Sub-Saharan Africa's shifting FDI landscape

SUB-SAHARAN AFRICA

FRANK L BARTELS AND **SADIQ ALLADINA** DISCUSS THE CHANGING DYNAMICS OF INVESTOR PERCEPTIONS IN SUB-SAHARAN AFRICA AND OFFER INSIGHTS AND POLICY ADVICE FOR THE REGION

Illustration by John Holcroft

A series of surveys that took place over a decade of the 2000s analysing location-specific factors for FDI from the perspective of multinational enterprises (MNEs) in sub-Saharan Africa (SSA), shows that the most important factors, such as a country's political economy and the trade dynamics of hosts to FDI, are stable over time.

The surveys also emphasise that by 2010, political and economic stability had taken a backseat to production inputs, which had become the single most important factor. It is recommended that countries in the region increase the supply of public goods that reduce transaction costs for FDI; the predictability of the overall policy environment; and the productivity-adjusted cost efficiency of inputs.

The Africa Investment Promotion Agency Network is a programme established in 2001 by the UN Industrial Development Organisation to provide African investment promotion agencies a platform for developing differentiated strategies to effectively promote FDI inflows into SSA. The foreign investor surveys started in 2003 and provide information for policy making. The surveys were repeated in 2005 and 2010.

In 2003, the respondents, MNE senior executives, answered a questionnaire on the importance of location-specific factors. The survey grew in size in 2005 and 2010, with more respondents and an average response rate of 36% across all three surveys.

An overwhelming number of respondents are investors in SSA's least developed countries. These countries are perceived as corrupt and heavily indebted.

Since 1980, SSA's share of FDI averaged only about 1% of global flows. This, along with state failure, market failure, corruption and overall political and economic dysfunction, prompted *The Economist* magazine to label Africa "the hopeless continent" in 2000. Eleven years on, the tide had turned with the magazine branding Africa "the hopeful continent".

In the past decade, Africa has grown faster than east Asia, doubled its trade with the rest of the world and propelled seven of its countries into the much-vaunted club of the 10 fastest growing global economies. According to the World Bank, this charge of fortune is attributable to increased average economic growth rates between 2006 and 2008, meaningful progress on the UN's Millennium Development Goals, increasingly attractive investment prospects, and gains from market-oriented reforms. And yet, SSA continues to face serious challenges with respect to FDI. FDI inflow growth to SSA has declined relative to other regions, despite policy reforms in the business environment.

Over the long term (2003 to 2010), the primary concern for MNEs has shifted from political and economic stability to the availability of production inputs. This change suggests that many MNEs have adapted to the relative level of instability in SSA and sharpened their focus on skilled labour and raw materials, thereby shifting from market-seeking to efficiency-seeking FDI. Related to this is that higher regional growth rates in recent years have enticed MNEs. It has long been held that without proper infrastructure, economic stability and investment climate transparency, resources directed to FDI promotion will be in vain because investors simply cannot price risk in environments lacking these benefits. Our latest findings run counter to the long-term view that political and economic stability is always paramount. While political and economic stability remain important in SSA, they simply do not matter as much as in the past.

Trade dynamics have become more important to FDI decision making. This can be explained by the increase in investments from non-traditional sources (ie regions other than Europe and America) that have exhibited a greater tolerance of corruption, lack of transparency and turmoil associated with unstable regimes; and the positive results of the structural adjustment programmes implemented during the 1980s and the Heavily Indebted Poor Countries initiative of the International Monetary Fund and World Bank.

The trade agreements are not perfect, however, and can be inconsistent and ineffective. The ability of SSA to attract FDI in recent years masks the deficiencies of its trade agreements and leaves considerable room for improvement in terms of policy making to boost export-oriented FDI and trade in the region.

Production options

Production constraints have eased over time and the relative importance of real options has declined. The two are interrelated: the increased availability of production inputs as measured by materials and labour has reduced the need to manage risk through joint ventures and the acquisition of existing assets in the host country. This trend, coupled with earlier observations, underscores the need for policy making to focus on the long-term importance of the political economy determinants of FDI; technological reskilling through education investments to enhance productivity-adjusted cost of labour; investments in infrastructure; judicious liberalisation of trade regulations; and enabling national systems of innovation to improve the capability of local firms to act as suppliers in global value and supply chains.

The importance of the local market of the host country has increased over time. According to the World Trade Organisation, intra-regional trade as a share of world merchandise exports in 2010 were very low in Africa (3%) compared with continents such as North America (16.9%), Europe (39.4%) and Asia (28.4%).

The absence of any meaningful functional integration in the SSA market should come as no surprise. At first glance, the importance of the local market seems counterintuitive given that the importance of the export market should grow over time as regional trade agreements further facilitate the flow of goods and allow foreign investors to reap the benefits of scale.

However, first, the run-up in resource prices in SSA has given investors, especially the BRICS countries, an incentive to focus on local markets. Second, Africa now has the fastest growing middle class in the world. In the past three decades, Africa's middle class has increased threefold to 313 million in 2010, representing 34.3% of the population according to the African Development Bank. Current projections indicate growth of this middle class to about 1.1 billion by 2060.

Incentives only matter after the foreign investor has established a presence in the host country. Once a foreign investment has been made, policymakers should shift emphasis from resources to market advantages that will ultimately reduce operational costs for investors. Examples include the removal of administrative obstacles and managerial impediments. Policymakers should note that once the FDI is made, bargaining power shifts from investor to host.

Policy implications

Political-economic stability and the availability of resources and other factor inputs remain crucial FDI inflows in SSA. But what is noteworthy is the shift in importance from political-economic stability to the availability of resources. By 2010, the availability of production inputs was as the single-most important location factor.

Despite recent improvements, SSA is still experiencing difficulty making its political economy attractive. Without the policy making that increases investor confidence, the region is unlikely to secure the positive externalities associated with FDI and will instead become significantly reliant on its natural resource base. SSA's overreliance on official development assistance lends support to the idea that FDI inflows to date have not adequately addressed budgetary gaps; this is worrisome given the austerity measures taken by the US and Europe that will invariably reduce assistance and magnify the need for SSA countries to improve competitiveness and diversify their economies.

Specific trade agreements in the EU and US reduce in their importance according to MNE executives. These agreements are failing to harmonise sub-regional trade agreements and internal import tariffs, which account for nearly 25% of SSA government revenues, and impede efforts of host countries to form cross-border supply chains. Inefficiencies stemming from poorly drafted agreements suggest there are untapped benefits from more coherent arrangements. Given the fragmentation of African markets, there exists an opportunity to enjoy the benefits of a large, unfettered trading zone through greater market integration. Essential to this would be refinement of existing trading agreements.

As host countries become specialised, local skills become crucial. In SSA's regional economic context, policy attention must turn to investments in human capital as this attribute has overtaken political and economic stability over time. Unlike broader location factors that lie beyond any single authority, human capital investment is a choice that African governments can make. However, there are cases where military spending as a percentage of GDP is far greater than spending on education and healthcare. What may prompt African governments to shift priorities is unclear.

The continued importance of skills raises the questions: which policies should be pursued and in what order? The surveys indicate that increased market competitiveness and precise policy prescriptions combined with exactly calibrated and increasing lower modal neutrality, which evolves from a preference for joint ventures, to transfer technology, to permitting wholly owned subsidiaries, are required.

The political and economic environment, and the elimination of trade distortions to enhance efficiency are integral to the sustained growth of FDI inflows in the region. Turning attention to other location-specific factors, such as incentives, at the expense of these priorities may be counterproductive. ■

Dr Frank L Bartels is former senior advisor at the UN Industrial Development Organisation. Sadiq Alladina, CFA, is his former analyst and works as a real estate investment professional in Canada.