on UNCTADStat (2019).

This policy brief outlines several important investment promotion instruments of both sender and recipient countries of FDI and assesses their impact. On the part of the investor countries, the focus is on policy measures taken by Germany. While the volume of German FDI in Africa continues to be low[3], it is particularly interesting to analyze due to its

1 This PEGNet Policy Brief is based on the report „Instrumente und Wirkung der Außenwirtschaftsförderung in Afrika" prepared for the Sector Project Sustainable Economic Development of Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH an finalized in September 2019. It was prepared by J. Glitsch, O. Godart, H. Görg, S. Mösle, and F. Steglich and published as a Kiel Center for Globalization Policy Paper No. 5 "Lagging behind? German foreign direct investment in Africa" (https://www.kcg-kiel.org/wp-content/uploads/2020/06/KCG-Policy-Paper_5.pdf). We are grateful to the German Federal Ministry for Economic Cooperation and Development and GIZ for funding this project and to the German Federal Ministry for Economic Affairs and Energy and PwC Germany for providing data on German investment guarantees.

2 In 2019, only two African economies, Mauritius and Rwanda, rank among the top 50 of the ease of doing business ranking, and many African countries are located on the lower ranges of the ranking. See https://www.doingbusiness.org/en/rankings (accessed 10 October 2019).

3 The volume of German FDI in Africa is also low in com-

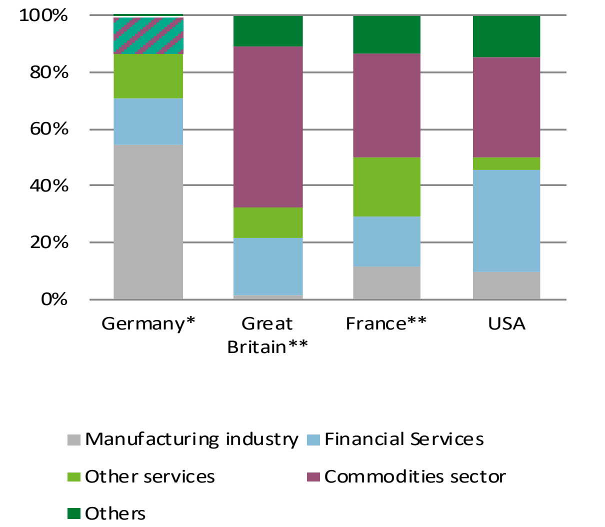
PEGNet
Poverty Reduction, Equity and Growth Network

KIEL INSTITUTE FOR THE WORLD ECONOMY
Kiellinie 66 | 24105 Kiel

E pegnet@ifw-kiel.de
www.pegnet.ifw-kiel.de

@PEGNetKiel

Figure 2: Sectoral distribution of German outward FDI stocks in Africa in international comparison



Source: Own visualizations based on data of the Bundesbank (for Germany), the Office of National Statistics (for Great Britain), the Banque de France (for France), and the Bureau of Economic Analysis (for USA).
*For Germany, the commodities sector is included in category „Others".
**Data for Great Britain and France are from 2014, for Germany and the US for 2017.

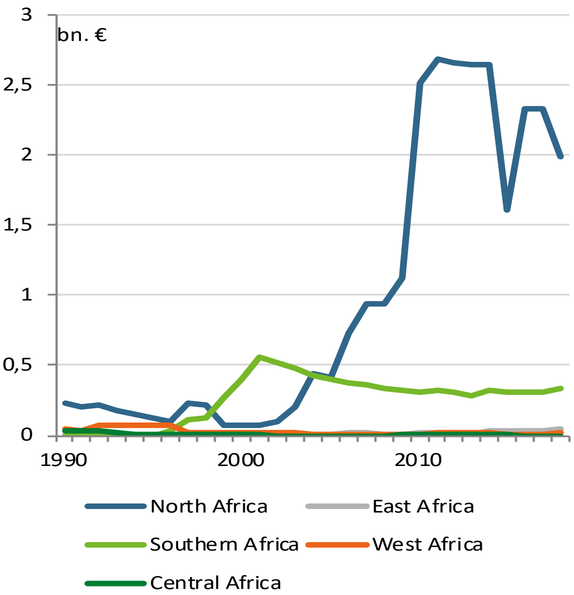
structure: German FDI is more concentrated in manufacturing (in particular, vehicle construction) than FDI of other, larger investor countries which focus more on natural resources (Figure 2). It may therefore particularly contribute to upgrading and diversifying the local economies.

Germany's investment promotion instruments

One of the major investment promotion instruments of the German Federal Government are **investment guarantees** to cover political risks, which are often high in developing and emerging countries.[4] The portfolio of the German government's investment guarantees in Africa has increased substantially since the 1990s but remains at a low level. Within Africa, North Africa is the most important region (Figure 3) where most of the guarantees amounting to around 2 billion euros in 2018 covered investments in the commodities sector. At the same time, sub-Saharan Africa accounted for less than 2 percent of total guarantee volume in 2018. While Southern Africa had a guarantee volume of 340 million euros, in East, West and Central Africa investment guarantees are scarcely used. In contrast to the focus on raw materials in North Africa, in Southern Africa the majority of all guarantees are located in the manufacturing sector.

Investment guarantees can – at least partly – compensate for poor legal protection of assets of foreign investors, although institutional quality remains a key determinant for FDI. This is the result of the empirical analysis by Glitsch et al. (2020) on the determinants of German FDI stocks for 115 destination countries since 2010. Accordingly, institutional characteristics of the recipient country are decisive but less important for the location decision of German FDI in the presence of guarantees. Thus, investment guarantees can contribute to facilitating investment in Africa.

Figure 3: German investment guarantee volume by regions in Africa



Note: The figure shows the maximum amount of capital cover provided by the investment guarantees of the Federal Government for each region in Africa. Source: Own visualization based on data on investment guarantees of PricewaterhouseCoopers GmbH Wirtschaftsprüfungsgesellschaft (PwC) on behalf of the Federal Government.

Another important investment promotion tool is the **network of the German Chambers of Commerce Abroad** (German: "**Auslandshandelskammern**", short: AHKs). The AHKs provide German companies active in foreign markets and those which are planning to invest abroad with information on investment opportunities and conditions, legal and tax matters, recruitment, and translation services. Furthermore, they offer the organization of delegation trips or trade fair appearances, location consulting, business partner mediation and market studies. In general, AHKs reduce information asymmetries between German investors and local business partners in order to facilitate investment. Especially in developing countries, transparent information about business conditions is often scarce, constituting a barrier to foreign investment (Harding and Javorcik, 2011). Worldwide, 140 AHKs are located in 92 countries. In Africa, AHKs are present in Egypt, Algeria, Angola, Ghana, Kenya, Morocco, Nigeria, South Africa, Tanzania and Tunisia. There are also regional offices in Ethiopia, Mozambique, Rwanda, Zimbabwe, Zambia and Uganda achieving a large coverage in Africa.[5]

Again based on the empirical analysis of German FDI, Glitsch et al. (2020) confirm that the presence of an AHK in a country is related to higher German FDI stocks in this country. This suggests that the existence of a German AHK may be associated with lower costs and obstacles to investment. In line with this finding, recent initiatives, like the German Desk Initiative or AfricaConnect, have the potential to reduce costly information barriers and facilitate FDI likewise.[6]

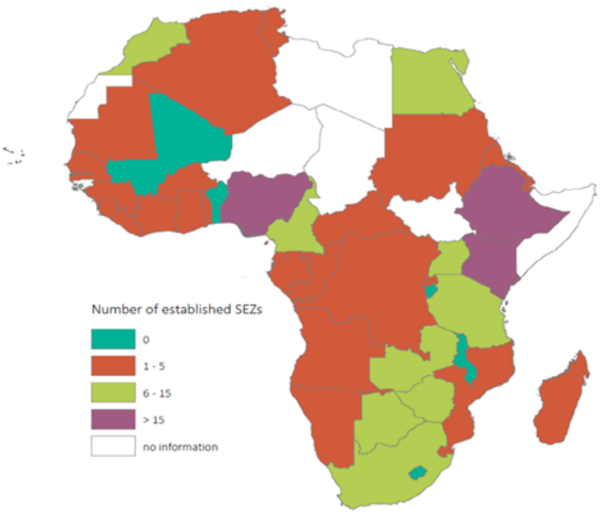
parison with the largest investor countries. While the German FDI stock in Africa has remained almost unchanged at below 10 billion US dollar over the past decade, France, the US, the UK and China have FDI stocks of between 40 and over 60 billion US dollars each. Especially China has increased its investments markedly over the past decade. See Glitsch et al. (2020) for more information.

4 For more information on the German investment guarantees, see BMWi (2019).

5 Via internet (09.07.2019) <https://www.ahk.de/standorte/ahk-standorte/>.

6 As these initiatives are still in their infancy, their impact remains to be seen.

Figure 4: Special Economic Zones in Africa



Source: Own visualization based on UNCTAD (2019).

Investment promotion instruments of recipient countries

On the part of investment recipients, many countries have **investment promotion agencies (IPAs)** in order to attract investors and bundle information. Similar to the AHKs, IPAs aim at reducing information asymmetries between investors and the recipient country. There are around 190 investment promotion agencies in almost all countries worldwide.[7] The umbrella organization, the World Association of Investment Promotion Agencies (WAIPA), represents the interests of 130 investment promotion agencies worldwide, of which 37 IPAs are located on the African continent. Some countries, including Egypt, South Africa and Tanzania have national IPAs as well as subnational IPAs specializing in specific regions.[8]

Investment agencies can facilitate investment, especially in countries with high bureaucratic hurdles and information asymmetries. This is especially important for many developing countries. Research shows that the existence of IPAs increases foreign investment, whereas such a positive correlation could not be found for developed countries (Harding and Javorcik, 2011; Harding and Javorcik, 2013). In countries with relatively weak institutions, IPAs thus contribute to reducing information asymmetries and promoting FDI.

However, in order for IPAs to unfold full potential, sufficient resources and a concrete mandate to promote investment are indispensable. A study on the IPAs of eight southern Mediterranean countries shows that one of the biggest obstacles to their work is a lack of resources (OECD, 2019). Another obstacle is a mismatch between investor needs and the portfolio of IPAs. A survey of foreign investors in African countries showed that IPAs are not their first contact when looking for new investment opportunities (UNIDO, 2011).[9] This indicates that IPAs in Africa – at least partly – do not satisfy the needs of foreign investors and thus miss their aim of reducing information asymmetries.

In recent years, many countries in Africa have also (re)discovered **special economic zones (SEZs)** as an instrument of industrial policy. SEZs are geographically defined areas selected by the government in which firms are subject to special laws and regulations different from those in the rest of the country. Generally, SEZs provide tax and other fiscal incentives (e.g. duty exemptions), administrative facilitations, special services and high-quality infrastructure for investors. Thus, they can compensate for weaknesses in the national investment climate and are therefore considered an important instrument for attracting investment. Besides facilitating FDI and creating employment opportunities, SEZs are often seen as an opportunity to unleash dynamic effects, such as the integration of local companies into global value chains via links with SEZ enterprises and through the support of industrial upgrading.

SEZs are increasingly gaining popularity, particularly in developing and emerging countries, which is reflected in their increasing number and importance for the global economy. According to recent estimates, the number of SEZs increased from 200 in the 1980s to currently more than 5,000 located in over 140 countries (UNCTAD, 2019) and they generate at least 20 percent of global trade in goods (OECD, 2018). Most SEZs are based in emerging and developing countries in Asia – more than 2,500 SEZs are located in China alone. In Africa, about 250 SEZs exist as of 2019 (Figure 4).

In spite of their popularity, the effects of SEZs are not clear-cut, especially in Africa.[10] Many SEZs in emerging and developing countries successfully generated FDI, exports and jobs, but only a few succeeded in realizing dynamic effects and contributing to broader economic structural change. In Africa, SEZs fell short of government expectations overall, in part due to inadequate planning and implementation and a lack of competitiveness (Farole, 2011; Farole and Moberg, 2017). A positive recent example is the Kigali Special Economic Zone in Rwanda (Steenbergen and Javorcik, 2017). Among others, the German car manufacturer Volkswagen opened a factory there in 2018. This investment of 16 million euros is expected to create around 1,000 jobs.[11]

The ambiguous evidence is also reflected in the empirical results presented by Glitsch et al. (2020). The impact of SEZs on German FDI seems to be, if at all, small. However, these results have to be interpreted cautiously because many countries which had no or unsuccessful SEZs have initiated new SEZ programs in recent years (e.g. Angola, Botswana, Ethiopia, Liberia, Rwanda, Senegal, Eswatini) and the zones are often still in the development phase. Hence, a thorough assessment of the SEZ boom in Africa is yet to be conducted.

Policy Conclusions

FDI in Africa accounts for less than 3 percent of global FDI stocks and German FDI in Africa constitutes even less than one percent of total German FDI stocks. The comparatively low level can serve

7 Cf. Harding and Javorcik (2013).
8 Cf. World Association of Investment Promotion Agencies (WAIPA) (2019). Via internet (24.07.2019) <http://www.waipa.org>.
9 Vogler (2018) provides a detailed evaluation of the promotion of IPAs in the context of German development cooperation.

10 Hachmeier und Mösle (2019) provide a detailed evaluation of the available research. See also Mösle (2019) for a summary on SEZs in Africa.
11 Neue Züricher Zeitung of 30.06.2018: „VW betritt in Rwanda Neuland". Via internet (05.08.2019) <https://www.nzz.ch/wirtschaft/vw-betritt-neu-land-in-rwanda-ld.1399152>.

as a motivation for investment promotion efforts from both African recipient countries and Germany.

Germany aims at increasing investment in Africa with the help of investment promotion instruments like investment guarantees and the network of German Chambers of Commerce Abroad (AHK). According to new empirical results, investment guarantees seem to compensate at least partially for poorer institutions in recipient countries and the AHK network plays an important role in facilitating German investment in Africa. Providing information about foreign markets to interested parties and protecting investment against political risks are key policy measures to promote investment abroad.

On the side of recipient countries, Investment Promotion Agencies (IPA) and Special Economic Zones (SEZs) are two major investment promotion tools. IPAs can facilitate FDI, especially in countries with information asymmetries and high bureaucratic obstacles, which often prevail in African countries. The impact of the recent SEZ boom in Africa remains to be evaluated because many zones are relatively new. Overall, strengthening institutions and a business friendly environment is the decisive factor to attract FDI but targeted investment promotion policies – at least partly – have the potential to compensate for weak general conditions.

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INVESTMENT PROMOTION IN TIMES OF COVID-19

At the moment, the COVID-19 pandemic is severely affecting foreign investment. According to recent estimates, FDI will drop by about 30 to 40 percent this year (UNCTAD, 2020; OECD, 2020). German FDI is no exception: In a survey conducted by the German Chamber of Industry and Commerce in spring 2020, almost half of the German companies that are active abroad indicated that planned investments will be postponed or cancelled altogether as a result of the pandemic (DIHK, 2020).

Developing and emerging countries are likely to be hit hardest as their FDI is more concentrated in sectors particularly impacted by the pandemic such as the primary sector and manufacturing (OECD, 2020).[1] For African countries, this reduces opportunities to benefit from FDI-associated gains, including the integration into global value chains (Seric et al., 2020). In light of increased competition for FDI and its potential to support the economic recovery from the COVID-19 crisis, investment promotion is likely to gain importance, both on part of recipient countries and as a tool of development cooperation.

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1 On the effect of COVID-19 on Special Economic Zones, including in Africa, see Gern and Mösle (2020).

Author

Saskia Mösle
Institute for the World Economy (IfW)
saskia.moesle@ifw-kiel.de

Frauke Steglich
Institute for the World Economy (IfW)
frauke.steglich@ifw-kiel.de

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