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Foreign direct investment in Africa: the private-sector response to improved governance

Stephen Thomsen, Chatham House

Summary

• Private capital flows to Africa in the form of foreign direct investment (FDI) are growing. While in the past much of this investment was limited to the raw materials sector, the current wave involves firms from more countries and sectors than ever before.

• Foreign investors, including from within Africa itself, invested almost $50 billion in Africa during 2000–03. While this represents only a small share of global flows, the more relevant comparison is with the size of the African economy. By this measure sub-Saharan Africa attracts almost as much FDI as Southeast Asia.[1]

• Although Europe remains the principal source of investment, a rising share is coming both from Asia and from within Africa itself.

• Investors have been influenced by improvements in governance, most notably with respect to the business climate, where the desire to attract foreign investors can provide a strong incentive for African governments to reform their policies and practices. Although much remains to be done, some countries have nevertheless made great progress in areas such as political and economic stabilization, privatization and simplification of cumbersome regulations.

• This foreign investment also has implications for patterns of trade and integration. Many African exports are channelled through multinational enterprises, helping to integrate African countries both with one another and with the global economy.

[1] Unless stated otherwise, all data are drawn from the UNCTAD database.

With the release of the Commission for Africa report (2005) and the Gleneagles summit, Africa has briefly been at the top of the global political agenda. The only point on which all sides agree has been the importance of governance, broadly defined as the way in which the state functions, and not just the laws it enacts. It includes but is not limited to the issue of corruption, protection of public order, and the quality and predictability of policy (Eifert and Ramachandran, 2004, p. 40). Governance is a broad-based concept and as such is difficult to measure directly except by inference.

One key element of governance which has attracted increasing attention is the climate for investment, whether by foreign or domestic firms. Partial evidence compiled by the World Bank on business climate conditions in individual African countries suggests both that the investment climate is improving and that there are wide variations across Africa.[2] UNCTAD (2004) also provides numerous examples of policy changes in individual African countries in the direction of greater liberalization.

Changes in the quality of the business climate can also be inferred from changes in the level of foreign investment across Africa. While it would be premature to talk of a sea change in investor perceptions, there is evidence of growing interest on the part of both regional and international investors in expanding across Africa. Foreign investment in the past has largely been confined to the raw materials sector or to import substitution in the largest markets, but recent investors have come from a wide variety of sectors and source countries.

FDI in Africa is increasing

After a long period in the 1970s and 1980s with no upward trend, FDI flows to Africa have grown fourfold over the past decade (Figure 1). While figures for 2004 are not yet available, they are likely to show further increases. This growth is partly explained by external events over which African countries have little control: rising commodity prices; new oil finds in Africa coupled with the desire of major importers to diversify their sources of supply; and preferential trading agreements with the EU and the US through the Everything But Arms (EBA) initiative and the African Growth and Opportunity Act (AGOA) respectively. But such flows are at least partly a response to improvements in governance and their impact on overall economic performance (as will be seen later).

[2] See, for example, a cross-country comparison of the investment climate in Eifert and Ramachandran (2004).

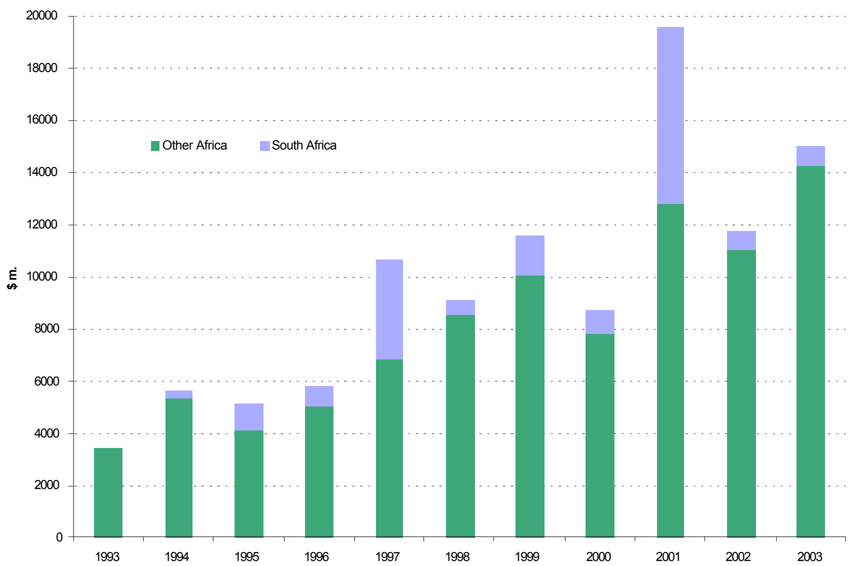
Diversification of home countries

Table 1 shows total investment in Africa by home region. The figures represent estimates based on home country sources which often provide little detailed information on FDI into Africa. Some country figures are also more recent than others. As a point of reference, African countries report inflows of $150 billion since 1970, or 50 per cent more than that reported by source countries.

European firms represent roughly two-thirds of total FDI in Africa, with over half of European investment emanating from the UK and France. Historical ties and the role of investors in the petroleum sector tell a large part of the story, but recent investments by French and British firms have tended to be more diversified. French tele-communications firms have been the most active participants in public–private partnerships in infrastructure in Africa, and Barclays Bank purchased the fourth largest South African bank, Absa, for $5.5 billion in 2005.

European investors also include firms from the Netherlands, Germany, Italy and Switzerland, among others. German firms are concentrated in South Africa and, unlike investors from other European countries, tend to favour manufacturing. American firms invest on the same scale as their British and French counterparts, with two-thirds of capital going into mining and petroleum. As with German firms, they have a substantial presence in manufacturing in South Africa.

FIGURE 1: FDI INFLOWS INTO AFRICA, 1993–2003



Source: UNCTAD

TABLE 1: FDI STOCKS IN AFRICA BY SOURCE REGION (2003 OR LATEST YEAR AVAILABLE)

	$m
Europe	64,889
North America	20,835
Asia	7,865
South Africa	2,084
Total	**95,673**

Sources: OECD *International Direct Investment Statistics*, UNCTAD, national sources.

The small share represented by Asian investors in Table 1 belies their significance as a major new source of capital. With the exception of Japanese firms, much of this investment has come in the past five years. Even more significantly, it has tended to be in newer sectors for Africa, such as clothing and apparel, with natural resources playing a much smaller role. Asian investment has also had a great impact in the countries in which Asian firms have invested because of their tendency of Asian firms to cluster in the same geographical location. Taiwanese firms, for example, employ over 40,000 workers in the textile sector in tiny Lesotho.

Asian investment in the apparel sector is intimately tied to the benefits for African countries under AGOA. As such, there is some concern about its durability given the time-bound nature of such preferences and the ending of the Multi-Fibre Arrangement. Asian investors in this sector have also not yet developed many linkages with the local economy, with most supplies still imported from Asia.

Asian firms have come principally from Taiwan, India, Malaysia, Japan, China (including Hong Kong) and Korea. Given their substantial presence worldwide, Japanese firms are largely under-represented in Africa. One notable exception involves production by Toyota and Nissan in South Africa. In contrast to Japanese firms, Malaysian investors have been active, particularly in telecommunications (South Africa) and textiles (Namibia).

Foreign direct investment in Africa by African firms appears in the official data to be negligible, mostly accounted for by the $2 billion that South African firms report as having been invested on the continent. Given the poor quality of FDI statistics in Africa, however, it seems more likely that much of this capital passes 'under the radar screens' in the sense that the origin or even the nature of the investment is not recorded. Data from other sources suggest that the African presence is substantial, particularly but not exclusively from South Africa.

A survey by UNIDO (2003) of 758 foreign investors in ten African countries, largely excluding the petroleum and mining sectors, found that the most frequent investors in these countries since 2000 have been African firms. In Tanzania, for example, more than 60 per cent of investors are African. With the exception of recent Asian investors, most of these investors operate in resource- or low-technology-based activities designed to provide goods or services to the local market. Where they do export, it is usually to neighbouring markets. For all investors in the survey, the most important considerations are political and economic stability and local market conditions in the host country.

In the UNIDO survey, two-thirds of African investors came from countries other than South Africa. If one looks instead at FDI in terms of capital invested, which gives greater weight to the largest projects, and if one includes mining, then South African firms appear to be much more dominant on the continent. Using survey data which go beyond the balance-of-payments reporting of FDI, Rumney and Pingo (2004) finds that South African firms account for over one-half of investments in five economies of the region over the past decade, including 86 per cent of investment in Lesotho and 80 per cent in Botswana. If one includes technology licensing and other agreements, the dominance of South African firms is likely to be even higher.

This South African investment is taking place across all major sectors: mining, telecommunications, power generation, retail trade, financial services and manufacturing. South African investors are able to capitalize on their experience within the South African economy, with its combination of both first- and third-world characteristics. South African investment in Africa may be understated since some South African firms have sought a primary listing in London and hence are usually considered to be UK investors in other African countries.

What do rising FDI inflows, both from outside and within Africa, imply for future African development?

The evidence presented above suggests that investment flows into and within Africa are rising steadily and that the foreign presence on the ground is perhaps significantly more than what is reported in the balance of payments. While the precarious nature of African development makes any talk of an African economic renaissance premature, the rise in inflows is nevertheless both a signal of renewed private-sector confidence in African prospects and an indication of the path which African development might follow in the near future.

Consider first the impact that FDI might have on African development. The list of what ails Africa is long, and few would argue that either aid or foreign investment alone can remedy the situation. But FDI can help to address one long-standing weakness. In addition to the capital, technology and expertise which foreign investors typically bring with them, they also offer the prospect of a greater diversification of the industrial base and of exports. The dependence of many African economies on exports of a limited range of commodities facing a secular decline in the terms of trade and subject to frequent shocks is one of the core weaknesses of Africa in its attempts to become more integrated with the global economy.

Asian investment in Africa and the subsequent rise in textile exports to the United States as a result of AGOA is one demonstration of how this integration might come about. With virtually no textile industry in 2000, Lesotho exported $450 million of textiles to the US market in 2004. The challenge for African governments is to make these changes durable; success is by no means assured given the time-bound and preferential nature of AGOA and the fact that foreign investors have not yet developed many local linkages in this sector. Nevertheless, if the clustering of foreign investors in this sector leads to agglomeration economies and dedicated infrastructure, it is possible that they will continue to export from the region even after benefits of preferential access have disappeared. At the very least, such activity demonstrates that foreign investors and some African economies can react remarkably quickly to opportunities to supply the global market.

Foreign investors can help to bring about greater integration not only with markets elsewhere but also within Africa. Pan-African ownership structures are more likely to foster pan-African solutions. In power generation, for example, Eskom of South Africa has a presence in 28 different countries on the continent. In the long run, regional investors such as Eskom might serve to encourage the rationalization of power infrastructure on the continent. The ability of Eskom to supply electricity from South Africa to Mozambique was one of the key elements behind one of the largest investments in Africa, the Mozal aluminium smelter in Mozambique. Imports of electricity by Mozambique have increased 20 times since the project came on line (Castel-Branco, 2004).

What do rising inflows say about the state of governance on the continent?

Political and economic stability are identified in surveys as key concerns of investors, and in these areas many African countries – with a few exceptions – have made good progress.

• Real GDP growth in Africa is expected to average five per cent in 2004–06 according to the African Development Bank. Growth in Tanzania and Mozambique, for example, has been at over 7 per cent in real terms since 2002 and is expected to continue at this rate at least through 2006. Growth in Uganda has averaged over 5 per cent in real terms over the past decade. Both Uganda and Mozambique have emerged from a period of political upheaval and violent conflict.

• At the same time, inflation is falling in Africa, reaching a historical low in 2004, and is expected to decline further over the next two years.

• Political stability is harder to measure, but according to the Commission for Africa more than two-thirds of sub-Saharan countries have held elections in the past five years.

In the 2003 UNIDO survey of foreign investors, in eight out of ten countries only 9 per cent of firms on average felt that the investment climate had deteriorated since established operations, compared to an average of 45 per cent believing that it had improved. In only two countries were negative and positive assessments evenly balanced.

In some countries, governments have sought to improve the investment climate as a direct consequence of the desire to attract more investment by simplifying investment procedures, signing bilateral investment and double taxation treaties, liberalizing trade and actively promoting foreign investment in their economies. Sometimes countries are not as open to foreign investors as they would like to believe, but in some cases host governments have made tangible progress not only in changing legislation but also in reforming a bureaucratic mindset within relevant government ministries. A World Bank study of Mozambique (Wells and Buehrer, 2000) found that investor interest in creating an aluminium smelter led to real and lasting changes in the way in which investments are approved.

Governance matters relating to foreign investment in the oil, gas and mining sectors will benefit increasingly in the future from the Extractive Industries Transparency Initiative under which both governments and companies publicly disclose all payments from the investor to the government. So far Ghana, Nigeria, the Republic of Congo and São Tomé and Príncipe have all signed up to the Initiative.

FDI and aid flows to Africa

Improved governance has implications beyond its influence on the level of inflows. For both investment and aid, better governance can bring about better-quality projects with higher social returns. Taylor (2005) cites one estimate that aid to Africa over the past 50 years has amounted to a trillion dollars at today's prices. A rough estimate for FDI to Africa since 1970 suggests a figure of $200 billion. And yet, in spite of these infusions of capital, Africa has had declining real per capita incomes for much of this period.

The revival of foreign investment in Africa suggests that the risks to private investment have been lowered as a result both of specific policy changes and of improvements in governance more generally. In turn, these improvements reduce the risks and raise the returns on investment which, according to estimates by UNCTAD (1999), have often been surprisingly high in Africa. This tentative renaissance in Africa strengthens the argument that increases in aid flows to Africa will be better spent than in the past.

Aid and FDI flows are complementary. Not only can public donors encourage private investors and vice versa, but together they can also make a greater contribution to development than either by itself. This can be seen most clearly with respect to infrastructure where neither the large aid-financed projects of the 1950s and 1960s nor the largely private projects of the 1990s have yielded the expected private and social returns in many cases. In this light, any increase in aid to Africa such as through debt relief agreed at the G8 meeting is likely to foster greater flows of foreign investment in the future. When allied with improvements in governance on the continent, the combined impact of increased aid and FDI might well yield positive results on a far greater scale than has previously been seen.

Stephen Thomsen is an Associate Fellow of the International Economics Programme at Chatham House.

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