Dynamics of FDI in Ethiopia: Bridging the Balance of Payments Gap (Ch. 3) and Enhancing the Role of FDI in Technology and Knowledge Transfer (Ch. 4)

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Background

- Ethiopia faces two types of gaps: The investment-saving (capital) and export-import (trade or foreign exchange) gap
- Government plans to fill these gaps using FDI
  - bridging the saving-investment (capital gap) by injecting foreign capital (investment)
  - narrow trade gap by enhancing exports & substituting imports
- Not automatic, in a weak policy environment, FDI may aggravate capital leakage & trade deficit
  - low value-adding activities (simple assembly that require large amounts of imported inputs), or when FDI is market seeking
  - Repatriation of profits & wages and repayments of loans
- the BoP impact is debatable & the empirical evidence is mixed

Background

- The role of FDI policy is crucial: active FDI policy is required to maximize the benefits and minimize its negative impacts
  - determine what type of FDI to attract, and
  - the conditions & incentive mechanisms to put in place
- GoE has designed several incentive schemes and revised proclamations and regulatory frameworks
  - However, export remains low and the significant shortage of foreign exchange persists with a huge BOP deficit
  - why existing policies not helping to ease the BOP pressure?
- The main aim of this chapter is to:
  - scrutinize existing FDI policies & identify areas for reform
  - propose policy options for maximizing benefits by drawing on lessons from successful countries

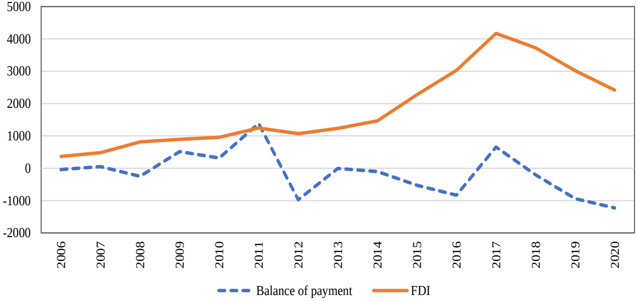
Background: FDI and BoP Performance

- FDI inflows to Ethiopia steadily rose since the early 2000s and showed a dramatic increase between 2012 and 2017
  - can be explained partly by the reform measures

- Mostly in manufacturing & from China, Turkey & India

- After 2016/17, net FDI inflows have been continuously $\Downarrow$, due to political instability & associated economic problems

Figure 3-3. Ethiopia: Trends in FDI and the Balance of Payments (Million USD)



Background: FDI and BoP Performance

- FDI as a share of GDP has also grown in the past years. It increased from 0.6% in 2012 to a peak of 5.8% in 2016. After 2016, it declined to reach 2.6% in 2019.
- Ethiopia's FDI-to-GDP ratio is higher than the average of SSA ($< 2\%$) and that of LIC ($< 3\%$)
- With the recent move to restrain the use of foreign loans, FDI has become, and is projected to remain, an important source of external finance to ease the country's BOP pressure
- Although this shift from debt financing to FDI financing of the BOP is important to reduce Ethiopia's external vulnerabilities, the current FDI inflows are not sufficient to cover the country's external gross financing needs

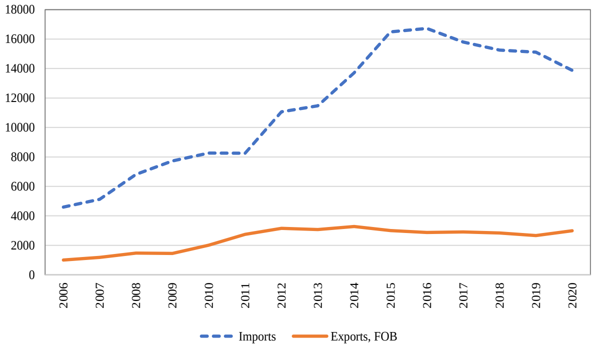
Background: FDI and BoP Performance

- The BOP is mostly in deficit $\Leftarrow$ high import volume that significantly outweighs the volume of exports & the increasing need for debt service
- After dipping in 2011/12, Ethiopia's BOP has remained in deficit except for 2016/17, a year that saw some pickup in FDI
- Given closed capital account, the external financing needs are mainly met by inflows of FDI and external loans
- The government's move to slow down external borrowings coupled with the unfortunate decline in FDI inflows has exacerbated the country's BOP pressure.
- The IMF characterizes Ethiopia's BOP pressure as acute & attributes this to the highly overvalued exchange rate, weak export performance, & increased external debt servicing needs

Background: FDI and BoP Performance

- Ethiopia runs a norm trade deficit, growing over the years
  - stagnant export of the goods sector & ever-increasing imports
- trade deficit started to show some improvement around 2015/16 $\Leftarrow$ import compression.
- GoE has been working to increase export-oriented FDI

Figure 3-4. Ethiopia: Imports and Exports (Excluding Services) (Million USD)



Lessons from other countries

- with the right policies & strategies to attract & manage FDI, it is possible to max the benefits & min the costs on the BoP
- Mauritius and the Dominican Republic examples of countries where relevant policy reforms in low-income countries can be used to exploit the positive role of FDI in boosting exports.
  - setting up export processing zones close to economic centers;
  - offering reliable infrastructure at competitive prices;
  - ensuring a conducive business environment with less corruption, crime, bureaucracy, taxes, etc.
  - macro reforms to control inflation & overvalued exchange rates
  - Madagascar & Lesotho benefited from following their examples
- FDI has had impact in structural transformation, export & industrialization of China, Thailand, Vietnam & Bangladesh.

Lessons from other countries

- These Asian countries and particularly China consider multiple objectives in designing its FDI policy
  - increasing the value-added of domestic industries,
  - promoting linkage and export, balancing trade, and
  - promoting technology transfer and regional development.
  - A particular focus to export promotion & technological adv.
- To achieve these objectives, these countries have used several laws and regulations governing FDI in the country.
  - incentive scheme, FDI promotion & performance requirements,
  - profit repatriation,
  - institutional reforms and
  - export processing zones (EPZs).

Policy recommendations and the way forward

- Important lesson for Ethiopia, Asian countries have:
  - clear, coherent & progressive policies to attract & utilize FDI
  - the commitment & capacity to implement these policies effectively
- For foreign exchange-constrained countries like Ethiopia, FDI is an important source of capital, to ease the BOP pressure
  - only if the FDI policies, requirements, incentives & monitoring mechanisms are well designed & properly implemented.
- Areas that require serious attention are
  - macroeconomic measures towards controlling the high inflation and ending the overvalued exchange rate;
  - enhancement of infrastructural as well as logistic services.
  - reducing bureaucratic hurdles & maintain peace & security
- serving the domestic market easier & lucrative than exporting $\rightarrow$ dealing with the anti-export bias (ExRate & trade cost)

Policy recommendations and the way forward

- Stronger bargaining power when negotiating with foreign investors and can also be more selective in the type of FDI

- Giving enough attention to managing FDI, rather than solely focusing on attraction

- The incentive scheme available to exporters and foreign investors should be redesigned in such a way that they become more result-based, easier to monitor, and less costly.

- Ethiopia can be an attractive location for FDI
  - Market access via AGOA, EBA, AfCFTA
  - Large and growing domestic market

- The government should therefore exert utmost effort to take bold reform measures and remove the identified major bottlenecks to attract and maximizing the benefits of FDI.

Enhancing the Role of FDI in Technology and Knowledge Transfer (Ch. 4)

Background

- FDI can help to transfers technology, know-how and expertise, including management practices, from source to host countries
- The extent to which this happens in practice varies significantly between countries
- the empirical evidence is inconclusive
- For some, FDI has been an effective tool for technology transfer & for others it is either neutral or an ineffective
- In general, FDI fails to deliver knowledge & technology due to
  - limited absorptive capacity,
  - weak supply chains,
  - the unskilled labor-intensive nature of the production process,
  - poor infrastructure,
  - fragile policy coordination and targeting, and so on

Background

- Ethiopia is keen to use FDI as a means to attrack technology and knowledge. However,
  - passive policy when it comes to the issue of technology & knowledge transfer
  - no specific interventions aimed at forming and strengthening linkages between FDI & local firms.
  - Moreover, there is no mechanism to monitor and evaluate the technology and knowledge spillover effect of FDI
- The purpose of this chapter is to:
  - examine the presence and depth of linkages between FDI and local firms and
  - propose policy options to strengthen the FDI-local firm linkage and enhance technology and knowledge spillover in the overall economy

Lessons from Asia

- In Singapore, Malaysia, Thailand, Indonesia and China FDI is strongly related to technology transfer
- This is attributed mainly to local policies & measures taken to increase the absorptive capacity of local firms
  - measures to improve the technology absorption capacity of SMEs & create linkage with MNCs
  - policy to strengthen linkages b/n research institutions & private sector
  - preferential treatment for technology transfer & JVs
- China's FDI policy has been pitched at developing JVs & attracting technology to improve productivity of local firms
- introduction of advanced foreign technologies and professional management is one of the reasons for promoting FDI in China

Ethiopia's Policy for Technology & Knowledge Transfer

- The current investment regulatory framework is defined by Proclamation 1180/2020 & Investment Regulation 474/2020.
- Any investor concluding a technology transfer agreement must register the agreement with EIC & EIC notifies other bodies
- Article 19 of Regulation 474/2020 specifies the procedure for knowledge and skill training and transfer to local employees.
  - the need to replace expats with Ethiopians through training
- The proclamation & the regulation do not explicitly reveal incentives to support technology & knowledge transfer
- they fail to explicitly stipulate requirements & incentives needed for JV, linkage creation, local input use, R&D arrangements

Ethiopia's Policy for Technology & Knowledge Transfer

- There is clear passivity in the policy framework for using FDI in transferring technology & knowledge
- Though refined repeatedly, the current proclamation and regulation remain general covering all types of investments. They are not sufficiently specific & lack structured instructions for implementation.
- Although FDI attraction is among the top priorities of the Ethiopian government, the investment proclamations and regulations practically fail to provide adequate strategies and incentives to encourage knowledge and technology transfers
- passive role of government in technology & knowledge transfer $\Rightarrow$ weak local learning & technological upgrading

Major Observations: Ethiopia

- FDI & local firms differ greatly in their organizational culture & local firms have a lot to learn from the foreign firms
- Ethiopia has not been successful in transferring technology & managerial know-how as much as it should or is expected
- Forward & backward linkages are very weak, can be attributed to several factors which require further empirical investigation

Major Observations: Ethiopia

- Technology & knowledge transfer is a daunting challenge
  - FDI is mostly market & resource-seeking, simple & labor-intensive production systems requiring unskilled labor
  - limited absorptive capacity of local firms
  - both FDI & local firms were largely dependent on imported inputs, leaving little room for domestic supply linkages.
  - lack of quality, sufficient capacity, reasonable price & timely delivery are the main constraints for dealing with local suppliers
  - main motivation for JV is accessing the domestic market

Policy Recommendations

- Although requirements of local input procurement, technology transfer and JVs may seem attractive, these can be counterproductive in Ethiopia where local supply capacity & absorptive capacity are low
  - The policy should instead provide incentives for the use of local materials & induce production linkages between foreign & domestic firms.
  - incentivizing JVs is also critical for boosting technology & knowledge transfer because daily interaction in the production management process induces explicit & tacit management knowledge transfer
- Encourage local firms to learn about export markets through targeted incentives

Policy Recommendations

- rectify the identified obstacles to technology and knowledge transfer in Ethiopia by the exhaustive engagement of all stakeholders.
- Increase the absorptive capacity, productivity and competitiveness of local firms by investing in the human capital, encouraging R&D activities, innovation, initial and recurrent training, staff exchange, and so forth
- Development of such infrastructure as power, water, internet and road, rail and air transport increases the probability of smooth interaction between MNCs and local firms and creates the necessary platform for knowledge transfer
- Policy as the core bridge must be consistent and effective to guide linkages, create competitive environment, putting requirements and incentives

Thank you!