Symposium de Haut Niveau sur la Coopération Afro -Arabe dans le Domaine de l’Investissement et du Commerce
Sous le theme “Pour le renforcement du Partenariat Economique Afro -Arabe”

High Level Forum on Arab-African Cooperation in Investment and Trade
Under the Theme “ For an Arab-African Economic Partnership”

Afro-Arab Cooperation on the Promotion of Investment Flows between Arab African Countries

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Afro-Arab cooperation on the promotion of investment flows between Africa and the Arab world

August 2010
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1 Preamble

The first and second Organising Committee meetings of the AU/LAS “High Level Experts Meeting on Investment Prospects in Africa and the Arab World” were convened at the Headquarters of the League of Arab States in Cairo, with the theme “Enhancing Afro-Arab Investment for Development”. The Organising Committee meetings commissioned two earlier reports: (1) a Technical Report, which reviewed the conditions surrounding both the level of foreign direct investment, as well as its determinants in Africa and the Arab world, and (2) an associated Joint Action Plan, which sought to identify concrete strategies and actions to enhance Afro-Arab investment exchange. These reports were presented at the HLEM held in April 2010. In what follows, they are referred to as the AU-LAS Technical Report (AU-LAS 2009a) and the AU-LAS Joint Action Plan (AU-LAS 2009b) respectively.

This study was prepared for a High Level Symposium on Afro-Arab cooperation on investment and trade organised jointly by the African Union (AU), the League of Arab States (LAS), the Arab Bank for Economic Development in Africa (BADEA) and the Libyan Jamahiriya. The report is commissioned by the Arab Bank for Economic Development in Africa (BADEA) The Symposium will be held on the 25-26 September 2010 in the Libyan Jamahiriya.

The main objectives of the High Level Symposium include:

- To deliberate on the factors behind the weakness of investment flows and trade between Africa and the Arab countries,
- To highlight Afro-Arab cooperation opportunities in the areas of trade and investment, leading to the promotion of socioeconomic development in the two regions,
- To exchange views on the desired policies and actions that encourage the private sector to effectively play its role in promoting the flow of investment and trade between the African and Arab countries,
- To contribute to the outcome of the second Afro-Arab summit, leading to fostering Afro-Arab cooperation in the area of investment flows and trade.

Accordingly, the main objectives of this study are to review the state of affairs of investment flows between African and Arab countries, and to identify concrete strategies and actions to enhance investment flows between Africa and the Arab world. This study reflects the more detailed information contained in the Technical Report and Joint Action Plan, but also updates the earlier reports in incorporating additional data, and by deepening the analytical content of the earlier reports.

2 Introduction

Investment (from both domestic and foreign investors and from private and public sources) is the foundation of physical capital accumulation, which in turn is one of the core determinants of a country’s economic growth rate. Domestic investment is undertaken by investors who are residents of the economy, while foreign investment is cross-border investment made by a
resident in one economy (investor) in an enterprise (investment enterprise) that is resident in another economy. Many developing countries have low savings rates and, hence, are unable to generate an adequate level of investment solely from domestic sources. As a consequence, foreign direct investment is of particular importance to developing countries.

According to the IMF and OECD definitions, foreign direct investment (FDI) occurs when the motivation of the investor is the development of a "lasting interest" in the investment enterprise, indicated by the investor owning at least 10% of the voting power of the investment enterprise. This differs from foreign portfolio investment (FPI), where the motivation of the investor is not generally to influence the management of the enterprise.

FDI is generally viewed as preferable to FPI because it tends to be less volatile. However, a high proportion of FDI in total foreign capital inflows may also be a sign of poor economic health. Countries with institutional weaknesses and high domestic risk will finance themselves primarily through FDI, which is seen as harder to expropriate (see for instance, Razin, Sadka, and Yuen 1998, Hausmann and Fernandez-Arias 2001 and Albuquerque 2003). Thus, while FDI may be more stable, a high dependence on FDI over FPI may be an indicator of a weak economy.

One advantage of FDI over domestic investment is that it may carry positive technology spillovers from the source to the host country. These technology spillovers improve productivity and promote growth, and can occur through several channels:

- A local firm copies some technology used by a multinational corporation (MNC) in the local market, thereby improving its productivity.
- The entry of an MNC into the local market increases competitive pressure forcing local firms to become more efficient.
- An MNC engages in skills development and training of local workers, who go on to work for local firms or start their own businesses.
- An MNC assists its local suppliers by (i) providing them with technical assistance, (ii) providing managerial and organisational training and assistance, (iii) assisting in the setting up of production facilities, and (iv) assisting local suppliers to find additional customers, including affiliates of the MNC.

Borensztein, De Gregorio, and Lee (1998) find that for 69 developing countries FDI increases productivity only when the host country has a minimum level of human capital stock. Thus, FDI promotes economic growth only if the host economy is sufficiently able to absorb the advanced technologies of the source country. In the case of South Africa

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1Note, however, that there is a countervailing view. Faria and Mauro (2004) argue that inalienability of FDI depends upon the sectoral allocation of FDI, such that the inalienability of FDI hypothesis applies mostly to high technology or human capital-intensive sectors where the benefits of expropriating foreign capital by the host country are very low. In most developing countries, FDI is concentrated in capital-intensive sectors and/or the primary commodities sector where the host country can easily expropriate foreign capital. Under such conditions, the Albuquerque (2003) prediction breaks down, leading to a relationship where institutional weaknesses and high domestic risk lead to a composition of foreign capital biased towards non-FDI foreign capital. Fedderke and Gwenhamo (2009), in testing for the two mechanisms in the case of South Africa, find support for the Faria and Mauro (2004) position, rather than the Albuquerque (2003) prediction.
specifically, Fedderke and Romm (2006) find that FDI to South Africa has led to positive spillovers on capital and labour productivity.

Borensztein, De Gregorio, and Lee (1998) also find that FDI leads to an increase in domestic investment though the effect is not robust. By contrast, Fedderke and Romm (2006) find that for South Africa FDI crowds-out domestic investment in the short-run, but does lead to an increase in domestic investment in the long-run. Any crowd-out of domestic investment is a short-run effect, while in the long-run FDI leads to an increase in domestic investment. These results suggest that FDI exercises a positive impact on long run growth performance, by directly raising the capital stock of countries, indirectly by raising domestic investment rate in the long run, as well as by generating positive technology transfers to the host country of the FDI. Thus the results do not indicate that policymakers face a trade-off between foreign and domestic investment, but a symbiotic relationship between the two instead. This is not surprising since the factors that attract foreign investment are also the factors that stimulate domestic investment - hence policies which create a favourable investment climate apply to all investment regardless of its origin, and hence are likely to promote both domestic and foreign investment.

3 Investment in African and Arab countries

Investment rates vary considerably across the African and Arab countries. Figures 1 and 2 report the investment and savings rates of League of Arab States and African Union countries respectively. The evidence suggests considerable heterogeneity both within and across regions in terms of investment and savings performance.

For the LAS countries, the average investment rate has been 22.65% of GDP over the 2000 - 2008 period, while the average savings rate has been 23.15%. If the West Bank and Gaza, Jordan and the Comoros are excluded from the sample, the average savings rate rises to 29.71%. The LAS countries on average therefore, have saved more than they have invested, rendering reliance on FDI less critical, and opening the possibility for the LAS to invest in other regions - including the AU. It is only for a few countries in the LAS (Morocco, Mauritania, West Bank and Gaza, Jordan, Sudan, Egypt, Djibouti) that the standard developing country pattern of a significantly higher investment than savings rate, necessitating foreign capital inflows to cover investment plans, applies.

By contrast, for the AU states the pattern is markedly different. Here the average investment rate over the 2000 - 2008 period is 20.68% of GDP, while the savings rate is only 10.87%, so that the average savings gap (calculated by the difference between the investment and savings rates) for the region amounts to 9.8% of GDP. For the AU, in contrast to the LAS, there is thus a strong need for foreign capital inflows. In the case of some countries (Lesotho, Eritrea, Liberia) the magnitude of the savings gap is particularly acute. But even on average across the region, there is a need for approximately 10% of GDP to cover the short-fall of savings relative to investment plans in the region. As a consequence, the AU is particularly reliant on foreign capital inflows in order to cover this short-fall.

Such foreign capital inflows can take one of two forms, portfolio capital inflows and foreign direct investment. We examine these two sources of capital flows for the two regions in turn.
Figure 1: League of Arab States Investment and Savings Rates (% of GDP).
Figure 2: African Union Investment and Savings Rates (% of GDP).
3.1 Foreign Portfolio Investment in African and Arab countries

Figures 3 and 4 illustrate the average foreign portfolio investment (excluding liabilities constituting foreign authorities’ reserves) over the period 2000 – 2008 to the Arab and African countries, respectively. For most Arab and African countries, FPI flows are non-existent. Only South Africa, Ghana and Lebanon received significant portfolio investment, while a few countries registered significant recorded outflows. The relative lack of FPI flows to African and Arab countries is not surprising given their relatively undeveloped and illiquid stock and bond exchanges. For instance, the market capitalisation of the stock exchange in 2008 was $491 282 million in South Africa, $85 885 million in Egypt, $9 641 million in Lebanon, $49 803 million in Nigeria and $3 394 million in Ghana, compared to $468 595 million in Hong Kong, $2 793 610 million in China, $494 631 in South Korea and $645 478 in India. The liquidity of the stock exchange (measured by the total value of stocks traded as a percentage of GDP) in 2008 was 145% in South Africa, 43% in Egypt, 2% in Lebanon, 10% in Nigeria and 1% in Ghana, compared to 289% in Hong Kong, 126% in China, 158% in South Korea and 91% in India.

In the case of the LAS countries, the presence of significant portfolio capital outflows is also the logical consequence of the savings exceeding investment rates. The excess of savings over investment results in the search of investment opportunities internationally, with a resultant outward flow of portfolio capital.

However, given the substantial savings gap (10% of GDP) in the AU, and the resultant need for foreign capital inflows, the lack of FPI flows makes the AU countries even more reliant on FDI for the foreign investment required to bridge the savings gap.

3.2 Foreign Direct Investment in African and Arab countries

In 2008 and early 2009, global FDI flows fell following a period of continuous growth from 2003 to 2007. In contrast, the share of global FDI inflows to developing countries rose to an all-time high of 37% in 2008. FDI inflows to Africa increased by a considerable 27%, and FDI inflows to West Asia increased by 16%. However, FDI inflows to developing countries began to decline in late 2008, almost a year after the downturn began in developed countries. (UNCTAD 2009b)

Figure 5 illustrates inward FDI to the sub-regions of Africa and West Asia since 2000. Over the last few years, inward FDI to West Asian countries has exceeded that to Africa. Within Africa, Northern and Western Africa have attracted the greatest share of Africa’s inward FDI. Eastern and Southern Africa have not performed particularly well in terms of inward FDI. Figures 6 and 7 break down the distribution of FDI inflows further, to show the average flows to specific African and Arab countries over 2000 – 2008. FDI inflows to Nigeria and Angola were significantly larger than to other African countries, largely driven by projects in the oil industry. The top 10 FDI host countries in Africa (excluding LAS members) accounted for 83% of the region’s inflows, while the top 5 FDI host countries in the Arab League accounted for 69% of the region’s inflows.

Figure 8 compares the FDI inflows to the top 10 Arab and African countries with those to the top 10 developing and transition economies in the world as a whole. On average, even the best performing African and Arab countries are not attracting as much FDI inflows
Figure 3: League of Arab States Portfolio Capital Flows.
Figure 4: African Union Portfolio Capital Flows
Figure 5: FDI Flows to the AU and LAS regions.
Figure 6: Average FDI Inflows to LAS Countries, 2000 - 2008.
Figure 7: Average FDI Inflows to non-LAS AU countries, 2000 - 2008.
as the top 10 developing and transition economies. Two exceptions are Saudi Arabia and United Arab Emirates, where FDI is mostly in petrochemicals, refining, real estate and construction.

Since FDI flows can change significantly from year to year and in response to economic cycles, it is important to consider the FDI stocks of countries, which gives a better reflection of the average FDI performance, particularly over the long run. Figures 9 and 10 illustrate the FDI stocks of Arab and African countries respectively.

South Africa accounts for 36% of Africa’s FDI stock, and Saudi Arabia accounts for 24% of the Arab League’s FDI stock. Figure 11 compares the top 10 African and Arab countries with the top 10 developing and transition economies in terms of their FDI stocks. Again, even the best performing African and Arab countries have not been able to attract levels of FDI comparable with the top 10 developing and transition economies. Two exceptions are South Africa, which was the eighth best developing and transition host economy (in terms of FDI stock) in 2008, and Saudi Arabia which was ninth best. There there is thus considerable room for African and Arab League countries to improve their performance in attracting FDI.

The sectoral composition of FDI differs among countries. In non-Arab African countries, FDI is concentrated in the primary and services sectors, and is marginal in the manufacturing industries. In non-African Arab countries, FDI is concentrated in the services sector and in manufacturing industries related to oil and gas, such as petrochemicals, refining, and liquefied natural gas (LNG). FDI in the primary sector is relatively small, as important restrictions to foreign participation remain in activities relating to upstream oil and gas. In African Arab countries, FDI is more diversified between primary, manufacturing and services activities, with some efficiency-seeking FDI in manufacturing activities. (UNCTAD 2009a)

Thus, while there are encouraging signs of diversification in the sectoral distribution of FDI into the two regions, equally it remains true that the FDI remains significantly tied to a primary resource base.

### 3.3 FDI Flows Between African and Arab countries

It is difficult to analyse investment flows between African and Arab countries due to the limited availability of data. Nevertheless, the existing partial data do reveal: (1) significant FDI flows from non-African Arab countries to North Africa, while FDI flows in the opposite direction have been negligible, (2) relatively large intra-regional FDI flows in countries that are AU-only and LAS-only member countries, and (3) weak FDI flows between Arab countries (including North Africa) and sub-Saharan Africa (UNCTAD 2009a)

Tables 1 and 2 illustrate West Asian cross-border mergers and acquisitions (M&A) purchases and greenfield FDI projects in Africa, respectively. Most of West Asian FDI in Africa is located in North Africa, particularly in Egypt with investments in the financial sector, construction and real estate, tourism, energy, insurance, manufacturing, fertilizers

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2The FDI stock of South Africa is significantly inflated due to the re-listing of companies from the Johannesburg to the London Stock Exchange. Anglo-American, Old Mutual, and South African Breweries moved their listing from the JSE to the LSE in 1999, Didata followed suit in 2000 and Investec in 2002. Upon re-listing, the South African plants of these firms became part of South Africa’s FDI stocks. Thus, a part of South Africa’s FDI stock reflects book-keeping changes rather than actual FDI into the country.
Figure 8: Comparing Top AU and LAS FDI Attracting Countries, with International Benchmark Countries.

Table 1: West Asia: net cross-border M and A purchases in Africa, 2001 -2009 (millions of Dollars)
Figure 9: FDI Stocks in LAS Countries.

Table 2: West Asia: greenfield FDI projects, 2003 - 2008 (number of deals)
Figure 10: FDI Stocks of AU Countries.
Figure 11: FDI Stocks in Top Developing and Transition Economies.
and telecommunications. Arab investment in other North African countries is mainly in telecommunications, with ports, real estate and tourism also receiving investment. The Gulf states have also made investments in agriculture in Africa to ensure food security. The location of this food security-related FDI in Africa is determined by both the availability of land as well as water resources to irrigate it. Some examples of investments include: the purchase of farmland in Sudan by the United Arab Emirates, Saudi Arabia’s purchase of land in the United Republic of Tanzania and proposal to invest in Ethiopia and Sudan; and Qatar’s interest in leasing land in Kenya. (UNCTAD 2010a)

3.4 Impact of the Financial Crisis on FDI in African and Arab countries

The global financial and economic crisis has had a significant effect on foreign direct investment. In 2008 and early 2009, global FDI flows fell following a period of continuous growth from 2003 to 2007. In contrast, the share of global FDI inflows to developing countries rose to an all-time high of 37% in 2008. FDI inflows to Africa increased by a considerable 27%, and FDI inflows to West Asia increased by 16%. However, FDI inflows to developing countries began to decline in late 2008, almost a year after the downturn began in developed countries. (UNCTAD 2009b) This may be attributable to declining confidence and the rapid deterioration of market prospects. Furthermore, because of the financial crisis companies face reduced access to credit and have difficulties in funding their investment projects.

The crisis has impacted on the sectoral distribution of FDI: mergers and acquisitions increased by 17% in the primary sector, but declined by 10% and 54% in the manufacturing and services sectors, respectively. (UNCTAD 2009b) The worsening economic situation has also changed the prime motivation for international expansion by MNCs from seeking to gain access to growing or new markets, to now seeking to contain and reduce costs (IBM Global Business Services 2009). Africa, particularly the North African countries, have benefited from companies seeking lower cost alternatives to European locations as companies increasingly view some African countries as potential alternatives to locations in Eastern Europe and Asia (IBM Global Business Services 2009). Some African locations now display attractive cost-quality trade-offs for some investment projects compared to competitor locations in Eastern Europe as they have more favourable business environments and competitive costs (IBM Global Business Services 2009).

Recovery of FDI inflows is expected to be slow in 2010, but should accelerate in 2011 provided the world economy recovers (UNCTAD 2009b). The sectors that have been badly affected by the cyclical changes in the economy, e.g. business services, electronics and ICT, may see a relatively rapid recovery in investment activity as the global economy begins to grow. Sectors that have been less responsive, or even counter-cyclical, with respect to foreign investment, such as minerals, are less likely to see a major increase in investment activity as a result of a future recovery in global economic activity. Furthermore, sectors that are experiencing a structural decline in investment activity, such as wood and paper, are unlikely to benefit as much from the economic recovery. (IBM Global Business Services 2009)

Encouraging investment exchange between African and Arab countries could help coun-
teract the expected slowdown of inward FDI in the aftermath of the financial crisis, in particular to the smaller and structurally weak African countries.

The financial crisis has also prompted many governments to introduce various initiatives to strengthen financial regulation and reform financial regulatory frameworks. Increased financial regulation could lead to healthier financial systems at national and international levels, better monitored and controlled financial risks and improved macroeconomic stability, which will assist the long-term growth of global FDI. However, the short and medium term effects of increased financial regulation on FDI flows is likely to be varied. The safer credit and renewed confidence in the financial system will render MNCs more willing and able to invest abroad, but greater restrictive measures could increase the complexity of international investment and the functioning of financial institutions. Furthermore, FDI could be diverted to countries with relatively low levels of financial regulation, unless international financial reform is well coordinated. (UNCTAD 2010b)

In net terms, therefore, while the financial crisis has lowered the absolute level of FDI flows internationally, it has also switched FDI flows toward developing and emerging markets in relative terms. For the AU and LAS countries the crisis has thus been of mixed effect in terms of FDI, and certainly the relative switch to developing and emerging markets in Africa has made the impact of the crisis less severe than might have been feared at its outset.

3.5 Impact of the Food Crisis on FDI in African and Arab countries

As discussed earlier, many of the Arab countries have invested in agricultural production in African countries to ensure food security for their populations. Foreign investment in agriculture also presents opportunities to strengthen local food security and have a beneficial impact on local development.

3.6 Impact of Climate Change on FDI in African and Arab countries

MNCs have an important role to play in combating climate change. They can reduce global greenhouse gas emissions through foreign investments that improve technologies and processes in their operations and value chains. They can also supply low-carbon products and services. The key sectors where there is scope for the reduction of emissions are sectors where MNCs are significant emitters (i.e. power and industry), sectors where emissions are mostly from consumption and public use (i.e. transport, buildings and waste management) and sectors where emissions are caused by changes in land-use such as deforestation and land degradation (i.e. forestry and agriculture). (UNCTAD 2010b)

Some low-carbon FDI projects in African and Arab countries include:

- In Nigeria, the China Civil Engineering Construction Company (CCECC) has started work on the LagosRail Mass Transit project. This represents an attempt to shift to mass transport systems and thereby reduce emissions in the sector.
• In Lesotho, Philips (Netherlands) has built a manufacturing facility of energy-efficient compact fluorescent lamps, as well as the first CFL recycling plant in Africa. Most of the facility’s output will be exported across Southern Africa, to satisfy the region’s increasing demand for energy-efficient lamps. This is expected to reduce the indirect emissions from electricity consumption in the building sector.

• In Ethiopia, Anmol Group (India) has recently invested in a large paper making plant in Ethiopia using waste paper which would normally be incinerated. This represents foreign investment in both low-carbon process and product, and will reduce emissions in the waste management sector.

• Morocco, South Africa, Tunisia and Zambia have received greenfield investments in alternative/renewable power generation.

• Algeria, Libyan Arab Jamahiriya, Mozambique, South Africa and Tanzania are among the largest developing country recipients of greenfield investments in the manufacturing of environmental-technology products, such as wind turbines, solar panels and biodiesel plants, and associated parts.

The general determinants of FDI (government policies, market conditions, costs of production and business conditions) are also the determinants of low-carbon FDI. There are also some climate change-specific factors, such as green branding strategies, regulations and pressure from consumers and investors. Developing countries are faced with two main challenges when moving toward a low-carbon economy: (1) financing and implementing investment in suitable activities; and (2) the creation and propagation of appropriate technology. There is thus considerable scope for Afro-Arab cooperation to promote low-carbon FDI while minimising the potential risks of these investments.

3.7 Overview

The data indicate that, in general, FDI performance in Africa and the Arab world has been worse than for other developing countries, but has also varied considerably across the different African and Arab countries. For instance, Saudi Arabia and South Africa are notable exceptions, as these countries are among the top 10 developing and transition FDI host economies in terms of FDI stock. It is therefore clearly possible for African and Arab countries to attract significant levels of foreign direct investment. This makes it crucial that we understand the drivers of foreign investment to ensure that more Arab and African countries can attract sustained high FDI inflows. We take a closer look at the determinants of foreign direct investment in the next section.

4 Determinants of Foreign Direct Investment

Private investment choices, by both domestic and foreign private investors, are made on the basis of the relative rates of return and risk levels of the different investment opportunities.
An investment that offers a high rate of return and a low level of risk is preferable to one offering a low rate of return and a high level of risk.\(^3\)

One can distinguish between two broad motivations for FDI: to access local markets, and/or to get access to lower cost inputs. Horizontal FDI, or market seeking FDI, is the establishment of duplicate production plants in the foreign country to serve the market there. Horizontal FDI is often undertaken to get around trade restrictions which make exporting too costly. A MNC will only set up a production facility in a new location if it is more profitable and less risky than exporting. A factor that significantly increases the return on horizontal FDI is a large and fast-growing market, but the other factors that affect the risk and return of an investment (infrastructure, political and macroeconomic stability, institutions, etc.) are also important for attracting horizontal FDI. Trade liberalisation has two opposing effects on horizontal FDI – greater openness encourages growth which leads to a larger market size, attracting horizontal FDI, but it also makes exporting more profitable since trade barriers are lower, reducing the need for horizontal FDI.

Vertical FDI, or resource seeking FDI, involves locating part of the production process in a foreign country in order to lower production costs. Unlike with horizontal FDI, where the concern is how best to serve the host market, with vertical FDI the concern is how best to serve the home market.\(^4\) Vertical FDI is attracted by the particular features of the host country that will lower the cost of production such as the costs of labour, the skills of the labour force, the abundance of natural resources and the quality and efficiency of infrastructure. Vertical FDI will only occur if the cost savings from producing abroad outweigh the trade costs incurred to transport the goods from the host to the home country.

The expected return on investment is determined by the income earned from the investment relative to its cost. The risk of an investment reflects the level of uncertainty about the future income stream that will be generated by the investment.

First, we outline the various factors that affect FDI, and then we review the investment climate in African and Arab countries. The focus is on the external factors that determine the size and location of the FDI of a multinational corporation (MNC).\(^5\) Although we emphasise FDI, those factors that promote FDI will also promote domestic investment because all types of investment choices are influenced by the risk and return of the investment opportunity. The same factors that increase the returns on FDI will also increase the returns on domestic investment, and the same factors that reduce the risk of FDI will also reduce the risk of domestic investment. Therefore, policymakers do not face a choice between stimulating domestic investment or foreign investment. The same policies that promote foreign investment will promote domestic investment.

The following factors will increase the rate of return by raising the profitability on an investment (please refer to the earlier AU-LAS Technical Report for greater detail on these factors:

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\(^3\)Public investment choices are made on a different basis to private investment decisions. Public investment is often in infrastructure and is motivated by the provision of public goods that will raise productivity in the economy, both directly and indirectly by raising the productivity of factors of production. Public investment decisions may also by politically motivated.

\(^4\)The home (or source) country is where the FDI originates from, while the host country is where the FDI is located.

\(^5\)See (Blonigen 2005) for a brief review of the literature dealing with the factors internal to a firm that motivate it to undertake FDI in the first place.
mechanisms, particularly concerning the empirical evidence in their support):

- **High institutional quality.** Good institutions are an important determinants of FDI because they can lower the costs of investment, by increasing the certainty of the investment environment, thereby lowering the risk of the investment, as well as by lowering the transactions costs surrounding exchange and contracting. Strong property rights are particularly important for FDI as they reduce the risk of expropriation of investment. Good institutions lower production costs thereby attracting vertical FDI, and increase economic growth thereby attracting horizontal FDI. Political institutions (which include the form of government) and the distribution of resources affect the distribution of political power and the way in which economic institutions are chosen. Good economic institutions include credible strong property rights and a lack of corruption. Moreover, Easterly and Levine (1998) argue that neighbourhood effects are an important determinant of economic performance – a country’s growth rate is affected by its neighbour’s growth performance, and economic policies are copied by neighbouring countries. Gwenhamo and Fedderke (2009) extend the idea to examine the impact of neighbouring country institutions, specifically property rights, on a country’s inward FDI. The presence of neighbourhood effects increases the uncertainty faced by investors because the quality and stability of institutions in the home country do not exist in isolation, but are influenced by the institutional environment of neighbouring countries. Poor institutions in a neighbouring country can be transmitted to the home country, causing a reduction in inward FDI. Finally, institutional distance between the source and host countries can have a negative effect on FDI because increased institutional distance increases perceived uncertainty or learning costs for the source country, or if institutions depend on economic and social history then we would observe more FDI, ceteris paribus, among countries with similar institutions (Benassy-Quere, Coupet, and Mayer 2007).

- **Larger market size.** Market size is a highly significant determinant of horizontal FDI. The larger is the market, the greater is the profitability from setting up a production plant, which attracts FDI. Developing countries typically have very small domestic markets, heightening the importance of trade openness and the development of regional markets. The development of regional markets removes trade barriers between neighbouring countries, allowing producers to access a larger market at lower cost. This raises the profitability of establishing a production plant in the host country, attracting horizontal FDI.

- **Higher economic growth.** Both current and future expected market size is an important determinant of horizontal FDI. Economic growth generates improved prospects for future market size and will attract FDI. In addition, the conditions that are required for economic growth are the same conditions required to attract inward FDI. A country that has achieved a sustained high growth rate is very likely to have strong institutions, political and macroeconomic stability, trade openness, good infrastructure, low tax rates, low labour costs, a skilled labour force and a flexible labour market. Hence, a sustained and high growth rate conceivably acts as a signal to potential investors that the country is a good target for investment.
• **Greater trade openness.** Greater trade openness is one way to for developing countries with very small domestic markets to achieve market size. Lower trade barriers between neighbouring countries reduces the costs of moving goods in and out of the countries. This allows producers access to a larger market at low cost. Trade liberalisation promotes export-led growth (Sachs and Warner 1995), which in turn improves prospects for future market size thereby attracting FDI. Greater trade openness also allows freedom of movement of intermediate inputs and goods in and out of the country. The increase in competition that arises from trade liberalisation results in increased efficiency as firms innovate to escape the new competitors. (Aghion, Fedderke, Howitt, Kularatne, and Viegi 2008). Increases in the efficiency of the domestic economy will increase its attractiveness to producers, stimulating FDI. However, greater openness will discourage horizontal FDI that is undertaken to “tariff-jump” (i.e. overcome trade barriers). The net impact of trade liberalisation on FDI is therefore uncertain. However, on balance, the existing empirical evidence suggests that greater trade openness will attract FDI.

• **Closeness to markets and coastal access.** Transport costs are determined by the geographical distance between markets, and whether or not the country has coastal access. The greater the geographical distance between markets, the higher the transport costs. Countries with coastal access face lower transport costs than landlocked countries because of their access to ports. Hence, greater proximity to markets and coastal access will reduce transport costs. Lower transport costs will tend to reduce horizontal FDI but increase vertical FDI.

• **Good infrastructure.** The availability and quality of infrastructure (water, transport, telecommunications and energy supply) has a positive effect on both horizontal and vertical FDI. Good infrastructure lowers the cost of locating production in a country. High quality infrastructure enables the import of intermediate inputs and the export of the final good to the foreign country, encouraging vertical FDI. The main service items traded (travel, freight, communications, banking and business services) depend crucially on the existence of high capacity and efficient infrastructure in both the importer and exporter countries (Nicoletti, Golub, Hajkova, Mirza, and Yoo 2003). The availability of high quality transport networks facilitates the efficient transportation of goods between countries, and is particularly important for overcoming any negative effects of geographical location. This is particularly important for Africa, where most countries are a great distance away from the key markets and which has the largest proportion of landlocked countries of all world regions. These geographical factors increase the costs of transporting goods to and from African countries, which negatively affects FDI. Improvements in infrastructure, particularly transport infrastructure, will reduce the transport costs faced by producers. It is crucial to have the right institutions to ensure that governments have the incentives to provide infrastructure through either public investment, public-private partnerships, or by allowing the privatisation of infrastructure provision.

• **Agglomeration effects.** Agglomeration effects can promote clustering – the concentration of firms in specific industries to benefit from a network of competitors, buyers
and suppliers – and thereby encourage both horizontal and vertical FDI. Yehoue (2009) shows that a simultaneous move of complementary firms (domestic or foreign) will create positive spillovers for the firms involved, via backward and forward linkages, which will increase the return of investment, attracting other investment.

- **Lower taxes.** Higher corporate taxes in the host country are likely to reduce the profitability of investment, and will reduce both horizontal and vertical FDI. However, the relationship between taxes and FDI is made more complicated because MNCs face taxes in the parent and host countries, and countries have different methods for dealing with this double taxation issue. Coordination of economic policy in general, but tax policy in particular, is a crucial consideration for FDI.

- **Flexible labour markets.** Lower labour costs reduce the costs of production and should encourage both vertical and horizontal FDI. Labour quality has a positive effect on both vertical and horizontal FDI as a more educated labour force can learn and adopt new technology faster reducing the cost of training local workers. Strict employment protection legislation lowers the return on FDI and makes it more difficult for MNCs to respond to demand and supply shocks.

- **An abundance of natural resources.** An abundance of natural resources will attract vertical FDI as MNCs seek to locate closer to available resources. However, countries with abundant natural resources are more prone to violent conflict, which is a form of political instability which increases the risk of investment, reducing both horizontal and vertical FDI. While an abundance of natural resources may be enough to attract FDI initially, unless countries address the other factors that determine FDI (such as institutions, political and macroeconomic stability, infrastructure, and trade openness) FDI inflows may not be sustained. Countries that currently rely heavily on natural resources for FDI need to channel the natural resource rents into improving infrastructure and institutions and generating human capital, and encourage diversification into other sectors such as manufacturing to ensure continued inward FDI in the long-term.

- **Harmonisation of policies.** A multinational agreement on policies could attract FDI by serving as mechanism to ensure governments remain committed to policies, and removing the transactions costs to potential investors arising from differences in national rules. Harmonisation could be particularly beneficial to AU and LAS member countries because it will avoid competition between governments (e.g. in taxes and subsidies) to attract FDI at the expense of other countries, and can stimulate investment between member countries by addressing major concerns of both the source and host countries. (Hoekman and Saggi 2000)

- **Harmonisation of business law.** Harmonized legal rules will lower transaction costs faced by potential investors, thereby attracting FDI. It will also prevent AU and LAS countries from resorting to lax rules in the relevant areas of the law, including tax, environmental protection, and financial market regulation to attract FDI. (Pistor 2002)
The following factors will reduce the level of risk associated with an investment, by lowering the uncertainty about the expected income from the investment (please refer to the earlier Technical Report for greater detail on these mechanisms):

- **High institutional quality.** Legal institutions – the laws and the quality of their enforcement – that protect investors are an important dimension of economic institutions because they reduce the risks of investment. Strong property rights are particularly important for FDI as they reduce the risk of expropriation of investment.

- **Political stability.** Greater political stability lowers the uncertainty associated with investment. Conflict is one form of political instability, the duration and probability of which increases with natural resource abundance (Collier and Hoeffler 1998). Most African and Arab countries are natural resource-rich, and therefore particularly vulnerable to conflict and must pay careful attention to ensuring political stability. Moreover, Svensson (1998) shows that governments in unstable and polarised countries lack the incentives to undertake legal reform so as to strengthen property rights. Political instability impedes the institutional reforms required to attract FDI.

- **Macroeconomic stability.** The primary sources of macroeconomic instability are inflation, real exchange rate movements and changes in the terms of trade. Both the level and volatility of these macroeconomic variables has an impact on FDI. The negative impact of macroeconomic instability on FDI highlights the importance of macroeconomic policy credibility. Good macroeconomic policy should not be subject to reversal at the policymaker’s whim, and investors should perceive good policies as stable. The right institutions constrain policymakers from reversing good policy choices, and hence are crucial for macroeconomic stability. More than just good policy, therefore, countries that wish to attract FDI need to have good policy which is **credible** - that is, which is not subject to sudden changes in the future. In the context of investment, which is generally undertaken over very long time horizons, this is of particular importance. In the case of FDI, where the investor is undertaking the investment in a foreign country, of which the investor may have limited knowledge, and in which the investor may have limited lobbying influence, the need for good, and also credible policy becomes absolutely vital.

### 4.1 Investment Climate in African and Arab Countries

In order to investigate the relationship between the above determinants and FDI for African and Arab countries, the countries are split into thirds based on the level of FDI stock, as shown in Table 3. The top third FDI host countries in Africa and the Arab world accounted for 91% of all inflows to African and Arab countries, while the middle third accounted for 8% and the bottom third accounted for less than 2%. Since FDI into the African and Arab regions is concentrated in a relatively small number of countries, it is important to understand the differences between these top host countries and the others. In effect, since the top third of African and Arab states get in excess of 90% of FDI flowing into the region, the important question is how this set of countries is different from the rest, in order to understand what might be attracting FDI to these locations. In addition, since even the top
third of African and Arab states does not do as well as the top FDI performing countries in the world, we also wish to know in what ways even the best performing countries in our regions might do better, so as to attract even more FDI than in the past. To do so, we also compare the performance of African and Arab countries with that of the ten developing and transition economies with the highest levels of FDI stock, the “benchmark” group.\(^6\)

### 4.1.1 Institutions in African and Arab countries

We begin by examining linkages between institutions and investment performance.

First, those African and Arab countries with better business environments attract more FDI. As the evidence of Figures 12 through 16 makes clear, this is evident from a range of dimensions. In terms of the number of start-up procedures to register a company, the time required to start a business, and the cost of business start-up procedures, the top third of

\(^6\)South Africa actually has the eighth highest, and Saudi Arabia the ninth highest, level of FDI stock of all developing and transition economies. However, for the purpose of this analysis we exclude South Africa and Saudi Arabia (because they are an African and Arab country, respectively) from the top ten and instead include the next two countries on the list, Chile and South Korea.
AU and LAS countries far out-perform the middle and bottom third of countries. Similarly, in terms of the time required to register property, and the ease with which information can be gained about business ventures (business disclosure index), and to a smaller extent the ease with which an investor can withdraw from an unsuccessful venture (time to resolve insolvency), the top one third of African and Arab states do considerably better than the middle and bottom third. In a number of dimensions there do no seem to be significant differences across the region, however. In terms of the number of procedures and length of time required to build a warehouse, and the number of procedures and length of time required to enforce a contract, African and Arab countries do not show much difference, regardless of their FDI performance.

What is also noticeable, however, is that the world’s top performers in terms of attracting FDI perform even better than the top one third African and Arab countries in a number of ways. In the benchmark countries the cost of starting up a business is lower, there are fewer procedures and it takes less time to register property or enforce a contract, the extent of business disclosure is higher and the time it takes to resolve insolvency is lower than in the top third AU-LAS countries. In the case of both the cost of starting a business, as well as the transparency of business reporting practices, the margins are large.

Thus the institutional environment within which business is conducted matters. The best performing African and Arab states have better business environments than those that are not as successful in attracting FDI. What is more, the international benchmark countries, those most successful in attracting FDI in the world, still outperform even the best grouping of countries in the Afro-Arab region, suggesting that there is still considerable scope for further improvement in creating an FDI-friendly business environment. In order to raise the low levels of FDI flowing to African and Arab countries, the business environment (in particular, starting a business, registering property, enforcing contracts, business disclosure and closing a business) must be improved.

Figure 17 compares the average performance of the four country groupings across a range of governance indicators. The six World Bank (WB) governance indicators range from $-2.5$ to $2.5$, with higher values indicating better governance outcomes. The Economic Freedom of the World (EFW) indicator has a scale of 0 to 10, with higher ratings reflecting stronger property rights and legal institutions.

The top third grouping again clearly perform better than the middle and bottom third groups on the Government Effectiveness, Regulatory Quality, Rule of Law, Control of Corruption and Legal Structure and Security of Property Rights indexes, suggesting that these factors are important for determining which African and Arab countries receive FDI. By contrast, there does not appear to be a link between the Voice and Accountability measures and inward FDI for African and Arab countries. Just as for the business environment, however, the African and Arab countries, on average, are outperformed on every measure by the benchmark group, and generally by a considerable margin.

Poor governance institutions and weak property rights are thus suggestive as significant explanatory factors in explaining the relatively low levels of FDI flowing to African and Arab countries relative to the benchmark countries. Institutions are fundamentally important for creating the right incentives for governments to pursue investment promoting policies. It is crucial for African and Arab countries to develop their governance institutions and strengthen their property rights in order to attract a greater share of the world’s inward FDI.
Figure 12: Starting a Business

Figure 13: Registering Property
Figure 14: Dealing with Licenses

Figure 15: Enforcing Contracts
This simple analysis shows that the business environment, governance and legal institutions, and property rights are likely to be important determinants of inward FDI to Arab and African countries as a whole, and the location of FDI between these countries. Developing countries have attempted to stimulate FDI by entering into increasing numbers of bilateral investment treaties as substitutes for strong institutions and property rights (Hallward-Driemeier 2003). However, Hallward-Driemeier (2003) show that bilateral investment treaties have not resulted in significantly higher FDI, and act more as complements to strong institutions and property rights. In order to attract more FDI, it is crucial that African and Arab countries improve their institutions. There is no simple substitute for strong governance institutions and property rights.

It does appear that some African and Arab countries are on the right track and have sought to improve their institutions. Figure 18 compares the Freedom House Political Rights and Civil Liberties indexes over time. These indexes are measured on a one-to-seven scale, with one representing the highest degree of freedom and seven the lowest and so a decline in the index represents an improvement. Over the period 1972 to 2008, the African and Arab countries have improved their political rights and civil liberties. However, in general these improvements have been smaller than those made by the benchmark group.

Most countries have also introduced changes to national laws and legislations to encourage FDI, although there are still countries that are doing the opposite. In 2009, Qatar and the Syrian Arab Republic liberalized foreign investment in certain sectors, the Libyan Arab Jamahiriya adopted an investment promotion law, and Rwanda introduced positive changes to the legal and business environment. However, Algeria imposed stricter rules on foreign investment, and Nigeria introduced a local content requirement for foreign investment in the oil and gas industry. (UNCTAD 2010b) While many African and Arab countries are taking steps to improve their institutional environments, there is still room for much more improvement.
Figure 17: World Bank Governance Indicators
Figure 18: Changes in the Institutional Environment
4.1.2 Political and Macroeconomic Stability in African and Arab countries

The *WB Political Stability and Absence of Violence/Terrorism* index illustrated in Figure 19 is a measure of political stability that ranges from $-2.5$ to $2.5$, with a higher value indicating a better outcome. On this measure there is not much systematic variation in political stability across African and Arab countries, at least across the range of FDI performance. One reason for this weak link between political stability and FDI across African and Arab countries may be explained by the dominance of natural resource-seeking FDI into these countries. Not only may FDI come to resource rich locations despite the disincentive of political uncertainty, but international studies have shown that natural resource dependence of an economy may itself be positively correlated with higher levels of political instability and conflict.

It is therefore noticeable that the world benchmark group of top-performing FDI countries is considerably more politically stable (on average) than the Afro-Arab region. The same is true of the two countries in the region with the strongest FDI performance (Saudi Arabia and South Africa). Thus, despite the lack of variation across countries in the Afro-Arab region on average in the political stability measures, for truly strong FDI performance political stability remains an important likely driver of international capital flows. Specifically, the high degree of political instability is a significant factor affecting the relatively low levels of FDI flowing into African and Arab countries relative to the benchmark countries.

In this respect, there is some cause for optimism. Political instability in the form of coups has declined in Africa – since January 1990 more than half of all sub-Saharan African countries have not experienced any coup attempts. For some countries this is because they became embroiled in more extreme forms of conflict: civil wars in Angola, Congo, Rwanda and Uganda, warlordism in Somalia, and inter-country war in Eritria and Ethiopia, while for other countries it is because they were able to develop stronger democratic institutions: Botswana, Mauritius, Namibia, Senegal, Burkina Faso, Cape Verde, Ghana, Malawi, Mozambique, Seychelles, South Africa and Tanzania (McGowan 2003). This again highlights the importance of institutions for investment. Good institutions, if robust, can remove the gains from engaging in conflict.

Figure 19: Political Instability
Figure 20: Macroeconomic Stability

Figure 20 compares the performance of the four country groupings across three indicators of macroeconomic stability: the level and standard deviation of inflation, and the real effective exchange rate (REER). The top third group have a lower level of the inflation rate than the middle and bottom third groups, but again the benchmark countries have significantly lower inflation rates. The EFW Standard deviation of inflation rates countries on their variation in the inflation rate, a 10 indicates there has been no variation over the last 5 years and a zero indicates that the standard deviation of inflation is about 25% annually. The measure indicates that the stability of inflation does not differ greatly across the four country groupings, and that on average African and Arab countries have had relatively stable inflation rates, though the benchmark countries internationally still outperform the Afro-Arab region on stability in inflation rates.

The REER is a weighted average of a country’s currency relative to a basket of other major currencies adjusted for the effects of inflation, and an increase in the index relative to the base year (2000) indicates that a country has become less internationally competitive over time. The data in Figure 16 indicate that from 2000 to 2008 the REER has appreciated in all the country groupings, but slightly more in the benchmark group than in the African and Arab countries. For the benchmark countries, the exchange rate appreciation is likely associated with their economic success while for African and Arab countries it is likely due to the commodity boom. While an appreciation in the REER could possibly have been a reason for poor FDI performance, the evidence here suggests that this is not the case. Strong
real exchange rate appreciations are unlikely to be responsible for the low levels of FDI in Africa and the Arab world. However, currency instability (measured by frequent currency crashes) of Africa (excluding North and CFA Africa) is worse than that of Asia (Rogho¤ and Reinhart 2003), and may be a more significant determinant of FDI in the region.

There is thus little evidence to suggest that real exchange rate appreciations can be held accountable for the poor FDI performance. Instead, the conditions for investment promotion set by the factors that are within the control of the domestic economy, including political instability and low inflation, seem more likely candidates.

4.1.3 Market size of African and Arab countries

The domestic markets in Africa and the Arab world are small – in 2008 the total GDP of sub-Saharan Africa was less than that of Australia (the world’s fourteenth largest economy) and the total GDP of the Middle East and North Africa was less than that of India (the world’s twelfth largest economy). Figure 21 shows the GDP for the different country groups across the Afro-Arab region, in contrast to that in the benchmark group of countries. Not only is the market size of the Afro-Arab countries with the largest share of FDI larger than the rest of the region, but the benchmark group of countries outstrip the Afro-Arab region in market size by a very considerable margin. The market sizes of African and Arab countries are dwarfed by the large markets of the benchmark group. The evidence is thus suggestive not only of the existence of a relationship between FDI and market size, but that the association is likely to be strong.

Small market size thus likely at least partially explains the low levels of FDI to African and Arab countries relative to the benchmark countries. In this respect, the lack of trade openness between African and Arab countries further serves to limit market size, and hence the attraction for horizontal market-seeking FDI. This highlights the importance for African and Arab countries of developing regional markets which remove trade barriers between neighbouring countries, allowing producers to access a larger market at lower cost. Figure
Figure 22: Market Size by Region
Figure 23: Market Size by Region
22 illustrates the gains in market size for West Asia, North Africa and Western Africa if the countries in these regions developed regional markets. The Western Asian market would be almost the size of the Netherlands market, the Northern African market would be of comparable size to Turkey, and the Western Africa market size would rival that of Venezuela. Figure 23 illustrates the gain in market size if countries in Southern, Eastern and Middle Africa developed regionally integrated markets. The Southern African regional market would be of similar size to that of Venezuela, the size of the Middle African market would be rival that of Ukraine, and the size of the Eastern African market would be comparable to that of Peru. These two graphs illustrate the relatively small size of African and Arab domestic markets, and highlight the significant gains in market size that can be realised through regional integration.

4.1.4 Economic growth in African and Arab countries

Figure 24 illustrates the average growth rates of countries in the four groups. There is clearly a link between economic growth and FDI for African and Arab countries, the top third group had the highest growth rate, and the bottom third had the lowest growth rate. It is also interesting to note that the African and Arab countries actually grew slightly faster than the benchmark group, which may be why they attracted inward FDI despite performing relatively poorly on the some of the other dimensions affecting inward FDI.7

4.1.5 Trade Openness in African and Arab countries

Since market size has a significant positive effect on FDI, it is crucial that African and Arab countries (which typically have small domestic markets) open up to trade to allow firms access to a larger market. Figure 25 compares the performance of countries across the

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7There is concern regarding reverse causality here: investment is important for growth, which in turn increases FDI. It is thus difficult to determine whether these countries grew faster because of greater FDI, or whether they received greater FDI because of higher growth.
Economic Freedom of the World’s *Freedom to trade internationally* index. The index is a composite index covering taxes on international trade, regulatory trade barriers, size of the trade sector relative to expected, black market exchange rates, and international capital market controls. The top third group have the most freedom to trade internationally of Arab and African countries, but still lag behind the benchmark group.

Regional trade agreements (RTAs) are potentially important for African and Arab countries as they lower the trade barriers between neighbouring countries which reduces the costs of moving goods in and out of the countries (though there are also costs present, for instance in the form of possible trade diversion). However, Elbadawi and Mwega (1998) finds that, with the exception of the Southern African Development Coordination Conference (SADCC), African regional integration schemes have not significantly increased inward FDI. This is in contrast with other developing country regions, where the Latin American Free Trade Association (LAFTA), Association of Southeast Asian Nations (ASEAN) and the Central American Common Market (CACM) are associated with greater inward FDI. The failure of African regional integration schemes may be attributable to poor institutions (so that governments failed to implement the signed treaties), low growth within the regional bloc, lack of diversification, and a lack of regional infrastructure (Geda and Kebret 2007).

One of the key difficulties with trade liberalisation in Africa has been the heavy reliance of African governments on tariffs for revenue. Improving tax collection institutions will lower these government’s dependence on tariff revenues, thereby lowering the costs of trade liberalisation.

A second difficulty is that foreign investors perceive trade liberalisation in Africa as transitory and subject to reversal (Asiedu 2002). This lack of credibility of trade reform in Africa arises for two reasons. First, African governments have traditionally used trade policy to manage their balance of payments: when the terms of trade deteriorated, trade restrictions were increased, and relaxed again when the terms of trade improved. Second, a number of African countries embark on reform as a condition of foreign aid, but once the aid
ends they abandon the reform process. African policymakers need to improve the credibility of their reforms to attract FDI. The right institutions are crucial for creating incentives that constrain policymakers from reversing trade liberalisation. Regional trade agreements may also improve policy credibility if the RTA members offer reciprocal free trade to a major external trading partner. The threat of losing privileged access to a major market, FDI, and technology transfers will prevent policy reversals and thereby enhance policy credibility (Collier and Gunning 1993).

4.1.6 Geography of African and Arab countries

One indicator of distance to major markets is the minimum Great-Circle (air) distance in kilometers from the country’s capital city to one of New York, Rotterdam, or Tokyo. Figure 26 compares this average air distance across our country groupings - and the evidence does indeed appear to confirm a negative relationship between distance from the major markets and inward FDI, as the benchmark group as well as the top FDI-performing Afro-Arab countries are on average closer to the main markets than African and Arab countries.

Perhaps even more significantly, more than a quarter of the population of sub-Saharan Africa live in landlocked countries, compared with just 2% in South Asia (Gallup, Sachs, and Mellinger 1999). The following African countries are landlocked: Burkina Faso, Central African Republic, Chad, Mali, Niger, Botswana, Malawi, Zambia, Zimbabwe, Burundi, Rwanda, Uganda, Ethiopia, Lesotho, Swaziland. Only two of the countries in the top third group are landlocked (Chad and Zambia), while none of the benchmark countries are landlocked. On average, the landlocked countries have attracted less FDI than coastal countries.

Since a large number of African countries are landlocked, thus increasing the cost of transporting goods to and from these countries, the importance of good infrastructure in the African context is significantly enhanced. Efficient road and rail networks linking the major manufacturing zones in landlocked countries with ports reduces the costs of transporting intermediate input goods and transporting out final export goods. These lower transport...
costs reduce the cost of producing in the host country and the costs of re-exporting the final good to the source country, attracting vertical FDI. This raises the importance of landlocked countries developing their transport infrastructure to lower the transport costs faced by producers.

4.1.7 Infrastructure in African and Arab countries

Figures 27 and 28 illustrate the differences between our country groupings across measures of energy supply, water, telecommunications and transport infrastructure. Per capita electricity consumption is an indicator of the quantity of energy supply infrastructure, while electric power transmission and distribution losses reflect the quality of energy supply infrastructure. The number of telephone mainlines indicates the quantity of telecommunications infrastructure. The quantity of transport infrastructure is measured by the total kilometers of road and rail network per square kilometer of land area, while the proportion of roads that are paved is a measure of the quality of the infrastructure.

It is evident that there is a positive relationship between infrastructure and inward FDI. The top third Afro-Arab country group have a greater quantity, and better quality, of energy supply, water and telecommunications infrastructure than the other African and Arab countries. The quality of the road network, rather than the quantity, appears to be a more important determinant of FDI for African and Arab countries. The top third group have a proportionally larger rail network than the other African and Arab countries. However, all the African and Arab countries lag behind the benchmark group in terms of all the measures of infrastructure development. The lack of infrastructure is therefore potentially a key factor affecting the low levels of FDI to African and Arab countries relative to the benchmark countries.

Infrastructure is particularly important for African countries because of their poor geographical location. Most African countries are a great distance away from the key markets and has the largest proportion of landlocked countries of all regions. These geographical factors increase the costs of transporting goods to and from African countries, which negatively affects FDI. Improvements in infrastructure, particularly transport infrastructure, will reduce the transport costs faced by producers. It is crucial to have the right institutions to ensure that governments have the incentives to provide infrastructure through either public investment, public-private partnerships, or by allowing the privatisation of infrastructure provision.

There have been some steps toward improving infrastructure. In 2006, the Economic and Monetary Community of Central Africa (CEMAC) approved a project to develop the Douala-Bangui and Douala-Ndjamena road corridor, linking Cameroon, the Central African Republic and Chad. Prior to the CEMAC project freight transport from Douala in Cameroon, the main port and regional gateway, took 15 days to N’Djamena in Chad and 10 days to Bangui, Central African Republic, and port delays could add up to an additional 28 days (ICA 2007). While this represents a move in the right direction, more needs to be done to improve infrastructure across African and Arab countries.

8 The high average for electric power consumption in the bottom third country grouping is driven by Kuwait, which has electric power consumption 11 times higher than the next highest in that country group.
9 However, there is a relative lack of data on road and rail density.
Figure 27: Infrastructure
Figure 28: Infrastructure
4.1.8 Agglomeration in African and Arab countries

Yehoue (2009) presents the export processing zones (EPZs) in Mauritius as an example of a successful cluster. Mauritius has moved from an economy highly dependent on the export of a single crop (sugar) to a diversified economy with strong manufacturing and tourism sectors. The development of the manufacturing sector is due largely to the EPZs. Government policy (improving institutions and providing incentives) together with the positive externalities provided by domestic entrepreneurs attracted significant FDI inflows and led to the success of the EPZs in Mauritius.

The Cameroonian government sought to attract FDI by creating an export processing zone (EPZ) under the 1990 Investment Code. However, the EPZ has failed to attract significant FDI because of lengthy and restrictive bureaucratic procedures, limited powers of the body established to develop and operate the zone, and the government’s failure to offer the incentives promised (Khan and Bamou 2006).

In 1995, a programme was instituted to develop export processing zones (EPZs) in Ghana with incentives such as tax holidays and guarantees of repatriation of profits and against nationalisations of assets. The establishment of the EPZs was partly responsible for the growth in non-traditional exports, particularly canned tuna and cocoa products (Asante 2006).

Most of the MNCs located in the Kenyan EPZs are from India and Sri Lanka, and from the garment industry. They were attracted by the low labour costs and the opportunities offered under the African Growth Opportunity Act (AGOA), especially the easy access to the US market (Mwega and Ngugi 2006).

These examples indicate that EPZs can be successful for attracting FDI, but it is crucial that the government does not renege on the promised incentives, and is pro-active in removing obstacles faced by investors.

4.1.9 Taxes in African and Arab countries

Figure 29 indicates the relative tax burden (government tax revenue as a % of GDP) across the different country groups. The evidence suggests the tax burden is not likely to be a significant factor in determining the location of FDI flows within the African and Arab countries. However, the benchmark group have a lower average tax burden than the African and Arab countries suggesting that the relatively high tax burden is possibly significant for explaining the low levels of FDI to African and Arab countries.

It must be borne in mind that simply lowering corporate taxes in isolation is not enough to significantly increase inward FDI. The lowering of corporate taxes must be part of a broader agenda of reform that also improves the other factors affecting FDI, particularly the effectiveness of governance institutions. Another important dimension of the reform process is improving the institutional capacity to collect taxes. Greater efficiency and effectiveness of tax collections will enable a lowering of the tax rate without significant loss of government revenue. It also has the advantage of allowing the opening up of the economy as government revenue will no longer rely heavily on import taxes, as is currently the case for many developing economies.
4.1.10 Labour markets in African and Arab countries

Figure 30 compares the countries’ performance across two indicators of labour market conditions. There is not much difference in the rigidity of employment conditions across African and Arab countries, but on average they have significantly more rigid employment conditions than the benchmark group. The EFW *Labour market regulations* index is composed of the following sub-components: minimum wage, hiring and firing regulations, centralised collective bargaining, mandated cost of hiring, mandated cost of worker dismissal, and conscription, and a higher rating indicates more flexible labour markets. The bottom third group perform the worst on this index as a result of these countries’ onerous labour market regulations, but there is not much variation in this index across African and Arab countries. However, the benchmark countries outperform the African and Arab countries on the EFW *Labour market regulations* index. Thus, there is some evidence to suggest that labour market conditions explain the distribution of FDI across African and Arab countries, and the proportion of the world’s inward FDI received by the African and Arab countries relative to benchmark countries.

4.1.11 Natural resources in African and Arab countries

FDI into Africa has tended to favour extractive industries based on natural resources. In 2008, the primary sector received a large proportion of FDI to Africa. This was mostly increased equity investments in greenfield or expansion projects in the first half of 2008, owing to the high commodity prices and positive global economic outlook. However, as commodity prices fell in late 2008, cross-border mergers and acquisitions in the sector declined rapidly: indeed divestments were greater than new acquisitions. The Arab countries also receive significant FDI into the primary sector, despite restrictions on foreign investment in the upstream segment of the oil and natural gas industry. MNCs have remained active in these countries even after the decline in oil prices in late 2008. (UNCTAD 2009b)
4.1.12 Harmonisation of policies and laws in African and Arab countries

The Organization for Harmonization in Africa of Business Laws (OHADA) was set up by a treaty in 1993 to establish a single, cross-border regime of uniform business laws. There are 16 member countries: Benin, Burkina Faso, Cameroon, Central Africa, Comoros, Congo, Ivory Coast, Gabon, Guinea, Bissau Guinea, Equatorial Guinea, Mali, Niger, Senegal, Chad, and Togo. OHADA’s laws are exclusively business-related and largely based on the French legal system. Legal professionals and business people in the member countries commend the laws’ clarity and are supportive of and hopeful for the OHADA system. However, Dickerson (2005) finds that OHADA has not been particularly successful at improving the protection of private property in member countries, and that U.S. investors have a generally unfavourable opinion of OHADA. It must be remembered that the OHADA laws have only been effective since 1998 so the long-term benefits may not yet be realised. For OHADA to be successful, local legal professionals, business people and potential foreign investors must be provided with complete and current information about OHADA (Dickerson 2005).

Almost all African countries have adopted Structural Adjustment Programs (SAPs) starting in mid 1980s, at various points. The identical nature of policy prescriptions by International Financial Institutions (IFIs) across African countries entails a defacto macroeconomic policy harmonisation, at least in nascent form, suggesting that there might already be a basis for formal harmonization of policies. Alemayehu (2001) shows that there is significant variation across African regional economic communities (RECs) and their member countries in the macroeconomic environment, the fiscal stance, the asymmetry of shocks and the policy response to shocks. This highlights the importance of developing a fiscal policy harmonization that suits the specific conditions of each REC.

There are two economic and monetary unions in Africa. The Economic and Monetary Community of Central Africa (CEMAC) comprises the six countries using the Central African CFA franc: Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea and Gabon. The West African Economic and Monetary Union (UEMOA) is an organisation of the eight countries using the West African franc: Benin, Burkina Faso, Cote
d’Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo.

There have been some attempts to harmonise policy and laws in African and Arab countries, but these projects are relatively young and there is still some way to go before the full benefits of harmonisation can be realised.

4.2 Regression Analysis

As a final step, we investigate the joint impact of the range of possible determinants of FDI we have encountered above. We do so by a panel regression analysis, which allows us to investigate the determinants of FDI in African and Arab countries over time, and allow for the presence of heterogeneity across countries by means of a country-specific effect that is fixed over time (which can control for factors such as geography, climate, etc.).

The limited availability of data, both in terms of number of countries and number of years, constrains the regression analysis and so the results must be interpreted with caution. Nevertheless the following model is estimated:

\[
\log (FDI)_{it} = \alpha_i + \beta_1 \log (GDP)_{it} + \beta_2 \text{tax}_{it} + \beta_3 \text{inflation}_{it} + \beta_4 \text{exports}_{it} + \beta_5 \text{imports}_{it} \\
+ \beta_6 \text{warehouse}_{it} + \beta_7 \text{corruption}_{it} + \beta_8 \text{freedomhouse}_{it} + \beta_9 \text{telephone}_{it} + u_{it}
\]

where, for country \(i\), in period \(t\), we denote:

- \(FDI\): Four measures of FDI performance are examined: inward FDI stock (model 1), inward FDI flow (model 2), inward FDI stock as a percentage of GDP (model 3), and inward FDI flow as a percentage of GDP (model 4).

- \(GDP\): Real GDP. Real GDP is omitted from models (3) and (4) because the dependent variables in these models are measured as a percentage of GDP.

- \(tax\): Tax revenue (% of GDP)

- \(inflation\): Inflation, GDP deflator (annual %)

- \(exports\): Exports of goods and services (% of GDP)

- \(imports\): Imports of goods and services (% of GDP)

- \(warehouse\): Number of procedures to build a warehouse. Since the various measures of the business environment discussed earlier are likely to be highly correlated with each other, we use only one – number of procedures to build a warehouse – as an indicator of the business environment.\(^\text{10}\)

- \(corruption\): World Bank Control of Corruption index. Again, we use just one because the six governance indicators are likely to be highly correlated.

- \(freedomhouse\): Sum of Freedom House Political Rights and Civil Liberties indices.

\(^{10}\)This variable had to be dropped from the regressions involving the sub-sample of Arab countries due to insufficient observations.
• telephone: Telephone lines (per 100 people). The various infrastructure measures are highly likely to be correlated, and so we only use one.

The discussion from the previous section leads us to expect $\beta_1 > 0$ (greater market size has a positive effect on FDI), $\beta_2 < 0$ (increase taxation has a negative effect on FDI), $\beta_3 < 0$ (higher inflation is associated with lower FDI), $\beta_6 < 0$ (a poorer business environment reduces FDI), $\beta_7 > 0$ (stronger governance institutions have a positive effect on FDI), $\beta_8 < 0$ (better political institutions is associated with greater FDI, since the Freedom House variables are on an inverted scale) and $\beta_9 > 0$ (greater infrastructure attracts FDI). If $\beta_4 > 0$, this suggests that FDI into African and Arab countries has a significant vertical component. By contrast, where $\beta_5 > 0$, the inference is that there is significant opportunity for horizontal FDI, while $\beta_5 \leq 0$ implies that the regional markets can be readily accessed from foreign production bases.

The results from the model described above are presented in Table 4, using available data from 2003 – 2008.

The positive and significant coefficient on exports in models (3) and (4) indicates a preponderance of vertical, rather than horizontal, FDI in African countries. Given the very small market size of most of the countries Afro-Arab region, such that domestic markets themselves offer little incentives to investors, this finding is not implausible. However, it does imply that in order to attract vertical FDI, competitive market conditions for production, to allow investors to export again, is crucial for the Afro-Arab region if FDI is to be attracted on a sustainable basis. Note however, that horizontal, market seeking FDI also plays a role, as indicated by the import and market size variable results discussed below.

For Arab countries, the significant negative coefficient on imports in model (1) suggests that the domestic market in Arab countries can be adequately accessed from foreign production bases, obviating the need for horizontal FDI. However, by contrast models (3) and (4) imply that greater imports are linked to greater FDI in African countries, suggesting that in the African region there have been some opportunities for horizontal, market seeking FDI, rather than servicing the African markets from foreign production bases.

The results further suggest that market size, the business environment and institutions are among the most significant determinants of FDI in both African and Arab countries. Market size, measured by real GDP, is a highly significant determinant of inward FDI – a 1% increase in real GDP is associated with a 4% increase in inward FDI stock in AU and LAS countries, a 7% increase in inward FDI flow in AU countries, and no significant effect on inward FDI flow in LAS countries.

The business environment is significant across most of the models, such that for instance an additional procedure to build a warehouse associated with a 106% decline in inward FDI flow. To measure the effect of institutions we use the World Bank Control of Corruption indicator and the sum of the Freedom House Political Rights and Civil Liberties indices. The results confirm that strong institutions have a positive impact on FDI – a one point improvement on the Control of Corruption indicator is associated with a 123% increase in inward FDI flow, though the Freedom House indices are generally statistically insignificant. While the magnitude of this effect may seem large, it must be remembered that a one-point improvement on these indices is a substantial change – the World Bank Control of Corruption index ranges from $-2.5$ to $2.5$. 

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<table>
<thead>
<tr>
<th>Dependent variable</th>
<th>Model (1)</th>
<th>Model (2)</th>
<th>Model (3)</th>
<th>Model (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Log real FDI inward stock</td>
<td>Log real FDI inward flow</td>
<td>FDI inward stock, % of GDP</td>
<td>FDI inward flow, % of GDP</td>
</tr>
<tr>
<td>Log Real GDP</td>
<td>3.714*** (0.528)**</td>
<td>3.921*** (0.778)**</td>
<td>3.611*** (0.493)**</td>
<td>5.228*** (1.186)**</td>
</tr>
<tr>
<td></td>
<td>6.356*** (1.544)**</td>
<td>2.218** (2.956)**</td>
<td>0.079*** (0.411)**</td>
<td>0.108*** (0.178)**</td>
</tr>
<tr>
<td>Tax revenue (% of GDP)</td>
<td>0.010*</td>
<td>0.018**</td>
<td>0.005***</td>
<td>0.007***</td>
</tr>
<tr>
<td></td>
<td>0.007**</td>
<td>0.003***</td>
<td>0.023***</td>
<td>0.032***</td>
</tr>
<tr>
<td>Inflation, GDP deflator (annual %)</td>
<td>-0.011*</td>
<td>-0.013**</td>
<td>-0.004***</td>
<td>-0.027***</td>
</tr>
<tr>
<td></td>
<td>-0.027**</td>
<td>-0.043***</td>
<td>0.036***</td>
<td>0.441***</td>
</tr>
<tr>
<td>Exports of goods and services (% of GDP)</td>
<td>0.008**</td>
<td>0.011**</td>
<td>0.002***</td>
<td>0.015***</td>
</tr>
<tr>
<td></td>
<td>0.012***</td>
<td>0.009***</td>
<td>0.059***</td>
<td>1.232***</td>
</tr>
<tr>
<td>Imports of goods and services (% of GDP)</td>
<td>-0.007*</td>
<td>-0.008**</td>
<td>-0.020***</td>
<td>-0.064***</td>
</tr>
<tr>
<td></td>
<td>-0.004***</td>
<td>0.009***</td>
<td>0.032***</td>
<td>0.782***</td>
</tr>
<tr>
<td>Procedures to build a warehouse (no)</td>
<td>-0.161**</td>
<td>-0.181***</td>
<td>dropped</td>
<td>-1.062***</td>
</tr>
<tr>
<td></td>
<td>dropped</td>
<td>-1.089***</td>
<td>-7.666***</td>
<td>-9.866***</td>
</tr>
<tr>
<td>WB Control of Corruption</td>
<td>0.111**</td>
<td>0.021***</td>
<td>-0.145***</td>
<td>1.231***</td>
</tr>
<tr>
<td></td>
<td>1.062***</td>
<td>0.422***</td>
<td>9.705***</td>
<td>7.108***</td>
</tr>
<tr>
<td>FH Political Rights + Civil Liberties</td>
<td>0.124**</td>
<td>0.158***</td>
<td>0.111***</td>
<td>0.435***</td>
</tr>
<tr>
<td></td>
<td>0.475***</td>
<td>0.154***</td>
<td>0.299***</td>
<td>1.631***</td>
</tr>
<tr>
<td>Telephone lines (per 100 people)</td>
<td>0.021*</td>
<td>0.074***</td>
<td>0.043***</td>
<td>-0.041***</td>
</tr>
<tr>
<td></td>
<td>-0.017***</td>
<td>-0.114***</td>
<td>-1.513***</td>
<td>-4.299***</td>
</tr>
<tr>
<td>Constant</td>
<td>-75.426***</td>
<td>-78.607***</td>
<td>-79.861***</td>
<td>-97.143***</td>
</tr>
<tr>
<td></td>
<td>-124.508***</td>
<td>-46.104***</td>
<td>93.173***</td>
<td>100.930***</td>
</tr>
<tr>
<td>Observations</td>
<td>82</td>
<td>57</td>
<td>25</td>
<td>81</td>
</tr>
<tr>
<td>Number of countries</td>
<td>26</td>
<td>18</td>
<td>8</td>
<td>26</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.68</td>
<td>0.66</td>
<td>0.96</td>
<td>0.60</td>
</tr>
</tbody>
</table>

Note: Standard errors in parentheses; * significant at 10%; ** significant at 5%; *** significant at 1%
There is some evidence that the other variables affect FDI, but the effects are not as robust as for market size, business environment and institutions. An increase in tax revenue is associated with an increase in FDI in African countries in models (3) and (4). This is contrary to expectations, but higher tax revenue may be due to a more efficient tax collection system which could reflect better government institutions in these countries. The tax burden does not have a significant effect on FDI in Arab countries. Model (2) indicates that a 1% increase in inflation is associated with a 4% decline in inward FDI flow in African countries. Conversely, model (3) suggests the reverse, but the effect is not economically significant. Inflation does not have a significant effect on FDI to LAS countries. There is no strong evidence that infrastructure is important – more telephone lines have a positive effect on FDI in Arab countries in model (1), but a negative effect on all countries in model (4), and no significant effect on African countries in all of the models.

Due to the lack of data, and the short time period covered in the estimation, all of these results must be interpreted with caution. Nevertheless, they do confirm that market size, the business environment and institutions matter for FDI in African and Arab countries.

5 Policy Priorities for the Promotion of FDI between African and Arab countries

The previous sections identified the following factors as crucial in explaining the very low levels of inward FDI to African and Arab countries compared to the top ten developing and transition FDI host countries:

- Ease of doing business
- Governance institutions
- Legal structure and property rights
- Inflation
- Market size
- Trade openness
- Infrastructure (quantity and quality)
- Tax burden
- Labour market flexibility

The following factors determine the proportion of inward FDI to the African and Arab regions that a particular country will attract:

- Ease of doing business
- Governance institutions
• Legal structure and property rights
• Market size
• Trade openness
• Infrastructure (quantity and quality)
• Tax burden

While many African and Arab countries have taken steps toward improving the investment environment, there is still considerable room for improvement, and the reform agenda is clear:

• Improve the business environment
• Strengthen governance and legal institutions and property rights
• Keep inflation low and stable
• Increase market size through the development of regional markets, and by stimulating growth
• Increase openness to trade
• Improve both the quantity and quality of infrastructure (energy supply, water, telecommunications and transport)
• Lower the tax burden
• Increase the flexibility of labour markets.

6 Concrete Actions to Realise Appropriate Policy Interventions

We have identified the broad areas of reform that are required for African and Arab countries to improve their attractiveness to FDI. The specific actions that can be taken to promote Afro-Arab investment exchange are (refer to the earlier Joint Action Plan for greater detail on these actions):

• Joint arrangements to coordinate policy across the two regions
• Generation and dissemination of coordinated data and information on investment in the two regions, including updated research findings on the state of the investment environment in the region, and investment opportunities that arise in the region
• Establishment of joint Afro-Arab investment guarantee arrangements
• Creation of joint mechanisms to facilitate the financing of investment

We discuss each of these actions in greater detail below.
6.1 Policy Coordination

The foundation for policy coordination already exists in the form of various customs unions, common markets, and economic and monetary unions within the AU and LAS. The economic integration of these regional unions could be extended to completion with full monetary union and fiscal policy harmonization.

A federation of Arab and African investment promotion intermediaries (IPIs) could be formed, with one of its tasks being the coordination of investment promotion policies across countries, and country-specific investment promotion intermediaries.

6.2 Provision of Information to Potential Investors

The objective is to provide reliable, detailed and up-to-date information required by prospective investors in order to:\(^{11}\)

- make a sound assessment of possible investment locations, and
- identify profitable investment opportunities that generate a higher rate of return than investments in competing locations.

This would require the monitoring of the investment environment (including the ease of doing business, labour markets, taxation, political and macroeconomic stability, and institutions) of AU and LAS member countries, in order to provide comprehensive, accurate and reliable data on the investment environment to governments, IPIs and potential investors. This might include ratings of countries’ performance on the various drivers of investment relative to the appropriate benchmarks. The data collected will assist IPIs and governments to identify the constraints faced by potential investors.

The provision of relevant information to prospective investors can be accomplished through:

- Development of investment promotion intermediaries, as well as an Afro-Arab federation of investment promotion intermediaries, which will:
  - Efficiently and effectively respond to investment inquiries from potential investors and their advisors.
  - Provide information that is of high quality and useful to prospective investors via websites.
  - Minimise inaccuracies about investment locations and present the location’s advantages in the best possible way.
  - Provide information on websites and in response to inquiries that reflects an understanding of the most important factors in various sectors and subsectors and for specific types of projects.
  - Assist potential investors by identifying potential problems they might face and developing solutions to these problems.

\(^{11}\)Refer to the earlier Joint Action Plan for greater detail on this action.
– Identify and lower, or ideally eliminate, existing constraints on potential investment. This may be particularly important for African and Arab countries, as many perform poorly on the various FDI drivers (as highlighted earlier). These countries will benefit significantly from improving their performance on the core drivers of FDI.

• Holding annual investment fairs to:
  – Provide high-quality, accurate and reliable information that is useful to prospective investors at the investment fair.
  – Minimise inaccuracies about investment locations and present the location’s advantages in the best possible way by directly engaging with potential investors at the investment fair.
  – Honestly inform potential investors about the risks, costs and obstacles of their location, and present solutions to these problems.
  – Exchange of experience and lessons learned between investment promotion agencies.

These actions can be undertaken by existing IPIs, or a new federation of national IPIs can be developed and tasked with the coordination of information provision to potential investors.

In order to ensure that the relevant data and information is available, there must be:

• Development of the capacity to identify investment opportunities to ensure:
  – Identification of specific investment opportunities in particular sectors in AU and LAS countries.
  – Production of research to develop an understanding of the most important factors affecting the return and risk of an investment in various sectors and subsectors and for specific types of projects.
  – Production of research in order to provide detailed information on those sectors, industries, or businesses in which economies are competitive.

• Monitoring of the investment environment (including the ease of doing business, labour markets, taxation, political and macroeconomic stability, and institutions), to ensure:
  – Provision of comprehensive, accurate and reliable data on the investment environment to governments, investment promotion intermediaries (IPIs) and potential investors.
  – Ratings of countries’ performance on the various drivers of investment relative to the appropriate benchmarks.
  – Assist IPIs and governments to identify the constraints faced by potential investors.
The identification of investment opportunities could be the duty of a department of the IPI Federation, or could be the responsibility of a separate newly-created agency, or could be outsourced to existing research units. The monitoring and data collection could be achieved by developing a new AU-LAS agency to do so, by purchasing data on the investment environment from existing private sector providers, such as Business Environment Risk Intelligence (BERI) or Transparency International, or by outsourcing to existing research units.

6.3 Investment Guarantee Arrangements

It is important to insure eligible projects against losses relating to risks of all types, as this will:\footnote{12}

- Provide assurance to investors that losses will be recovered, subject to a portion for which the investor is liable.
- Deter harmful actions by building relationships with shareholder governments.
- Resolve potential investment disputes before they reach claim status, helping to maintain investments and keep revenues flowing.
- Provide potential investors with improved access to project finance from banks.
- Potentially lower the borrowing costs faced by investors as they have guaranteed loans.
- Provide insurance coverage for long periods, thereby increasing the tenor of loans available to investors.

There are two alternative ways to ensure that investments are guaranteed against risks: membership in the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group, and the development of a new AU-LAS investment guarantee agency.

6.4 Facilitate Financing of Investments

African and Arab countries must ensure that potential investors have improved access to credit to finance investment. This is particularly important due to the current global financial crisis. The objectives are:\footnote{13}

- Improved access to financial intermediaries.
- Increased financing available to foreign investment projects.

This can be achieved by:

- Enhancing the functioning and capacity of financial systems in AU and LAS member countries.

\footnote{12}{Refer to the earlier Joint Action Plan for greater detail on this action.}
\footnote{13}{Refer to the earlier Joint Action Plan for greater detail on this action.}
• Developing regional financial hubs that specialise in funding investments in particular regions, such as Johannesburg (South Africa), Mauritius and the Qatar Financial Centre in Doha.

• Linking IPIs and financial intermediaries so that:
  
  – potential investors are informed about financing options, and
  
  – financial intermediaries have full information about investment projects allowing them to efficiently allocate funds.

• Promoting relationships between the financial intermediaries and the investment guarantee agency so the financial intermediaries have accurate knowledge about the risks and insurance coverage of investment projects.

• Inviting financial intermediaries to exhibit at an investment fair to provide investors with information about financing opportunities. This will also make financial intermediaries aware of the projects that require financing.
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HIGH LEVEL SYMPOSIUM ON AFRO-ARAB COOPERATION IN INVESTMENT AND TRADE
TRIPOLI, 25/26 SEPTEMBER, 2010

AFRO-ARAB COOPERATION ON THE PROMOTION OF INVESTMENT FLOWS BETWEEN AFRICA AND THE ARAB WORLD

Views Expressed are those of the Author and Do Not Represent the Organizers of the Symposium
Afro-Arab cooperation on the promotion of investment flows between Africa and the Arab world

August 2010
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1 Preamble

The first and second Organising Committee meetings of the AU/LAS “High Level Experts Meeting on Investment Prospects in Africa and the Arab World” were convened at the Headquarters of the League of Arab States in Cairo, with the theme “Enhancing Afro-Arab Investment for Development”. The Organising Committee meetings commissioned two earlier reports: (1) a Technical Report, which reviewed the conditions surrounding both the level of foreign direct investment, as well as its determinants in Africa and the Arab world, and (2) an associated Joint Action Plan, which sought to identify concrete strategies and actions to enhance Afro-Arab investment exchange. These reports were presented at the HLEM held in April 2010. In what follows, they are referred to as the AU-LAS Technical Report (AU-LAS 2009a) and the AU-LAS Joint Action Plan (AU-LAS 2009b) respectively.

This study was prepared for a High Level Symposium on Afro-Arab cooperation on investment and trade organised jointly by the African Union (AU), the League of Arab States (LAS), the Arab Bank for Economic Development in Africa (BADEA) and the Libyan Jamahiriya. The report is commissioned by the Arab Bank for Economic Development in Africa (BADEA) The Symposium will be held on the 25-26 September 2010 in the Libyan Jamahiriya.

The main objectives of the High Level Symposium include:

- To deliberate on the factors behind the weakness of investment flows and trade between Africa and the Arab countries,
- To highlight Afro-Arab cooperation opportunities in the areas of trade and investment, leading to the promotion of socioeconomic development in the two regions,
- To exchange views on the desired policies and actions that encourage the private sector to effectively play its role in promoting the flow of investment and trade between the African and Arab countries,
- To contribute to the outcome of the second Afro-Arab summit, leading to fostering Afro-Arab cooperation in the area of investment flows and trade.

Accordingly, the main objectives of this study are to review the state of affairs of investment flows between African and Arab countries, and to identify concrete strategies and actions to enhance investment flows between Africa and the Arab world. This study reflects the more detailed information contained in the Technical Report and Joint Action Plan, but also updates the earlier reports in incorporating additional data, and by deepening the analytical content of the earlier reports.

2 Introduction

Investment (from both domestic and foreign investors and from private and public sources) is the foundation of physical capital accumulation, which in turn is one of the core determinants of a country’s economic growth rate. Domestic investment is undertaken by investors who are residents of the economy, while foreign investment is cross-border investment made by a
resident in one economy (investor) in an enterprise (investment enterprise) that is resident in another economy. Many developing countries have low savings rates and, hence, are unable to generate an adequate level of investment solely from domestic sources. As a consequence, foreign direct investment is of particular importance to developing countries.

According to the IMF and OECD definitions, foreign direct investment (FDI) occurs when the motivation of the investor is the development of a “lasting interest” in the investment enterprise, indicated by the investor owning at least 10% of the voting power of the investment enterprise. This differs from foreign portfolio investment (FPI), where the motivation of the investor is not generally to influence the management of the enterprise.

FDI is generally viewed as preferable to FPI because it tends to be less volatile. However, a high proportion of FDI in total foreign capital inflows may also be a sign of poor economic health. Countries with institutional weaknesses and high domestic risk will finance themselves primarily through FDI, which is seen as harder to expropriate (see for instance, Razin, Sadka, and Yuen 1998, Hausmann and Fernandez-Arias 2001 and Albuquerque 2003).¹ Thus, while FDI may be more stable, a high dependence on FDI over FPI may be an indicator of a weak economy.

One advantage of FDI over domestic investment is that it may carry positive technology spillovers from the source to the host country. These technology spillovers improve productivity and promote growth, and can occur through several channels:

- A local firm copies some technology used by a multinational corporation (MNC) in the local market, thereby improving its productivity.
- The entry of an MNC into the local market increases competitive pressure forcing local firms to become more efficient.
- An MNC engages in skills development and training of local workers, who go on to work for local firms or start their own businesses.
- An MNC assists its local suppliers by (i) providing them with technical assistance, (ii) providing managerial and organisational training and assistance, (iii) assisting in the setting up of production facilities, and (iv) assisting local suppliers to find additional customers, including affiliates of the MNC.

Borensztein, De Gregorio, and Lee (1998) find that for 69 developing countries FDI increases productivity only when the host country has a minimum level of human capital stock. Thus, FDI promotes economic growth only if the host economy is sufficiently able to absorb the advanced technologies of the source country. In the case of South Africa

¹Note, however, that there is a countervailing view. Faria and Mauro (2004) argue that inalienability of FDI depends upon the sectoral allocation of FDI, such that the inalienability of FDI hypothesis applies mostly to high technology or human capital-intensive sectors where the benefits of expropriating foreign capital by the host country are very low. In most developing countries, FDI is concentrated in capital-intensive sectors and/or the primary commodities sector where the host country can easily expropriate foreign capital. Under such conditions, the Albuquerque (2003) prediction breaks down, leading to a relationship where institutional weaknesses and high domestic risk lead to a composition of foreign capital biased towards non-FDI foreign capital. Fedderke and Gwenhamo (2009), in testing for the two mechanisms in the case of South Africa, find support for the Faria and Mauro (2004) position, rather than the Albuquerque (2003) prediction.
specifically, Fedderke and Romm (2006) find that FDI to South Africa has led to positive spillovers on capital and labour productivity.

Borensztein, De Gregorio, and Lee (1998) also find that FDI leads to an increase in domestic investment though the effect is not robust. By contrast, Fedderke and Romm (2006) find that for South Africa FDI crowds-out domestic investment in the short-run, but does lead to an increase in domestic investment in the long-run. Any crowd-out of domestic investment is a short-run effect, while in the long-run FDI leads to an increase in domestic investment. These results suggest that FDI exercises a positive impact on long run growth performance, by directly raising the capital stock of countries, indirectly by raising domestic investment rate in the long run, as well as by generating positive technology transfers to the host country of the FDI. Thus the results do not indicate that policymakers face a trade-off between foreign and domestic investment, but a symbiotic relationship between the two instead. This is not surprising since the factors that attract foreign investment are also the factors that stimulate domestic investment - hence policies which create a favourable investment climate apply to all investment regardless of its origin, and hence are likely to promote both domestic and foreign investment.

3 Investment in African and Arab countries

Investment rates vary considerably across the African and Arab countries. Figures 1 and 2 report the investment and savings rates of League of Arab States and African Union countries respectively. The evidence suggests considerable heterogeneity both within and across regions in terms of investment and savings performance.

For the LAS countries, the average investment rate has been 22.65% of GDP over the 2000 - 2008 period, while the average savings rate has been 23.15%. If the West Bank and Gaza, Jordan and the Comoros are excluded from the sample, the average savings rate rises to 29.71%. The LAS countries on average therefore, have saved more than they have invested, rendering reliance on FDI less critical, and opening the possibility for the LAS to invest in other regions - including the AU. It is only for a few countries in the LAS (Morocco, Mauritania, West Bank and Gaza, Jordan, Sudan, Egypt, Djibouti) that the standard developing country pattern of a significantly higher investment than savings rate, necessitating foreign capital inflows to cover investment plans, applies.

By contrast, for the AU states the pattern is markedly different. Here the average investment rate over the 2000 - 2008 period is 20.68% of GDP, while the savings rate is only 10.87%, so that the average savings gap (calculated by the difference between the investment and savings rates) for the region amounts to 9.8% of GDP. For the AU, in contrast to the LAS, there is thus a strong need for foreign capital inflows. In the case of some countries (Lesotho, Eritrea, Liberia) the magnitude of the savings gap is particularly acute. But even on average across the region, there is a need for approximately 10% of GDP to cover the short-fall of savings relative to investment plans in the region. As a consequence, the AU is particularly reliant on foreign capital inflows in order to cover this short-fall.

Such foreign capital inflows can take one of two forms, portfolio capital inflows and foreign direct investment. We examine these two sources of capital flows for the two regions in turn.
Figure 1: League of Arab States Investment and Savings Rates (% of GDP).
Figure 2: African Union Investment and Savings Rates (% of GDP).
3.1 Foreign Portfolio Investment in African and Arab countries

Figures 3 and 4 illustrate the average foreign portfolio investment (excluding liabilities constituting foreign authorities’ reserves) over the period 2000 – 2008 to the Arab and African countries, respectively. For most Arab and African countries, FPI flows are non-existent. Only South Africa, Ghana and Lebanon received significant portfolio investment, while a few countries registered significant recorded outflows. The relative lack of FPI flows to African and Arab countries is not surprising given their relatively undeveloped and illiquid stock and bond exchanges. For instance, the market capitalisation of the stock exchange in 2008 was $491 282 million in South Africa, $85 885 million in Egypt, $9 641 million in Lebanon, $49 803 million in Nigeria and $3 394 million in Ghana, compared to $468 595 million in Hong Kong, $2 793 610 million in China, $494 631 in South Korea and $645 478 in India. The liquidity of the stock exchange (measured by the total value of stocks traded as a percentage of GDP) in 2008 was 145% in South Africa, 43% in Egypt, 2% in Lebanon, 10% in Nigeria and 1% in Ghana, compared to 289% in Hong Kong, 126% in China, 158% in South Korea and 91% in India.

In the case of the LAS countries, the presence of significant portfolio capital outflows is also the logical consequence of the savings exceeding investment rates. The excess of savings over investment results in the search of investment opportunities internationally, with a resultant outward flow of portfolio capital.

However, given the substantial savings gap (10% of GDP) in the AU, and the resultant need for foreign capital inflows, the lack of FPI flows makes the AU countries even more reliant on FDI for the foreign investment required to bridge the savings gap.

3.2 Foreign Direct Investment in African and Arab countries

In 2008 and early 2009, global FDI flows fell following a period of continuous growth from 2003 to 2007. In contrast, the share of global FDI inflows to developing countries rose to an all-time high of 37% in 2008. FDI inflows to Africa increased by a considerable 27%, and FDI inflows to West Asia increased by 16%. However, FDI inflows to developing countries began to decline in late 2008, almost a year after the downturn began in developed countries. (UNCTAD 2009b)

Figure 5 illustrates inward FDI to the sub-regions of Africa and West Asia since 2000. Over the last few years, inward FDI to West Asian countries has exceeded that to Africa. Within Africa, Northern and Western Africa have attracted the greatest share of Africa’s inward FDI. Eastern and Southern Africa have not performed particularly well in terms of inward FDI. Figures 6 and 7 break down the distribution of FDI inflows further, to show the average flows to specific African and Arab countries over 2000 – 2008. FDI inflows to Nigeria and Angola were significantly larger than to other African countries, largely driven by projects in the oil industry. The top 10 FDI host countries in Africa (excluding LAS members) accounted for 83% of the region’s inflows, while the top 5 FDI host countries in the Arab League accounted for 69% of the region’s inflows.

Figure 8 compares the FDI inflows to the top 10 Arab and African countries with those to the top 10 developing and transition economies in the world as a whole. On average, even the best performing African and Arab countries are not attracting as much FDI inflows
Figure 3: League of Arab States Portfolio Capital Flows.
Figure 4: African Union Portfolio Capital Flows
Figure 5: FDI Flows to the AU and LAS regions.
Figure 6: Average FDI Inflows to LAS Countries, 2000 - 2008.
Figure 7: Average FDI Inflows to non-LAS AU countries, 2000 - 2008.
as the top 10 developing and transition economies. Two exceptions are Saudi Arabia and United Arab Emirates, where FDI is mostly in petrochemicals, refining, real estate and construction.

Since FDI flows can change significantly from year to year and in response to economic cycles, it is important to consider the FDI stocks of countries, which gives a better reflection of the average FDI performance, particularly over the long run. Figures 9 and 10 illustrate the FDI stocks of Arab and African countries respectively.

South Africa accounts for 36% of Africa’s FDI stock,\(^2\) and Saudi Arabia accounts for 24% of the Arab League’s FDI stock. Figure 11 compares the top 10 African and Arab countries with the top 10 developing and transition economies in terms of their FDI stocks. Again, even the best performing African and Arab countries have not been able to attract levels of FDI comparable with the top 10 developing and transition economies. Two exceptions are South Africa, which was the eighth best developing and transition host economy (in terms of FDI stock) in 2008, and Saudi Arabia which was ninth best. There there is thus considerable room for African and Arab League countries to improve their performance in attracting FDI.

The sectoral composition of FDI differs among countries. In non-Arab African countries, FDI is concentrated in the primary and services sectors, and is marginal in the manufacturing industries. In non-African Arab countries, FDI is concentrated in the services sector and in manufacturing industries related to oil and gas, such as petrochemicals, refining, and liquefied natural gas (LNG). FDI in the primary sector is relatively small, as important restrictions to foreign participation remain in activities relating to upstream oil and gas. In African Arab countries, FDI is more diversified between primary, manufacturing and services activities, with some efficiency-seeking FDI in manufacturing activities. (UNCTAD 2009a)

Thus, while there are encouraging signs of diversification in the sectoral distribution of FDI into the two regions, equally it remains true that the FDI remains significantly tied to a primary resource base.

### 3.3 FDI Flows Between African and Arab countries

It is difficult to analyse investment flows between African and Arab countries due to the limited availability of data. Nevertheless, the existing partial data do reveal: (1) significant FDI flows from non-African Arab countries to North Africa, while FDI flows in the opposite direction have been negligible, (2) relatively large intra-regional FDI flows in countries that are AU-only and LAS-only member countries, and (3) weak FDI flows between Arab countries (including North Africa) and sub-Saharan Africa (UNCTAD 2009a).

Tables 1 and 2 illustrate West Asian cross-border mergers and acquisitions (M&A) purchases and greenfield FDI projects in Africa, respectively. Most of West Asian FDI in Africa is located in North Africa, particularly in Egypt with investments in the financial sector, construction and real estate, tourism, energy, insurance, manufacturing, fertilizers

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\(^2\)The FDI stock of South Africa is significantly inflated due to the re-listing of companies from the Johannesburg to the London Stock Exchange. Anglo-American, Old Mutual, and South African Breweries moved their listing from the JSE to the LSE in 1999, Didata followed suit in 2000 and Investec in 2002. Upon re-listing, the South African plants of these firms became part of South Africa’s FDI stocks. Thus, a part of South Africa’s FDI stock reflects book-keeping changes rather than actual FDI into the country.
Figure 8: Comparing Top AU and LAS FDI Attracting Countries, with International Benchmark Countries.

Table 1: West Asia: net cross-border M and A purchases in Africa, 2001 -2009 (millions of Dollars)
Figure 9: FDI Stocks in LAS Countries.

Table 2: West Asia: greenfield FDI projects, 2003 - 2008 (number of deals)
Figure 10: FDI Stocks of AU Countries.
Figure 11: FDI Stocks in Top Developing and Transition Economies.
and telecommunications. Arab investment in other North African countries is mainly in telecommunications, with ports, real estate and tourism also receiving investment. The Gulf states have also made investments in agriculture in Africa to ensure food security. The location of this food security-related FDI in Africa is determined by both the availability of land as well as water resources to irrigate it. Some examples of investments include: the purchase of farmland in Sudan by the United Arab Emirates, Saudi Arabia’s purchase of land in the United Republic of Tanzania and proposal to invest in Ethiopia and Sudan; and Qatar’s interest in leasing land in Kenya. (UNCTAD 2010a)

3.4 Impact of the Financial Crisis on FDI in African and Arab countries

The global financial and economic crisis has had a significant effect on foreign direct investment. In 2008 and early 2009, global FDI flows fell following a period of continuous growth from 2003 to 2007. In contrast, the share of global FDI inflows to developing countries rose to an all-time high of 37% in 2008. FDI inflows to Africa increased by a considerable 27%, and FDI inflows to West Asia increased by 16%. However, FDI inflows to developing countries began to decline in late 2008, almost a year after the downturn began in developed countries. (UNCTAD 2009b) This may be attributable to declining confidence and the rapid deterioration of market prospects. Furthermore, because of the financial crisis companies face reduced access to credit and have difficulties in funding their investment projects.

The crisis has impacted on the sectoral distribution of FDI: mergers and acquisitions increased by 17% in the primary sector, but declined by 10% and 54% in the manufacturing and services sectors, respectively. (UNCTAD 2009b) The worsening economic situation has also changed the prime motivation for international expansion by MNCs from seeking to gain access to growing or new markets, to now seeking to contain and reduce costs (IBM Global Business Services 2009). Africa, particularly the North African countries, have benefited from companies seeking lower cost alternatives to European locations as companies increasingly view some African countries as potential alternatives to locations in Eastern Europe and Asia (IBM Global Business Services 2009). Some African locations now display attractive cost-quality trade-offs for some investment projects compared to competitor locations in Eastern Europe as they have more favourable business environments and competitive costs (IBM Global Business Services 2009).

Recovery of FDI inflows is expected to be slow in 2010, but should accelerate in 2011 provided the world economy recovers (UNCTAD 2009b). The sectors that have been badly affected by the cyclical changes in the economy, e.g. business services, electronics and ICT, may see a relatively rapid recovery in investment activity as the global economy begins to grow. Sectors that have been less responsive, or even counter-cyclical, with respect to foreign investment, such as minerals, are less likely to see a major increase in investment activity as a result of a future recovery in global economic activity. Furthermore, sectors that are experiencing a structural decline in investment activity, such as wood and paper, are unlikely to benefit as much from the economic recovery. (IBM Global Business Services 2009)

Encouraging investment exchange between African and Arab countries could help coun-
teract the expected slowdown of inward FDI in the aftermath of the financial crisis, in particular to the smaller and structurally weak African countries.

The financial crisis has also prompted many governments to introduce various initiatives to strengthen financial regulation and reform financial regulatory frameworks. Increased financial regulation could lead to healthier financial systems at national and international levels, better monitored and controlled financial risks and improved macroeconomic stability, which will assist the long-term growth of global FDI. However, the short and medium term effects of increased financial regulation on FDI flows is likely to be varied. The safer credit and renewed confidence in the financial system will render MNCs more willing and able to invest abroad, but greater restrictive measures could increase the complexity of international investment and the functioning of financial institutions. Furthermore, FDI could be diverted to countries with relatively low levels of financial regulation, unless international financial reform is well coordinated. (UNCTAD 2010b)

In net terms, therefore, while the financial crisis has lowered the absolute level of FDI flows internationally, it has also switched FDI flows toward developing and emerging markets in relative terms. For the AU and LAS countries the crisis has thus been of mixed effect in terms of FDI, and certainly the relative switch to developing and emerging markets in Africa has made the impact of the crisis less severe than might have been feared at its outset.

3.5 Impact of the Food Crisis on FDI in African and Arab countries

As discussed earlier, many of the Arab countries have invested in agricultural production in African countries to ensure food security for their populations. Foreign investment in agriculture also presents opportunities to strengthen local food security and have a beneficial impact on local development.

3.6 Impact of Climate Change on FDI in African and Arab countries

MNCs have an important role to play in combating climate change. They can reduce global greenhouse gas emissions through foreign investments that improve technologies and processes in their operations and value chains. They can also supply low-carbon products and services. The key sectors where there is scope for the reduction of emissions are sectors where MNCs are significant emitters (i.e. power and industry), sectors where emissions are mostly from consumption and public use (i.e. transport, buildings and waste management) and sectors where emissions are caused by changes in land-use such as deforestation and land degradation (i.e. forestry and agriculture). (UNCTAD 2010b)

Some low-carbon FDI projects in African and Arab countries include:

- In Nigeria, the China Civil Engineering Construction Company (CCECC) has started work on the LagosRail Mass Transit project. This represents an attempt to shift to mass transport systems and thereby reduce emissions in the sector.
• In Lesotho, Philips (Netherlands) has built a manufacturing facility of energy-efficient compact fluorescent lamps, as well as the first CFL recycling plant in Africa. Most of the facility’s output will be exported across Southern Africa, to satisfy the region’s increasing demand for energy-efficient lamps. This is expected to reduce the indirect emissions from electricity consumption in the building sector.

• In Ethiopia, Anmol Group (India) has recently invested in a large paper making plant in Ethiopia using waste paper which would normally be incinerated. This represents foreign investment in both low-carbon process and product, and will reduce emissions in the waste management sector.

• Morocco, South Africa, Tunisia and Zambia have received greenfield investments in alternative/renewable power generation.

• Algeria, Libyan Arab Jamahiriya, Mozambique, South Africa and Tanzania are among the largest developing country recipients of greenfield investments in the manufacturing of environmental-technology products, such as wind turbines, solar panels and biodiesel plants, and associated parts.

The general determinants of FDI (government policies, market conditions, costs of production and business conditions) are also the determinants of low-carbon FDI. There are also some climate change-specific factors, such as green branding strategies, regulations and pressure from consumers and investors. Developing countries are faced with two main challenges when moving toward a low-carbon economy: (1) financing and implementing investment in suitable activities; and (2) the creation and propagation of appropriate technology. There is thus considerable scope for Afro-Arab cooperation to promote low-carbon FDI while minimising the potential risks of these investments.

3.7 Overview

The data indicate that, in general, FDI performance in Africa and the Arab world has been worse than for other developing countries, but has also varied considerably across the different African and Arab countries. For instance, Saudi Arabia and South Africa are notable exceptions, as these countries are among the top 10 developing and transition FDI host economies in terms of FDI stock. It is therefore clearly possible for African and Arab countries to attract significant levels of foreign direct investment. This makes it crucial that we understand the drivers of foreign investment to ensure that more Arab and African countries can attract sustained high FDI inflows. We take a closer look at the determinants of foreign direct investment in the next section.

4 Determinants of Foreign Direct Investment

Private investment choices, by both domestic and foreign private investors, are made on the basis of the relative rates of return and risk levels of the different investment opportunities.
An investment that offers a high rate of return and a low level of risk is preferable to one offering a low rate of return and a high level of risk.\textsuperscript{3}

One can distinguish between two broad motivations for FDI: to access local markets, and/or to get access to lower cost inputs. Horizontal FDI, or market seeking FDI, is the establishment of duplicate production plants in the foreign country to serve the market there. Horizontal FDI is often undertaken to get around trade restrictions which make exporting too costly. A MNC will only set up a production facility in a new location if it is more profitable and less risky than exporting. A factor that significantly increases the return on horizontal FDI is a large and fast-growing market, but the other factors that affect the risk and return of an investment (infrastructure, political and macroeconomic stability, institutions, etc.) are also important for attracting horizontal FDI. Trade liberalisation has two opposing effects on horizontal FDI – greater openness encourages growth which leads to a larger market size, attracting horizontal FDI, but it also makes exporting more profitable since trade barriers are lower, reducing the need for horizontal FDI.

Vertical FDI, or resource seeking FDI, involves locating part of the production process in a foreign country in order to lower production costs. Unlike with horizontal FDI, where the concern is how best to serve the host market, with vertical FDI the concern is how best to serve the home market.\textsuperscript{4} Vertical FDI is attracted by the particular features of the host country that will lower the cost of production such as the costs of labour, the skills of the labour force, the abundance of natural resources and the quality and efficiency of infrastructure. Vertical FDI will only occur if the cost savings from producing abroad outweigh the trade costs incurred to transport the goods from the host to the home country.

The expected return on investment is determined by the income earned from the investment relative to its cost. The risk of an investment reflects the level of uncertainty about the future income stream that will be generated by the investment.

First, we outline the various factors that affect FDI, and then we review the investment climate in African and Arab countries. The focus is on the external factors that determine the size and location of the FDI of a multinational corporation (MNC).\textsuperscript{5} Although we emphasise FDI, those factors that promote FDI will also promote domestic investment because all types of investment choices are influenced by the risk and return of the investment opportunity. The same factors that increase the returns on FDI will also increase the returns on domestic investment, and the same factors that reduce the risk of FDI will also reduce the risk of domestic investment. Therefore, policymakers do not face a choice between stimulating domestic investment or foreign investment. The same policies that promote foreign investment will promote domestic investment.

The following factors will increase the rate of return by raising the profitability on an investment (please refer to the earlier AU-LAS Technical Report for greater detail on these

\textsuperscript{3}Public investment choices are made on a different basis to private investment decisions. Public investment is often in infrastructure and is motivated by the provision of public goods that will raise productivity in the economy, both directly and indirectly by raising the productivity of factors of production. Public investment decisions may also be politically motivated.

\textsuperscript{4}The home (or source) country is where the FDI originates from, while the host country is where the FDI is located.

\textsuperscript{5}See (Blonigen 2005) for a brief review of the literature dealing with the factors internal to a firm that motivate it to undertake FDI in the first place.
mechanisms, particularly concerning the empirical evidence in their support):

- **High institutional quality.** Good institutions are an important determinants of FDI because they can lower the costs of investment, by increasing the certainty of the investment environment, thereby lowering the risk of the investment, as well as by lowering the transactions costs surrounding exchange and contracting. Strong property rights are particularly important for FDI as they reduce the risk of expropriation of investment. Good institutions lower production costs thereby attracting vertical FDI, and increase economic growth thereby attracting horizontal FDI. Political institutions (which include the form of government) and the distribution of resources affect the distribution of political power and the way in which economic institutions are chosen. Good economic institutions include credible strong property rights and a lack of corruption. Moreover, Easterly and Levine (1998) argue that neighbourhood effects are an important determinant of economic performance – a country’s growth rate is affected by its neighbour’s growth performance, and economic policies are copied by neighbouring countries. Gwenhamo and Fedderke (2009) extend the idea to examine the impact of neighbouring country institutions, specifically property rights, on a country’s inward FDI. The presence of neighbourhood effects increases the uncertainty faced by investors because the quality and stability of institutions in the home country do not exist in isolation, but are influenced by the institutional environment of neighbouring countries. Poor institutions in a neighbouring country can be transmitted to the home country, causing a reduction in inward FDI. Finally, institutional distance between the source and host countries can have a negative effect on FDI because increased institutional distance increases perceived uncertainty or learning costs for the source country, or if institutions depend on economic and social history then we would observe more FDI, ceteris paribus, among countries with similar institutions (Benassy-Quere, Coupet, and Mayer 2007).

- **Larger market size.** Market size is a highly significant determinant of horizontal FDI. The larger is the market, the greater is the profitability from setting up a production plant, which attracts FDI. Developing countries typically have very small domestic markets, heightening the importance of trade openness and the development of regional markets. The development of regional markets removes trade barriers between neighbouring countries, allowing producers to access a larger market at lower cost. This raises the profitability of establishing a production plant in the host country, attracting horizontal FDI.

- **Higher economic growth.** Both current and future expected market size is an important determinant of horizontal FDI. Economic growth generates improved prospects for future market size and will attract FDI. In addition, the conditions that are required for economic growth are the same conditions required to attract inward FDI. A country that has achieved a sustained high growth rate is very likely to have strong institutions, political and macroeconomic stability, trade openness, good infrastructure, low tax rates, low labour costs, a skilled labour force and a flexible labour market. Hence, a sustained and high growth rate conceivably acts as a signal to potential investors that the country is a good target for investment.
**Greater trade openness.** Greater trade openness is one way to for developing countries with very small domestic markets to achieve market size. Lower trade barriers between neighbouring countries reduces the costs of moving goods in and out of the countries. This allows producers access to a larger market at low cost. Trade liberalisation promotes export-led growth (Sachs and Warner 1995), which in turn improves prospects for future market size thereby attracting FDI. Greater trade openness also allows freedom of movement of intermediate inputs and goods in and out of the country. The increase in competition that arises from trade liberalisation results in increased efficiency as firms innovate to escape the new competitors. (Aghion, Fedderke, Howitt, Kularatne, and Viegi 2008). Increases in the efficiency of the domestic economy will increase its attractiveness to producers, stimulating FDI. However, greater openness will discourage horizontal FDI that is undertaken to “tariff-jump” (i.e. overcome trade barriers). The net impact of trade liberalisation on FDI is therefore uncertain. However, on balance, the existing empirical evidence suggests that greater trade openness will attract FDI.

**Closeness to markets and coastal access.** Transport costs are determined by the geographical distance between markets, and whether or not the country has coastal access. The greater the geographical distance between markets, the higher the transport costs. Countries with coastal access face lower transport costs than landlocked countries because of their access to ports. Hence, greater proximity to markets and coastal access will reduce transport costs. Lower transport costs will tend to reduce horizontal FDI but increase vertical FDI.

**Good infrastructure.** The availability and quality of infrastructure (water, transport, telecommunications and energy supply) has a positive effect on both horizontal and vertical FDI. Good infrastructure lowers the cost of locating production in a country. High quality infrastructure enables the import of intermediate inputs and the export of the final good to the foreign country, encouraging vertical FDI. The main service items traded (travel, freight, communications, banking and business services) depend crucially on the existence of high capacity and efficient infrastructure in both the importer and exporter countries (Nicoletti, Golub, Hajkova, Mirza, and Yoo 2003). The availability of high quality transport networks facilitates the efficient transportation of goods between countries, and is particularly important for overcoming any negative effects of geographical location. This is particularly important for Africa, where most countries are a great distance away from the key markets and which has the largest proportion of landlocked countries of all world regions. These geographical factors increase the costs of transporting goods to and from African countries, which negatively affects FDI. Improvements in infrastructure, particularly transport infrastructure, will reduce the transport costs faced by producers. It is crucial to have the right institutions to ensure that governments have the incentives to provide infrastructure through either public investment, public-private partnerships, or by allowing the privatisation of infrastructure provision.

**Agglomeration effects.** Agglomeration effects can promote clustering – the concentration of firms in specific industries to benefit from a network of competitors, buyers
and suppliers – and thereby encourage both horizontal and vertical FDI. Yehoue (2009) shows that a simultaneous move of complementary firms (domestic or foreign) will create positive spillovers for the firms involved, via backward and forward linkages, which will increase the return of investment, attracting other investment.

- **Lower taxes.** Higher corporate taxes in the host country are likely to reduce the profitability of investment, and will reduce both horizontal and vertical FDI. However, the relationship between taxes and FDI is made more complicated because MNCs face taxes in the parent and host countries, and countries have different methods for dealing with this double taxation issue. Coordination of economic policy in general, but tax policy in particular, is a crucial consideration for FDI.

- **Flexible labour markets.** Lower labour costs reduce the costs of production and should encourage both vertical and horizontal FDI. Labour quality has a positive effect on both vertical and horizontal FDI as a more educated labour force can learn and adopt new technology faster reducing the cost of training local workers. Strict employment protection legislation lowers the return on FDI and makes it more difficult for MNCs to respond to demand and supply shocks.

- **An abundance of natural resources.** An abundance of natural resources will attract vertical FDI as MNCs seek to locate closer to available resources. However, countries with abundant natural resources are more prone to violent conflict, which is a form of political instability which increases the risk of investment, reducing both horizontal and vertical FDI. While an abundance of natural resources may be enough to attract FDI initially, unless countries address the other factors that determine FDI (such as institutions, political and macroeconomic stability, infrastructure, and trade openness) FDI inflows may not be sustained. Countries that currently rely heavily on natural resources for FDI need to channel the natural resource rents into improving infrastructure and institutions and generating human capital, and encourage diversification into other sectors such as manufacturing to ensure continued inward FDI in the long-term.

- **Harmonisation of policies.** A multinational agreement on policies could attract FDI by serving as mechanism to ensure governments remain committed to policies, and removing the transactions costs to potential investors arising from differences in national rules. Harmonisation could be particularly beneficial to AU and LAS member countries because it will avoid competition between governments (e.g. in taxes and subsidies) to attract FDI at the expense of other countries, and can stimulate investment between member countries by addressing major concerns of both the source and host countries. (Hoekman and Saggi 2000)

- **Harmonisation of business law.** Harmonized legal rules will lower transaction costs faced by potential investors, thereby attracting FDI. It will also prevent AU and LAS countries from resorting to lax rules in the relevant areas of the law, including tax, environmental protection, and financial market regulation to attract FDI. (Pistor 2002)
The following factors will reduce the level of risk associated with an investment, by lowering the uncertainty about the expected income from the investment (please refer to the earlier Technical Report for greater detail on these mechanisms):

- **High institutional quality.** Legal institutions – the laws and the quality of their enforcement – that protect investors are an important dimension of economic institutions because they reduce the risks of investment. Strong property rights are particularly important for FDI as they reduce the risk of expropriation of investment.

- **Political stability.** Greater political stability lowers the uncertainty associated with investment. Conflict is one form of political instability, the duration and probability of which increases with natural resource abundance (Collier and Hoefler 1998). Most African and Arab countries are natural resource-rich, and therefore particularly vulnerable to conflict and must pay careful attention to ensuring political stability. Moreover, Svensson (1998) shows that governments in unstable and polarised countries lack the incentives to undertake legal reform so as to strengthen property rights. Political instability impedes the institutional reforms required to attract FDI.

- **Macroeconomic stability.** The primary sources of macroeconomic instability are inflation, real exchange rate movements and changes in the terms of trade. Both the level and volatility of these macroeconomic variables have an impact on FDI. The negative impact of macroeconomic instability on FDI highlights the importance of macroeconomic policy credibility. Good macroeconomic policy should not be subject to reversal at the policymaker’s whim, and investors should perceive good policies as stable. The right institutions constrain policymakers from reversing good policy choices, and hence are crucial for macroeconomic stability. More than just good policy, therefore, countries that wish to attract FDI need to have good policy which is credible - that is, which is not subject to sudden changes in the future. In the context of investment, which is generally undertaken over very long time horizons, this is of particular importance. In the case of FDI, where the investor is undertaking the investment in a foreign country, of which the investor may have limited knowledge, and in which the investor may have limited lobbying influence, the need for good, and also credible policy becomes absolutely vital.

### 4.1 Investment Climate in African and Arab Countries

In order to investigate the relationship between the above determinants and FDI for African and Arab countries, the countries are split into thirds based on the level of FDI stock, as shown in Table 3. The top third FDI host countries in Africa and the Arab world accounted for 91% of all inflows to African and Arab countries, while the middle third accounted for 8% and the bottom third accounted for less than 2%. Since FDI into the African and Arab regions is concentrated in a relatively small number of countries, it is important to understand the differences between these top host countries and the others. In effect, since the top third of African and Arab states get in excess of 90% of FDI flowing into the region, the important question is how this set of countries is different from the rest, in order to understand what might be attracting FDI to these locations. In addition, since even the top
third of African and Arab states does not do as well as the top FDI performing countries in the world, we also wish to know in what ways even the best performing countries in our regions might do better, so as to attract even more FDI than in the past. To do so, we also compare the performance of African and Arab countries with that of the ten developing and transition economies with the highest levels of FDI stock, the “benchmark” group.6

### 4.1.1 Institutions in African and Arab countries

We begin by examining linkages between institutions and investment performance.

First, those African and Arab countries with better business environments attract more FDI. As the evidence of Figures 12 through 16 makes clear, this is evident from a range of dimensions. In terms of the number of start-up procedures to register a company, the time required to start a business, and the cost of business start-up procedures, the top third of

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6South Africa actually has the eighth highest, and Saudi Arabia the ninth highest, level of FDI stock of all developing and transition economies. However, for the purpose of this analysis we exclude South Africa and Saudi Arabia (because they are an African and Arab country, respectively) from the top ten and instead include the next two countries on the list, Chile and South Korea.
AU and LAS countries far out-perform the middle and bottom third of countries. Similarly, in terms of the time required to register property, and the ease with which information can be gained about business ventures (business disclosure index), and to a smaller extent the ease with which an investor can withdraw from an unsuccessful venture (time to resolve insolvency), the top one third of African and Arab states do considerably better than the middle and bottom third. In a number of dimensions there do no seem to be significant differences across the region, however. In terms of the number of procedures and length of time required to build a warehouse, and the number of procedures and length of time required to enforce a contract, African and Arab countries do not show much difference, regardless of their FDI performance.

What is also noticeable, however, is that the world’s top performers in terms of attracting FDI perform even better than the top one third African and Arab countries in a number of ways. In the benchmark countries the cost of starting up a business is lower, there are fewer procedures and it takes less time to register property or enforce a contract, the extent of business disclosure is higher and the time it takes to resolve insolvency is lower than in the top third AU-LAS countries. In the case of both the cost of starting a business, as well as the transparency of business reporting practices, the margins are large.

Thus the institutional environment within which business is conducted matters. The best performing African and Arab states have better business environments than those that are not as successful in attracting FDI. What is more, the international benchmark countries, those most successful in attracting FDI in the world, still outperform even the best grouping of countries in the Afro-Arab region, suggesting that there is still considerable scope for further improvement in creating an FDI-friendly business environment. In order to raise the low levels of FDI flowing to African and Arab countries, the business environment (in particular, starting a business, registering property, enforcing contracts, business disclosure and closing a business) must be improved.

Figure 17 compares the average performance of the four country groupings across a range of governance indicators. The six World Bank (WB) governance indicators range from −2.5 to 2.5, with higher values indicating better governance outcomes. The Economic Freedom of the World (EFW) indicator has a scale of 0 to 10, with higher ratings reflecting stronger property rights and legal institutions.

The top third grouping again clearly perform better than the middle and bottom third groups on the Government Effectiveness, Regulatory Quality, Rule of Law, Control of Corruption and Legal Structure and Security of Property Rights indexes, suggesting that these factors are important for determining which African and Arab countries receive FDI. By contrast, there does not appear to be a link between the Voice and Accountability measures and inward FDI for African and Arab countries. Just as for the business environment, however, the African and Arab countries, on average, are outperformed on every measure by the benchmark group, and generally by a considerable margin.

Poor governance institutions and weak property rights are thus suggestive as significant explanatory factors in explaining the relatively low levels of FDI flowing to African and Arab countries relative to the benchmark countries. Institutions are fundamentally important for creating the right incentives for governments to pursue investment promoting policies. It is crucial for African and Arab countries to develop their governance institutions and strengthen their property rights in order to attract a greater share of the world’s inward FDI.
Figure 12: Starting a Business

Figure 13: Registering Property
Figure 14: Dealing with Licenses

Figure 15: Enforcing Contracts
This simple analysis shows that the business environment, governance and legal institutions, and property rights are likely to be important determinants of inward FDI to Arab and African countries as a whole, and the location of FDI between these countries. Developing countries have attempted to stimulate FDI by entering into increasing numbers of bilateral investment treaties as substitutes for strong institutions and property rights (Hallward-Driemeier 2003). However, Hallward-Driemeier (2003) show that bilateral investment treaties have not resulted in significantly higher FDI, and act more as complements to strong institutions and property rights. In order to attract more FDI, it is crucial that African and Arab countries improve their institutions. There is no simple substitute for strong governance institutions and property rights.

It does appear that some African and Arab countries are on the right track and have sought to improve their institutions. Figure 18 compares the Freedom House Political Rights and Civil Liberties indexes over time. These indexes are measured on a one-to-seven scale, with one representing the highest degree of freedom and seven the lowest and so a decline in the index represents an improvement. Over the period 1972 to 2008, the African and Arab countries have improved their political rights and civil liberties. However, in general these improvements have been smaller than those made by the benchmark group.

Most countries have also introduced changes to national laws and legislations to encourage FDI, although there are still countries that are doing the opposite. In 2009, Qatar and the Syrian Arab Republic liberalized foreign investment in certain sectors, the Libyan Arab Jamahiriya adopted an investment promotion law, and Rwanda introduced positive changes to the legal and business environment. However, Algeria imposed stricter rules on foreign investment, and Nigeria introduced a local content requirement for foreign investment in the oil and gas industry. (UNCTAD 2010b) While many African and Arab countries are taking steps to improve their institutional environments, there is still room for much more improvement.
Figure 17: World Bank Governance Indicators
Figure 18: Changes in the Institutional Environment
4.1.2 Political and Macroeconomic Stability in African and Arab countries

The *WB Political Stability and Absence of Violence/Terrorism* index illustrated in Figure 19 is a measure of political stability that ranges from $-2.5$ to $2.5$, with a higher value indicating a better outcome. On this measure there is not much systematic variation in political stability across African and Arab countries, at least across the range of FDI performance. One reason for this weak link between political stability and FDI across African and Arab countries may be explained by the dominance of natural resource-seeking FDI into these countries. Not only may FDI come to resource rich locations despite the disincentive of political uncertainty, but international studies have shown that natural resource dependence of an economy may itself be positively correlated with higher levels of political instability and conflict.

It is therefore noticeable that the world benchmark group of top-performing FDI countries is considerably more politically stable (on average) than the Afro-Arab region. The same is true of the two countries in the region with the strongest FDI performance (Saudi Arabia and South Africa) Thus, despite the lack of variation across countries in the Afro-Arab region on average in the political stability measures, for truly strong FDI performance political stability remains an important likely driver of international capital flows. Specifically, the high degree of political instability is a significant factor affecting the relatively low levels of FDI flowing into African and Arab countries relative to the benchmark countries.

In this respect, there is some cause for optimism. Political instability in the form of coups has declined in Africa – since January 1990 more than half of all sub-Saharan African countries have not experienced any coup attempts. For some countries this is because they became embroiled in more extreme forms of conflict: civil wars in Angola, Congo, Rwanda and Uganda, warlordism in Somalia, and inter-country war in Eritria and Ethiopia, while for other countries it is because they were able to develop stronger democratic institutions: Botswana, Mauritius, Namibia, Senegal, Burkina Faso, Cape Verde, Ghana, Malawi, Mozambique, Seychelles, South Africa and Tanzania (McGowan 2003). This again highlights the importance of institutions for investment. Good institutions, if robust, can remove the gains from engaging in conflict.
Figure 20 compares the performance of the four country groupings across three indicators of macroeconomic stability: the level and standard deviation of inflation, and the real effective exchange rate (REER). The top third group have a lower level of the inflation rate than the middle and bottom third groups, but again the benchmark countries have significantly lower inflation rates. The *EFW Standard deviation of inflation* rates countries on their variation in the inflation rate, a 10 indicates there has been no variation over the last 5 years and a zero indicates that the standard deviation of inflation is about 25% annually. The measure indicates that the stability of inflation does not differ greatly across the four country groupings, and that on average African and Arab countries have had relatively stable inflation rates, though the benchmark countries internationally still outperform the Afro-Arab region on stability in inflation rates.

The REER is a weighted average of a country’s currency relative to a basket of other major currencies adjusted for the effects of inflation, and an increase in the index relative to the base year (2000) indicates that a country has become less internationally competitive over time. The data in Figure 16 indicate that from 2000 to 2008 the REER has appreciated in all the country groupings, but slightly more in the benchmark group than in the African and Arab countries. For the benchmark countries, the exchange rate appreciation is likely associated with their economic success while for African and Arab countries it is likely due to the commodity boom. While an appreciation in the REER could possibly have been a reason for poor FDI performance, the evidence here suggests that this is not the case. Strong
real exchange rate appreciations are unlikely to be responsible for the low levels of FDI in Africa and the Arab world. However, currency instability (measured by frequent currency crashes) of Africa (excluding North and CFA Africa) is worse than that of Asia (Rogoff and Reinhart 2003), and may be a more significant determinant of FDI in the region.

There is thus little evidence to suggest that real exchange rate appreciations can be held accountable for the poor FDI performance. Instead, the conditions for investment promotion set by the factors that are within the control of the domestic economy, including political instability and low inflation, seem more likely candidates.

4.1.3 Market size of African and Arab countries

The domestic markets in Africa and the Arab world are small – in 2008 the total GDP of sub-Saharan Africa was less than that of Australia (the world’s fourteenth largest economy) and the total GDP of the Middle East and North Africa was less than that of India (the world’s twelfth largest economy). Figure 21 shows the GDP for the different country groups across the Afro-Arab region, in contrast to that in the benchmark group of countries. Not only is the market size of the Afro-Arab countries with the largest share of FDI larger than the rest of the region, but the benchmark group of countries outstrip the Afro-Arab region in market size by a very considerable margin. The market sizes of African and Arab countries are dwarfed by the large markets of the benchmark group. The evidence is thus suggestive not only of the existence of a relationship between FDI and market size, but that the association is likely to be strong.

Small market size thus likely at least partially explains the low levels of FDI to African and Arab countries relative to the benchmark countries. In this respect, the lack of trade openness between African and Arab countries further serves to limit market size, and hence the attraction for horizontal market-seeking FDI. This highlights the importance for African and Arab countries of developing regional markets which remove trade barriers between neighbouring countries, allowing producers to access a larger market at lower cost. Figure
Figure 22: Market Size by Region
Figure 23: Market Size by Region
22 illustrates the gains in market size for West Asia, North Africa and Western Africa if the countries in these regions developed regional markets. The Western Asian market would be almost the size of the Netherlands market, the Northern African market would be of comparable size to Turkey, and the Western Africa market size would rival that of Venezuela. Figure 23 illustrates the gain in market size if countries in Southern, Eastern and Middle Africa developed regionally integrated markets. The Southern African regional market would be of similar size to that of Venezuela, the size of the Middle African market would be rival that of Ukraine, and the size of the Eastern African market would be comparable to that of Peru. These two graphs illustrate the relatively small size of African and Arab domestic markets, and highlight the significant gains in market size that can be realised through regional integration.

4.1.4 Economic growth in African and Arab countries

Figure 24 illustrates the average growth rates of countries in the four groups. There is clearly a link between economic growth and FDI for African and Arab countries, the top third group had the highest growth rate, and the bottom third had the lowest growth rate. It is also interesting to note that the African and Arab countries actually grew slightly faster than the benchmark group, which may be why they attracted inward FDI despite performing relatively poorly on the some of the other dimensions affecting inward FDI.7

4.1.5 Trade Openness in African and Arab countries

Since market size has a significant positive effect on FDI, it is crucial that African and Arab countries (which typically have small domestic markets) open up to trade to allow firms access to a larger market. Figure 25 compares the performance of countries across the

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7There is concern regarding reverse causality here: investment is important for growth, which in turn increases FDI. It is thus difficult to determine whether these countries grew faster because of greater FDI, or whether they received greater FDI because of higher growth.
Economic Freedom of the World’s *Freedom to trade internationally* index. The index is a composite index covering taxes on international trade, regulatory trade barriers, size of the trade sector relative to expected, black market exchange rates, and international capital market controls. The top third group have the most freedom to trade internationally of Arab and African countries, but still lag behind the benchmark group.

Regional trade agreements (RTAs) are potentially important for African and Arab countries as they lower the trade barriers between neighbouring countries which reduces the costs of moving goods in and out of the countries (though there are also costs present, for instance in the form of possible trade diversion). However, Elbadawi and Mwega (1998) finds that, with the exception of the Southern African Development Coordination Conference (SADCC), African regional integration schemes have not significantly increased inward FDI. This is in contrast with other developing country regions, where the Latin American Free Trade Association (LAFTA), Association of Southeast Asian Nations (ASEAN) and the Central American Common Market (CACM) are associated with greater inward FDI. The failure of African regional integration schemes may be attributable to poor institutions (so that governments failed to implement the signed treaties), low growth within the regional bloc, lack of diversification, and a lack of regional infrastructure (Geda and Kebret 2007).

One of the key difficulties with trade liberalisation in Africa has been the heavy reliance of African governments on tariffs for revenue. Improving tax collection institutions will lower these government’s dependence on tariff revenues, thereby lowering the costs of trade liberalisation.

A second difficulty is that foreign investors perceive trade liberalisation in Africa as transitory and subject to reversal (Asiedu 2002). This lack of credibility of trade reform in Africa arises for two reasons. First, African governments have traditionally used trade policy to manage their balance of payments: when the terms of trade deteriorated, trade restrictions were increased, and relaxed again when the terms of trade improved. Second, a number of African countries embark on reform as a condition of foreign aid, but once the aid

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**Figure 25: Freedom to Trade**

![Economic Freedom of the World's Freedom to trade internationally index. The top third group have the most freedom to trade internationally.]
ends they abandon the reform process. African policymakers need to improve the credibility of their reforms to attract FDI. The right institutions are crucial for creating incentives that constrain policymakers from reversing trade liberalisation. Regional trade agreements may also improve policy credibility if the RTA members offer reciprocal free trade to a major external trading partner. The threat of losing privileged access to a major market, FDI, and technology transfers will prevent policy reversals and thereby enhance policy credibility (Collier and Gunning 1993).

4.1.6 Geography of African and Arab countries

One indicator of distance to major markets is the minimum Great-Circle (air) distance in kilometers from the country’s capital city to one of New York, Rotterdam, or Tokyo. Figure 26 compares this average air distance across our country groupings - and the evidence does indeed appear to confirm a negative relationship between distance from the major markets and inward FDI, as the benchmark group as well as the top FDI-performing Afro-Arab countries are on average closer to the main markets than African and Arab countries.

Perhaps even more significantly, more than a quarter of the population of sub-Saharan Africa live in landlocked countries, compared with just 2% in South Asia (Gallup, Sachs, and Mellinger 1999). The following African countries are landlocked: Burkina Faso, Central African Republic, Chad, Mali, Niger, Botswana, Malawi, Zambia, Zimbabwe, Burundi, Rwanda, Uganda, Ethiopia, Lesotho, Swaziland. Only two of the countries in the top third group are landlocked (Chad and Zambia), while none of the benchmark countries are landlocked. On average, the landlocked countries have attracted less FDI than coastal countries.

Since a large number of African countries are landlocked, thus increasing the cost of transporting goods to and from these countries, the importance of good infrastructure in the African context is significantly enhanced. Efficient road and rail networks linking the major manufacturing zones in landlocked countries with ports reduces the costs of transporting in intermediate input goods and transporting out final export goods. These lower transport
costs reduce the cost of producing in the host country and the costs of re-exporting the final good to the source country, attracting vertical FDI. This raises the importance of landlocked countries developing their transport infrastructure to lower the transport costs faced by producers.

4.1.7 Infrastructure in African and Arab countries

Figures 27 and 28 illustrate the differences between our country groupings across measures of energy supply, water, telecommunications and transport infrastructure. Per capita electricity consumption is an indicator of the quantity of energy supply infrastructure, while electric power transmission and distribution losses reflect the quality of energy supply infrastructure. The number of telephone mainlines indicates the quantity of telecommunications infrastructure. The quantity of transport infrastructure is measured by the total kilometers of road and rail network per square kilometer of land area, while the proportion of roads that are paved is a measure of the quality of the infrastructure.

It is evident that there is a positive relationship between infrastructure and inward FDI. The top third Afro-Arab country group have a greater quantity, and better quality, of energy supply, water and telecommunications infrastructure than the other African and Arab countries.\(^8\) The quality of the road network, rather than the quantity, appears to be a more important determinant of FDI for African and Arab countries.\(^9\) The top third group have a proportionally larger rail network than the other African and Arab countries. However, all the African and Arab countries lag behind the benchmark group in terms of all the measures of infrastructure development. The lack of infrastructure is therefore potentially a key factor affecting the low levels of FDI to African and Arab countries relative to the benchmark countries.

Infrastructure is particularly important for African countries because of their poor geographical location. Most African countries are a great distance away from the key markets and has the largest proportion of landlocked countries of all regions. These geographical factors increase the costs of transporting goods to and from African countries, which negatively affects FDI. Improvements in infrastructure, particularly transport infrastructure, will reduce the transport costs faced by producers. It is crucial to have the right institutions to ensure that governments have the incentives to provide infrastructure through either public investment, public-private partnerships, or by allowing the privatisation of infrastructure provision.

There have been some steps toward improving infrastructure. In 2006, the Economic and Monetary Community of Central Africa (CEMAC) approved a project to develop the Douala-Bangui and Douala-N’djamena road corridor, linking Cameroon, the Central African Republic and Chad. Prior to the CEMAC project freight transport from Douala in Cameroon, the main port and regional gateway, took 15 days to N’Djamena in Chad and 10 days to Bangui, Central African Republic, and port delays could add up to an additional 28 days (ICA 2007). While this represents a move in the right direction, more needs to be done to improve infrastructure across African and Arab countries.

\(^8\)The high average for electric power consumption in the bottom third country grouping is driven by Kuwait, which has electric power consumption 11 times higher than the next highest in that country group.

\(^9\)However, there is a relative lack of data on road and rail density.
Figure 27: Infrastructure
Figure 28: Infrastructure
4.1.8 Agglomeration in African and Arab countries

Yehoue (2009) presents the export processing zones (EPZs) in Mauritius as an example of a successful cluster. Mauritius has moved from an economy highly dependent on the export of a single crop (sugar) to a diversified economy with strong manufacturing and tourism sectors. The development of the manufacturing sector is due largely to the EPZs. Government policy (improving institutions and providing incentives) together with the positive externalities provided by domestic entrepreneurs attracted significant FDI inflows and led to the success of the EPZs in Mauritius.

The Cameroonian government sought to attract FDI by creating an export processing zone (EPZ) under the 1990 Investment Code. However, the EPZ has failed to attract significant FDI because of lengthy and restrictive bureaucratic procedures, limited powers of the body established to develop and operate the zone, and the government’s failure to offer the incentives promised (Khan and Bamou 2006).

In 1995, a programme was instituted to develop export processing zones (EPZs) in Ghana with incentives such as tax holidays and guarantees of repatriation of profits and against nationalisations of assets. The establishment of the EPZs was partly responsible for the growth in non-traditional exports, particularly canned tuna and cocoa products (Asante 2006).

Most of the MNCs located in the Kenyan EPZs are from India and Sri Lanka, and from the garment industry. They were attracted by the low labour costs and the opportunities offered under the African Growth Opportunity Act (AGOA), especially the easy access to the US market (Mwega and Ngugi 2006).

These examples indicate that EPZs can be successful for attracting FDI, but it is crucial that the government does not renege on the promised incentives, and is pro-active in removing obstacles faced by investors.

4.1.9 Taxes in African and Arab countries

Figure 29 indicates the relative tax burden (government tax revenue as a % of GDP) across the different country groups. The evidence suggests the tax burden is not likely to be a significant factor in determining the location of FDI flows within the African and Arab countries. However, the benchmark group have a lower average tax burden than the African and Arab countries suggesting that the relatively high tax burden is possibly significant for explaining the low levels of FDI to African and Arab countries.

It must be borne in mind that simply lowering corporate taxes in isolation is not enough to significantly increase inward FDI. The lowering of corporate taxes must be part of a broader agenda of reform that also improves the other factors affecting FDI, particularly the effectiveness of governance institutions. Another important dimension of the reform process is improving the institutional capacity to collect taxes. Greater efficiency and effectiveness of tax collections will enable a lowering of the tax rate without significant loss of government revenue. It also has the advantage of allowing the opening up of the economy as government revenue will no longer rely heavily on import taxes, as is currently the case for many developing economies.
4.1.10 Labour markets in African and Arab countries

Figure 30 compares the countries’ performance across two indicators of labour market conditions. There is not much difference in the rigidity of employment conditions across African and Arab countries, but on average they have significantly more rigid employment conditions than the benchmark group. The EFW *Labour market regulations* index is composed of the following sub-components: minimum wage, hiring and firing regulations, centralised collective bargaining, mandated cost of hiring, mandated cost of worker dismissal, and conscription, and a higher rating indicates more flexible labour markets. The bottom third group perform the worst on this index as a result of these countries’ onerous labour market regulations, but there is not much variation in this index across African and Arab countries. However, the benchmark countries outperform the African and Arab countries on the EFW *Labour market regulations* index. Thus, there is some evidence to suggest that labour market conditions explain the distribution of FDI across African and Arab countries, and the proportion of the world’s inward FDI received by the African and Arab countries relative to benchmark countries.

4.1.11 Natural resources in African and Arab countries

FDI into Africa has tended to favour extractive industries based on natural resources. In 2008, the primary sector received a large proportion of FDI to Africa. This was mostly increased equity investments in greenfield or expansion projects in the first half of 2008, owing to the high commodity prices and positive global economic outlook. However, as commodity prices fell in late 2008, cross-border mergers and acquisitions in the sector declined rapidly: indeed divestments were greater than new acquisitions. The Arab countries also receive significant FDI into the primary sector, despite restrictions on foreign investment in the upstream segment of the oil and natural gas industry. MNCs have remained active in these countries even after the decline in oil prices in late 2008. (UNCTAD 2009b)
4.1.12 Harmonisation of policies and laws in African and Arab countries

The Organization for Harmonization in Africa of Business Laws (OHADA) was set up by a treaty in 1993 to establish a single, cross-border regime of uniform business laws. There are 16 member countries: Benin, Burkina Faso, Cameroon, Central Africa, Comoros, Congo, Ivory Coast, Gabon, Guinea, Bissau Guinea, Equatorial Guinea, Mali, Niger, Senegal, Chad, and Togo. OHADA’s laws are exclusively business-related and largely based on the French legal system. Legal professionals and business people in the member countries commend the laws’ clarity and are supportive of and hopeful for the OHADA system. However, Dickerson (2005) finds that OHADA has not been particularly successful at improving the protection of private property in member countries, and that U.S. investors have a generally unfavourable opinion of OHADA. It must be remembered that the OHADA laws have only been effective since 1998 so the long-term benefits may not yet be realised. For OHADA to be successful, local legal professionals, business people and potential foreign investors must be provided with complete and current information about OHADA (Dickerson 2005).

Almost all African countries have adopted Structural Adjustment Programs (SAPs) starting in mid 1980s, at various points. The identical nature of policy prescriptions by International Financial Institutions (IFIs) across African countries entails a defacto macroeconomic policy harmonisation, at least in nascent form, suggesting that there might already be a basis for formal harmonization of policies. Alemayehu (2001) shows that there is significant variation across African regional economic communities (RECs) and their member countries in the macroeconomic environment, the fiscal stance, the asymmetry of shocks and the policy response to shocks. This highlights the importance of developing a fiscal policy harmonization that suits the specific conditions of each REC.

There are two economic and monetary unions in Africa. The Economic and Monetary Community of Central Africa (CEMAC) comprises the six countries using the Central African CFA franc: Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea and Gabon. The West African Economic and Monetary Union (UEMOA) is an organisation of the eight countries using the West African franc: Benin, Burkina Faso, Cote
d’Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo.

There have been some attempts to harmonise policy and laws in African and Arab countries, but these projects are relatively young and there is still some way to go before the full benefits of harmonisation can be realised.

4.2 Regression Analysis

As a final step, we investigate the joint impact of the range of possible determinants of FDI we have encountered above. We do so by a panel regression analysis, which allows us to investigate the determinants of FDI in African and Arab countries over time, and allow for the presence of heterogeneity across countries by means of a country-specific effect that is fixed over time (which can control for factors such as geography, climate, etc.).

The limited availability of data, both in terms of number of countries and number of years, constrains the regression analysis and so the results must be interpreted with caution. Nevertheless the following model is estimated:

\[
\log(FDI)_{it} = \alpha_i + \beta_1 \log(GDP)_{it} + \beta_2 tax_{it} + \beta_3 inflation_{it} + \beta_4 exports_{it} + \beta_5 imports_{it} + \beta_6 warehouse_{it} + \beta_7 corruption_{it} + \beta_8 freedomhouse_{it} + \beta_9 telephone_{it} + u_{it}
\]

where, for country \(i\), in period \(t\), we denote:

- **FDI**: Four measures of FDI performance are examined: inward FDI stock (model 1), inward FDI flow (model 2), inward FDI stock as a percentage of GDP (model 3), and inward FDI flow as a percentage of GDP (model 4).
- **GDP**: Real GDP. Real GDP is omitted from models (3) and (4) because the dependent variables in these models are measured as a percentage of GDP.
- **tax**: Tax revenue (% of GDP)
- **inflation**: Inflation, GDP deflator (annual %)
- **exports**: Exports of goods and services (% of GDP)
- **imports**: Imports of goods and services (% of GDP)
- **warehouse**: Number of procedures to build a warehouse. Since the various measures of the business environment discussed earlier are likely to be highly correlated with each other, we use only one – number of procedures to build a warehouse – as an indicator of the business environment.\(^{10}\)
- **corruption**: World Bank Control of Corruption index. Again, we use just one because the six governance indicators are likely to be highly correlated.
- **freedomhouse**: Sum of Freedom House Political Rights and Civil Liberties indices.

\(^{10}\)This variable had to be dropped from the regressions involving the sub-sample of Arab countries due to insufficient observations.
• telephone: Telephone lines (per 100 people). The various infrastructure measures are highly likely to be correlated, and so we only use one.

The discussion from the previous section leads us to expect $\beta_1 > 0$ (greater market size has a positive effect on FDI), $\beta_2 < 0$ (increase taxation has a negative effect on FDI), $\beta_3 < 0$ (higher inflation is associated with lower FDI), $\beta_6 < 0$ (a poorer business environment reduces FDI), $\beta_7 > 0$ (stronger governance institutions have a positive effect on FDI), $\beta_8 < 0$ (better political institutions is associated with greater FDI, since the Freedom House variables are on an inverted scale) and $\beta_9 > 0$ (greater infrastructure attracts FDI). If $\beta_4 > 0$, this suggests that FDI into African and Arab countries has a significant vertical component. By contrast, where $\beta_5 > 0$, the inference is that there is significant opportunity for horizontal FDI, while $\beta_5 \leq 0$ implies that the regional markets can be readily accessed from foreign production bases.

The results from the model described above are presented in Table 4, using available data from 2003 – 2008.

The positive and significant coefficient on exports in models (3) and (4) indicates a preponderance of vertical, rather than horizontal, FDI in African countries. Given the very small market size of most of the countries Afro-Arab region, such that domestic markets themselves offer little incentives to investors, this finding is not implausible. However, it does imply that in order to attract vertical FDI, competitive market conditions for production, to allow investors to export again, is crucial for the Afro-Arab region if FDI is to be attracted on a sustainable basis. Note however, that horizontal, market seeking FDI also plays a role, as indicated by the import and market size variable results discussed below.

For Arab countries, the significant negative coefficient on imports in model (1) suggests that the domestic market in Arab countries can be adequately accessed from foreign production bases, obviating the need for horizontal FDI. However, by contrast models (3) and (4) imply that greater imports are linked to greater FDI in African countries, suggesting that in the African region there have been some opportunities for horizontal, market seeking FDI, rather than servicing the African markets from foreign production bases.

The results further suggest that market size, the business environment and institutions are among the most significant determinants of FDI in both African and Arab countries. Market size, measured by real GDP, is a highly significant determinant of inward FDI – a 1% increase in real GDP is associated with a 4% increase in inward FDI stock in AU and LAS countries, a 7% increase in inward FDI flow in AU countries, and no significant effect on inward FDI flow in LAS countries.

The business environment is significant across most of the models, such that for instance an additional procedure to build a warehouse associated with a 106% decline in inward FDI flow. To measure the effect of institutions we use the World Bank Control of Corruption indicator and the sum of the Freedom House Political Rights and Civil Liberties indices. The results confirm that strong institutions have a positive impact on FDI – a one point improvement on the Control of Corruption indicator is associated with a 123% increase in inward FDI flow, though the Freedom House indices are generally statistically insignificant. While the magnitude of this effect may seem large, it must be remembered that a one-point improvement on these indices is a substantial change – the World Bank Control of Corruption index ranges from $-2.5$ to $2.5$.  

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### Table 4

<table>
<thead>
<tr>
<th>Dependent variable</th>
<th>Model (1)</th>
<th>Model (2)</th>
<th>Model (3)</th>
<th>Model (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Log real FDI inward stock</td>
<td>Log real FDI inward flow</td>
<td>FDI inward stock, % of GDP</td>
<td>FDI inward flow, % of GDP</td>
</tr>
<tr>
<td>All</td>
<td>Log Real GDP</td>
<td>3.714 (0.528)**</td>
<td>3.921 (0.778)**</td>
<td>3.611 (0.493)**</td>
</tr>
<tr>
<td>AU</td>
<td>3.901 (0.605)</td>
<td>4.018 (0.602)</td>
<td>3.627 (0.497)</td>
<td>5.241 (1.200)</td>
</tr>
<tr>
<td>LAS</td>
<td>3.529 (0.468)</td>
<td>3.818 (0.534)</td>
<td>3.584 (0.478)</td>
<td>5.183 (1.166)</td>
</tr>
<tr>
<td>Tax revenue (% of GDP)</td>
<td>0.010 (0.012)</td>
<td>0.018 (0.023)</td>
<td>0.005 (0.005)</td>
<td>0.007 (0.027)</td>
</tr>
<tr>
<td>Inflation, GDP deflator (annual %)</td>
<td>-0.011 (0.007)</td>
<td>-0.013 (0.010)</td>
<td>-0.004 (0.005)</td>
<td>-0.027 (0.017)</td>
</tr>
<tr>
<td>Exports of goods and services (% of GDP)</td>
<td>0.008 (0.010)</td>
<td>0.011 (0.013)</td>
<td>0.002 (0.013)</td>
<td>0.015 (0.023)</td>
</tr>
<tr>
<td>Tax revenue (% of GDP)</td>
<td>0.009 (0.008)</td>
<td>0.009 (0.010)</td>
<td>0.003 (0.010)</td>
<td>0.004 (0.021)</td>
</tr>
<tr>
<td>Procedures to build a warehouse (no)</td>
<td>-0.161 (0.130)</td>
<td>-0.181 (0.160)</td>
<td>-0.145 (0.160)</td>
<td>-0.162 (0.299)**</td>
</tr>
<tr>
<td>WB Control of Corruption</td>
<td>0.111 (0.246)</td>
<td>0.021 (0.365)</td>
<td>-0.145 (0.206)</td>
<td>1.231 (0.558)**</td>
</tr>
<tr>
<td>FH Political Rights + Civil Liberties</td>
<td>0.124 (0.069)*</td>
<td>0.158 (0.095)</td>
<td>0.111 (0.070)</td>
<td>0.435 (0.155)**</td>
</tr>
<tr>
<td>Telephone lines (per 100 people)</td>
<td>0.021 (0.043)</td>
<td>0.074 (0.135)</td>
<td>0.043 (0.021)**</td>
<td>-0.041 (0.098)</td>
</tr>
</tbody>
</table>

Note: Standard errors in parentheses; * significant at 10%; ** significant at 5%; *** significant at 1%.
There is some evidence that the other variables affect FDI, but the effects are not as robust as for market size, business environment and institutions. An increase in tax revenue is associated with an increase in FDI in African countries in models (3) and (4). This is contrary to expectations, but higher tax revenue may be due to a more efficient tax collection system which could reflect better government institutions in these countries. The tax burden does not have a significant effect on FDI in Arab countries. Model (2) indicates that a 1% increase in inflation is associated with a 4% decline in inward FDI flow in African countries. Conversely, model (3) suggests the reverse, but the effect is not economically significant. Inflation does not have a significant effect on FDI to LAS countries. There is no strong evidence that infrastructure is important – more telephone lines have a positive effect on FDI in Arab countries in model (1), but a negative effect on all countries in model (4), and no significant effect on African countries in all of the models.

Due to the lack of data, and the short time period covered in the estimation, all of these results must be interpreted with caution. Nevertheless, they do confirm that market size, the business environment and institutions matter for FDI in African and Arab countries.

5 Policy Priorities for the Promotion of FDI between African and Arab countries

The previous sections identified the following factors as crucial in explaining the very low levels of inward FDI to African and Arab countries compared to the top ten developing and transition FDI host countries:

- Ease of doing business
- Governance institutions
- Legal structure and property rights
- Inflation
- Market size
- Trade openness
- Infrastructure (quantity and quality)
- Tax burden
- Labour market flexibility

The following factors determine the proportion of inward FDI to the African and Arab regions that a particular country will attract:

- Ease of doing business
- Governance institutions
• Legal structure and property rights
• Market size
• Trade openness
• Infrastructure (quantity and quality)
• Tax burden

While many African and Arab countries have taken steps toward improving the investment environment, there is still considerable room for improvement, and the reform agenda is clear:

• Improve the business environment
• Strengthen governance and legal institutions and property rights
• Keep inflation low and stable
• Increase market size through the development of regional markets, and by stimulating growth
• Increase openness to trade
• Improve both the quantity and quality of infrastructure (energy supply, water, telecommunications and transport)
• Lower the tax burden
• Increase the flexibility of labour markets.

6 Concrete Actions to Realise Appropriate Policy Interventions

We have identified the broad areas of reform that are required for African and Arab countries to improve their attractiveness to FDI. The specific actions that can be taken to promote Afro-Arab investment exchange are (refer to the earlier Joint Action Plan for greater detail on these actions):

• Joint arrangements to coordinate policy across the two regions
• Generation and dissemination of coordinated data and information on investment in the two regions, including updated research findings on the state of the investment environment in the region, and investment opportunities that arise in the region
• Establishment of joint Afro-Arab investment guarantee arrangements
• Creation of joint mechanisms to facilitate the financing of investment

We discuss each of these actions in greater detail below.
6.1 Policy Coordination

The foundation for policy coordination already exists in the form of various customs unions, common markets, and economic and monetary unions within the AU and LAS. The economic integration of these regional unions could be extended to completion with full monetary union and fiscal policy harmonization.

A federation of Arab and African investment promotion intermediaries (IPIs) could be formed, with one of its tasks being the coordination of investment promotion policies across countries, and country-specific investment promotion intermediaries.

6.2 Provision of Information to Potential Investors

The objective is to provide reliable, detailed and up-to-date information required by prospective investors in order to:\(^{11}\)

- make a sound assessment of possible investment locations, and
- identify profitable investment opportunities that generate a higher rate of return than investments in competing locations.

This would require the monitoring of the investment environment (including the ease of doing business, labour markets, taxation, political and macroeconomic stability, and institutions) of AU and LAS member countries, in order to provide comprehensive, accurate and reliable data on the investment environment to governments, IPIs and potential investors. This might include ratings of countries’ performance on the various drivers of investment relative to the appropriate benchmarks. The data collected will assist IPIs and governments to identify the constraints faced by potential investors.

The provision of relevant information to prospective investors can be accomplished through:

- Development of investment promotion intermediaries, as well as an Afro-Arab federation of investment promotion intermediaries, which will:
  - Efficiently and effectively respond to investment inquiries from potential investors and their advisors.
  - Provide information that is of high quality and useful to prospective investors via websites.
  - Minimise inaccuracies about investment locations and present the location’s advantages in the best possible way.
  - Provide information on websites and in response to inquiries that reflects an understanding of the most important factors in various sectors and subsectors and for specific types of projects.
  - Assist potential investors by identifying potential problems they might face and developing solutions to these problems.

\(^{11}\)Refer to the earlier Joint Action Plan for greater detail on this action.
- Identify and lower, or ideally eliminate, existing constraints on potential investment. This may be particularly important for African and Arab countries, as many perform poorly on the various FDI drivers (as highlighted earlier). These countries will benefit significantly from improving their performance on the core drivers of FDI.

- Holding annual investment fairs to:
  - Provide high-quality, accurate and reliable information that is useful to prospective investors at the investment fair.
  - Minimise inaccuracies about investment locations and present the location’s advantages in the best possible way by directly engaging with potential investors at the investment fair.
  - Honestly inform potential investors about the risks, costs and obstacles of their location, and present solutions to these problems.
  - Exchange of experience and lessons learned between investment promotion agencies.

These actions can be undertaken by existing IPIs, or a new federation of national IPIs can be developed and tasked with the coordination of information provision to potential investors.

In order to ensure that the relevant data and information is available, there must be:

- Development of the capacity to identify investment opportunities to ensure:
  - Identification of specific investment opportunities in particular sectors in AU and LAS countries.
  - Production of research to develop an understanding of the most important factors affecting the return and risk of an investment in various sectors and subsectors and for specific types of projects.
  - Production of research in order to provide detailed information on those sectors, industries, or businesses in which economies are competitive.

- Monitoring of the investment environment (including the ease of doing business, labour markets, taxation, political and macroeconomic stability, and institutions), to ensure:
  - Provision of comprehensive, accurate and reliable data on the investment environment to governments, investment promotion intermediaries (IPIs) and potential investors.
  - Ratings of countries’ performance on the various drivers of investment relative to the appropriate benchmarks.
  - Assist IPIs and governments to identify the constraints faced by potential investors.
The identification of investment opportunities could be the duty of a department of the IPI Federation, or could be the responsibility of a separate newly-created agency, or could be outsourced to existing research units. The monitoring and data collection could be achieved by developing a new AU-LAS agency to do so, by purchasing data on the investment environment from existing private sector providers, such as Business Environment Risk Intelligence (BERI) or Transparency International, or by outsourcing to existing research units.

6.3 Investment Guarantee Arrangements

It is important to insure eligible projects against losses relating to risks of all types, as this will:

- Provide assurance to investors that losses will be recovered, subject to a portion for which the investor is liable.
- Deter harmful actions by building relationships with shareholder governments.
- Resolve potential investment disputes before they reach claim status, helping to maintain investments and keep revenues flowing.
- Provide potential investors with improved access to project finance from banks.
- Potentially lower the borrowing costs faced by investors as they have guaranteed loans.
- Provide insurance coverage for long periods, thereby increasing the tenor of loans available to investors.

There are two alternative ways to ensure that investments are guaranteed against risks: membership in the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group, and the development of a new AU-LAS investment guarantee agency.

6.4 Facilitate Financing of Investments

African and Arab countries must ensure that potential investors have improved access to credit to finance investment. This is particularly important due to the current global financial crisis. The objectives are:

- Improved access to financial intermediaries.
- Increased financing available to foreign investment projects.

This can be achieved by:

- Enhancing the functioning and capacity of financial systems in AU and LAS member countries.

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12 Refer to the earlier Joint Action Plan for greater detail on this action.
13 Refer to the earlier Joint Action Plan for greater detail on this action.
• Developing regional financial hubs that specialise in funding investments in particular regions, such as Johannesburg (South Africa), Mauritius and the Qatar Financial Centre in Doha.

• Linking IPIs and financial intermediaries so that:
  – potential investors are informed about financing options, and
  – financial intermediaries have full information about investment projects allowing them to efficiently allocate funds.

• Promoting relationships between the financial intermediaries and the investment guarantee agency so the financial intermediaries have accurate knowledge about the risks and insurance coverage of investment projects.

• Inviting financial intermediaries to exhibit at an investment fair to provide investors with information about financing opportunities. This will also make financial intermediaries aware of the projects that require financing.
References


