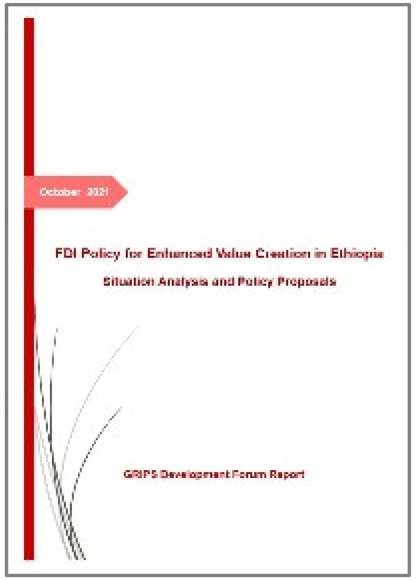
FDI Policy for Enhanced Value Creation in Ethiopia

Situation Analysis and Policy Proposals

GRIPS Development Forum Report
October 2021

Background



- Since 2008, the GRIPS Development Forum (GDF) and the Japan International Cooperation Agency (JICA) have conducted a bilateral industrial policy dialogue with the Ethiopian government.
- This paper is one of its policy research outputs. GDF is fully responsible for its content.
  Available at:
  https://www.grips.ac.jp/forum-e/pdf_e21/FDI_proposal_08.pdf
- Our analyses and proposals are grounded on the past developmental experiences of Japan and Asia, Ethiopia-Japan Industrial Policy Dialogue, and JICA's industrial cooperation in Ethiopia.
- There is another fuller study, *Ethiopia FDI Policy Report*, prepared jointly by the Policy Studies Institute (PSI) and GDF. It will be launched in early 2022.

Preview: FDI Policy Report (PSI & GRIPS, 2022)

Preview: Key Policy Recommendations

- Ethiopia needs **a new and comprehensive FDI policy** incorporating the points below, rather than minor revisions of existing Proclamations and Regulations.
- Ethiopia should invite both **large labor-intensive FDI** and **smaller technology-intensive FDI**, with weight shifting gradually from the former to the latter.
- To welcome all investors (especially value-creating ones), **relax FDI restrictions** on minimum capital size and the sector designation of industrial parks.
- Export, technology transfer, local procurement and partnership should be **encouraged with performance-linked incentives**, but should not be forced as conditions of doing business in Ethiopia.
- **Improve the monitoring capability**—set simple and monitorable performance criteria and enhance EIC’s capacity to monitor them. Modify or abolish incentives that are ineffective.
- **Industrial park management** must be upgraded for cost-effective investor support, long-term profitability and protection against negative shocks.

Part I

Current Status and Future Orientation

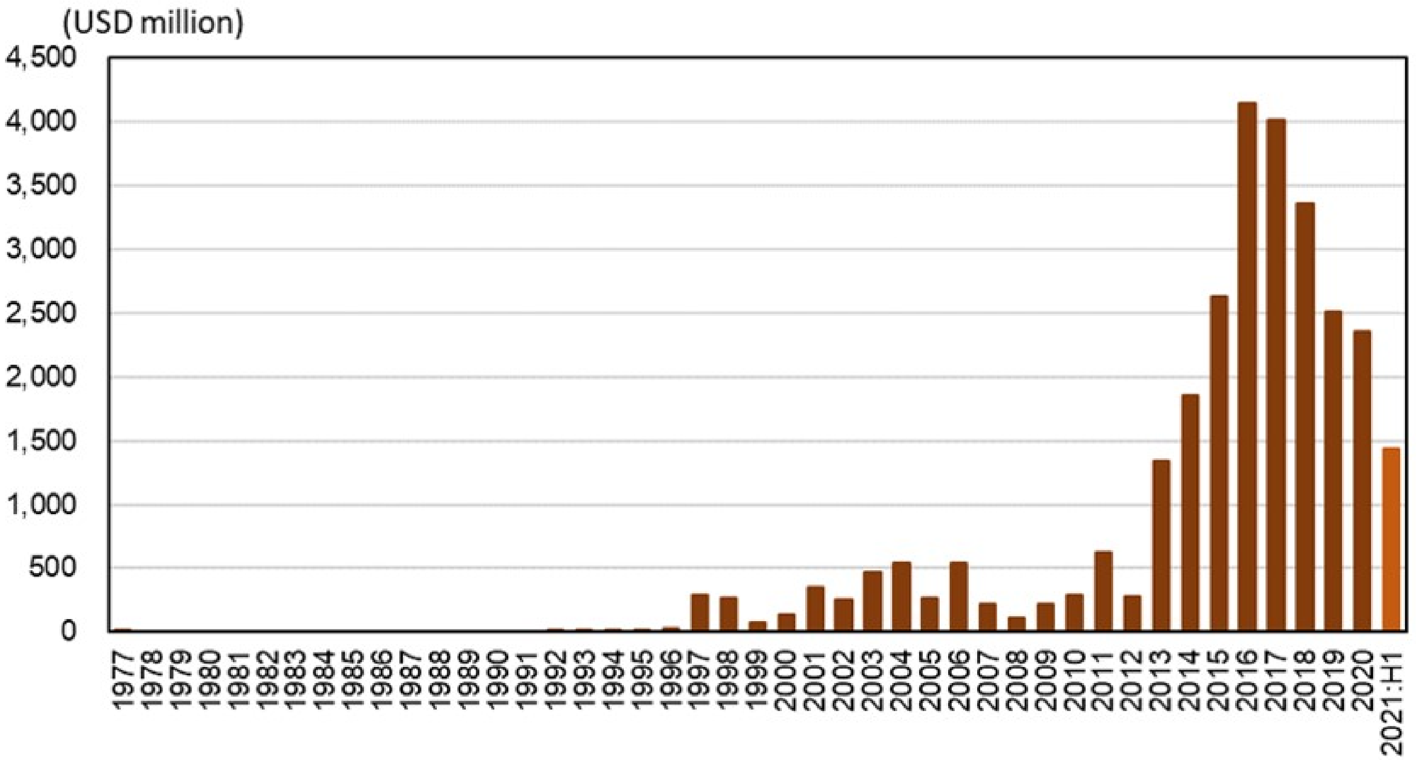
Basic Observation

- The Ethiopian economy faces a number of challenges: poor business environment, macroeconomic imbalances, internal instability and conflicts, the COVID pandemic, etc. This paper addresses some of these challenges in the economic sphere.
- FDI is one of the key pillars of industrial strategy. FDI policy should be upgraded so Ethiopia can take full advantage of the presence of FDI.
- FDI benefits—jobs, income, technology transfer, global management, value creation, GVC participation, etc.—do not occur automatically. Domestic conditions must be prepared by both government and private actors.

Current Status: FDI Inflow

- Ethiopia is in the early stage of FDI-supported industrialization. FDI has not yet contributed significantly to the attainment of development potential.
- FDI inflow began to accelerate in 2013 and peaked in 2016 and 2017, followed by a decline. In 2019, Ethiopia's FDI receipt ($2.5 billion) was the fourth largest in Africa, but was a tiny proportion (0.14%) of world total.

Net FDI Inflow into Ethiopia

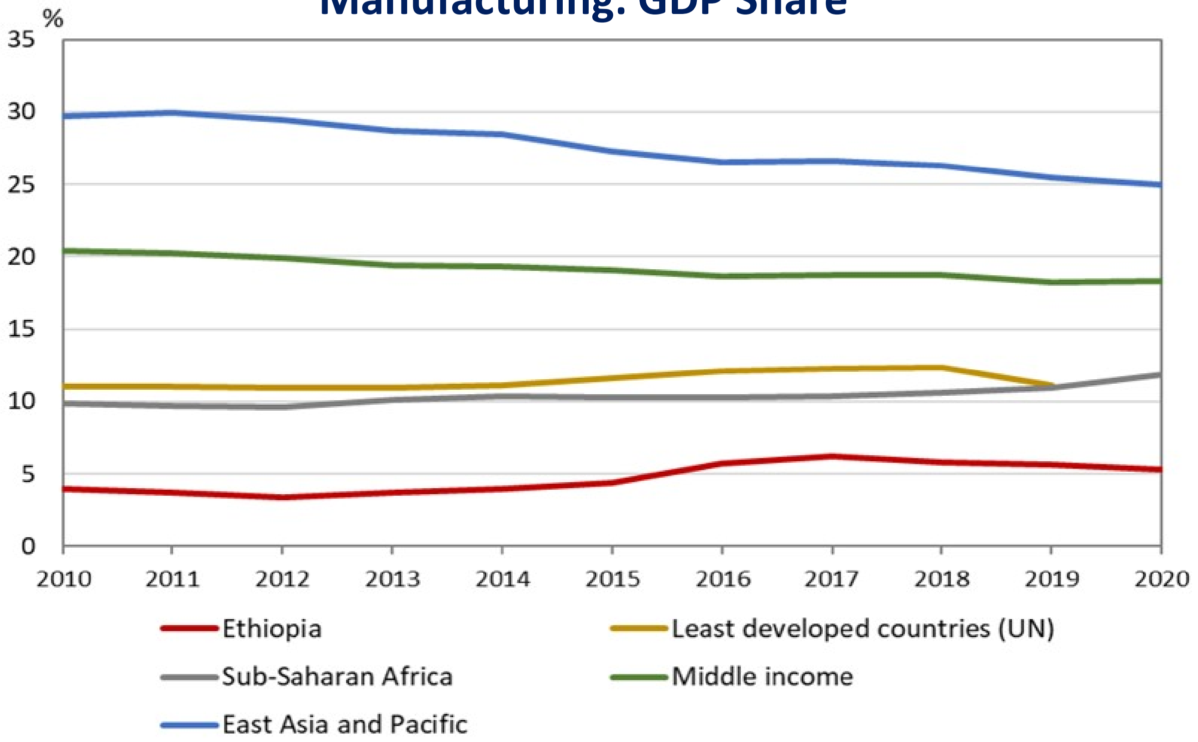


Sources: For 1977-2019, WB, *World Development Indicators*; original data come from IMF, *Balance of Payments database*, supplemented by data from UNCTAD and official national sources. For 2020 and 2021:H1, NBE data as reported in TradingEconomics.com which includes the license fee for foreign participation in the telecom sector amounting to $850 million.

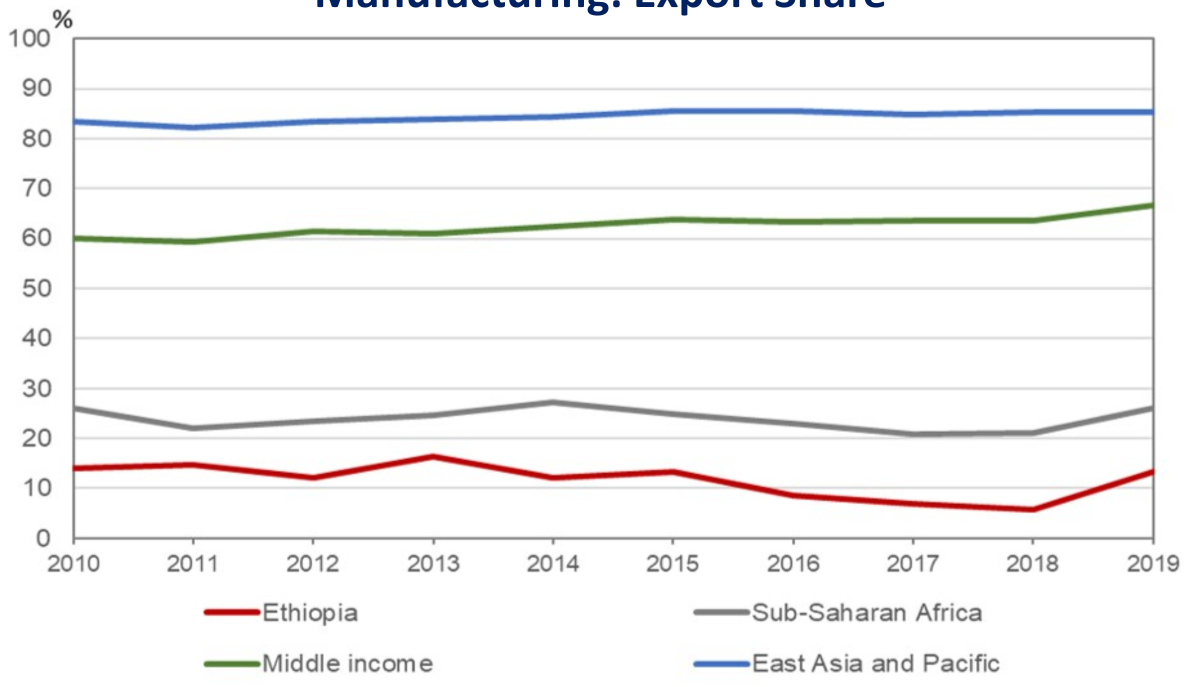
Manufacturing is Small and Stagnant

- We expect manufacturing to rise to 20-30% of GDP, or higher, in rapidly industrializing economies. Manufacturing should also dominate the nation's export. Neither has yet occurred in Ethiopia.
- Ethiopia's garment export was $143 million in 2019 (UNCTAD 2021), a very small share (0.03%) of global garment trade.

Manufacturing: GDP Share



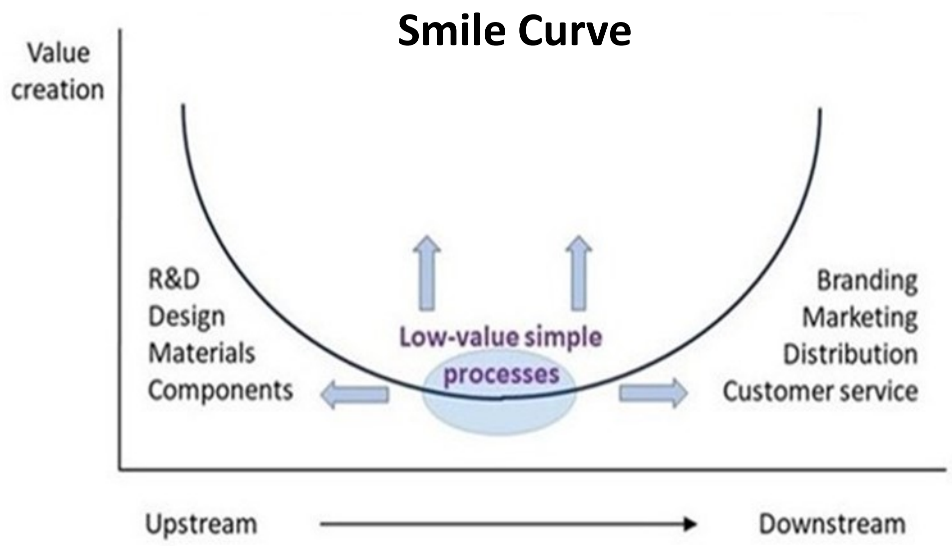
Manufacturing: Export Share



Labor Quality

- Ethiopia's labor productivity grew 4.9% per year during 2000-2016, but its absolute level remains low compared with such economies as Vietnam, Myanmar, Cambodia and Tanzania (Ethiopia Productivity Report 2020).
- Ethiopian wage is low, but low labor quality offsets this advantage.
- Ethiopian workers are trainable in technical skills but weak in mindset and discipline (modern factory knowledge, motivation to work, timeliness, etc.) Absenteeism is high and job hopping is frequent.
- Some FDI managers complain about Ethiopian workers while others praise them for being as good as workers they know in more developed countries. This points to the possibility that Ethiopian workers become productive when appropriate guidance and incentives are given.

Little Participation in GVC



- Many Ethiopian firms are content with domestic sales because domestic prices are better with less requirements, or because their technology and management are too weak to export, or both.
- Even when they export, they receive only low value because they lack knowledge, processing or branding. Ethiopian coffee growers receive small value while great value is added by foreign processers and retailers.
- In the garment sector, Bangladesh and Vietnam produce about 60% of the total export value domestically. In Ethiopia, domestic value is small (cheap labor, land, electricity, etc.) because all fabric and accessories are imported and only simple items are produced.
- Almost all of Ethiopia’s garment export is attributed to FDI firms. Domestic garment firms are basically non-exporters.

Industrial Parks

- Ethiopia's modern industrial parks have a short history of a decade or so. The state has taken the initiative in building industrial parks as receivers of FDI. Ethiopia issued Eurobonds to partly finance park construction.
- Ethiopia's parks were initially quite successful. The flagship Hawassa Industrial Park was quickly filled with garment firms.
- However, various factors slowed down growth—the lack of foreign currency, inefficient infrastructure services, political instability, COVID, etc.

(More later)

Poor Business Climate

- Despite much effort so far, Ethiopia's business climate remains poor by global or East Asian standards.
- The World Bank Ease of Doing Business ranking is also low and stagnant: (from 2015 to 2019) 159th, 159th, 161st, 159th and 159th among 190 economies. But WB's EDB ranking has been terminated.
- WB's EDB assessed the simplicity and speed of ten regulatory procedures (getting licenses and permits). There are other important business issues as well. Both aspects, procedure and substance, must be greatly improved.

World Bank's EDB: Ten Regulatory Procedures	
- Starting a business - Construction permits - Getting electricity - Registering property - Getting credit	- Protecting minority investors - Paying taxes - Trading across borders - Enforcing contracts - Resolving insolvency

Other Important Business Issues	
- Foreign currency - Efficient logistics - Stable power supply - Labor quality & cost - Business finance	- Trade privileges - Industrial land supply - Policy coherency & predictability - Political stability - Safety & security

FDI Policy Must Be Enhanced

- Every latecomer starts small, thus insignificant size in the early stage should not be a cause of alarm. However, if ineffective policy is the main reason for limited performance, that should be a serious concern. Passage of time will not solve problems.
- Ethiopia has conducted vigorous industrial policy but failed to produce satisfactory results relative to expectation or plan targets. Regarding FDI, initial FDI attraction was good but subsequent inflow did not accelerate in volume and quality unlike in Malaysia, Thailand, Vietnam, etc. Questions remain about the cost-effectiveness of past incentive policies.
- Ethiopia needs more policy learning for staying on a solid path to lower middle income and higher. International experiences must be studied, and the Ethiopian model should be constructed with appropriate selectivity and adjustment to local reality ("translative adaptation").

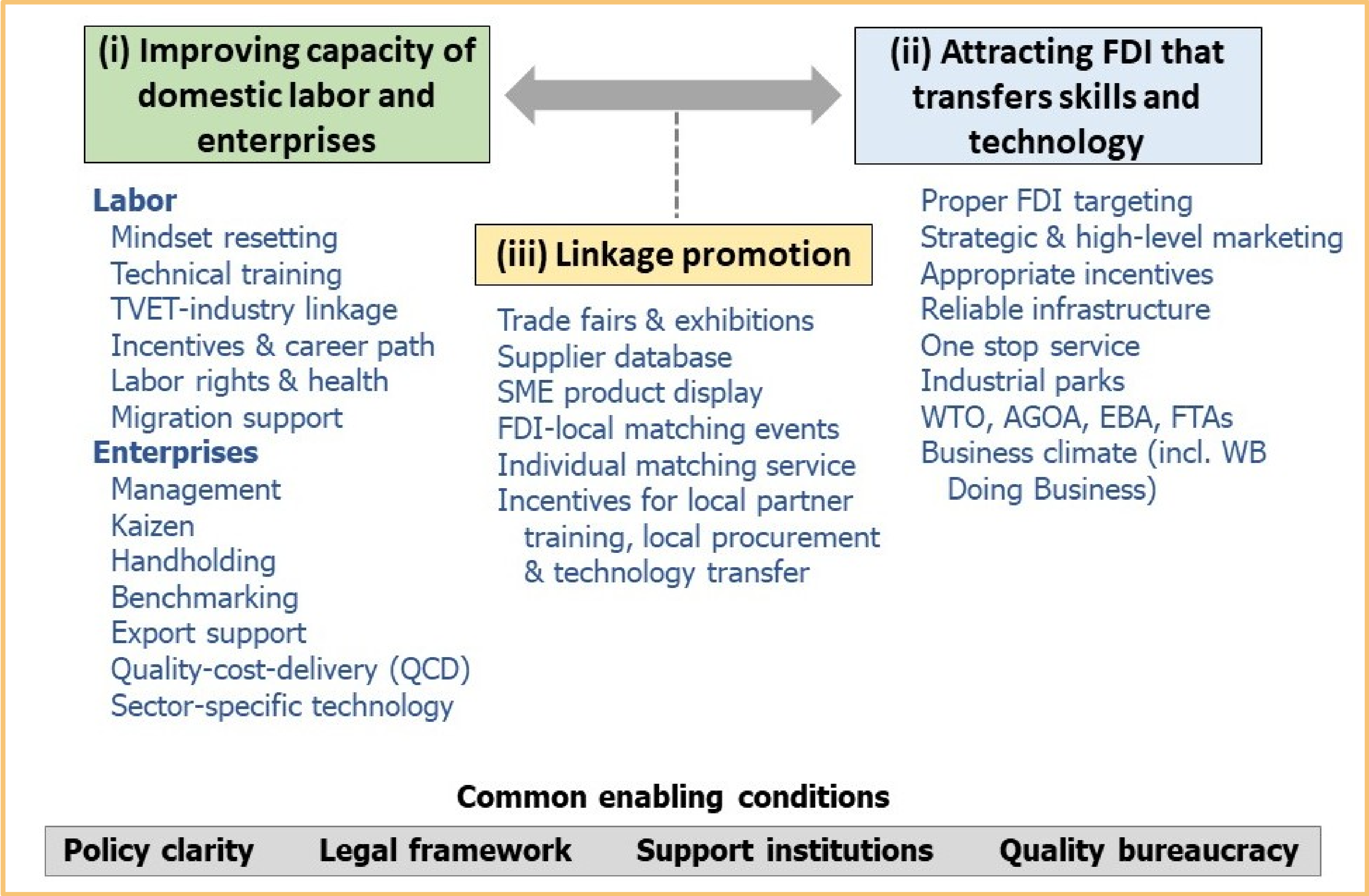
Comparative Advantage in Labor

- Labor quality is currently low. However, labor should become the main source of Ethiopia’s comparative advantage in the future. Ethiopia should offer skilled labor at a reasonable cost and in abundant supply.
- Ethiopian workers have the potential to become highly productive if proper guidance, incentives and opportunities are offered. However, due to the lack of these conditions, labor advantage remains latent.
- Some FDI firms confirm the sufficient quality of Ethiopian workers after training them with globally common corporate programs, but such cases are rare (Ethiopia Productivity Report 2020).
- FDI policy is critical for fully developing Ethiopia’s dynamic labor advantage.
- Most other African countries cannot rely on labor advantage because their wages are already high despite low productivity.

Part II

Policy Challenges and Recommended Actions

1. Upgrading Ethiopian Labor and Enterprises



Three-part strategy is recommended:
- Improve domestic capacity
- Attract high-quality FDI
- Link the two

Domestic firms must work with FDI. Formation of FDI enclaves should be avoided.

Blue letter items are concrete policy actions recommended in the Ethiopian context.

Domestic Capacity Building

- Strengthening domestic labor and enterprises is the very core of any industrial policy.
- Recommended actions in the above diagram are all desirable, but each requires serious learning, careful planning and competent execution and monitoring. All cannot be introduced at once.
- Prioritize. Select one to a few actions, concentrate policy attention and resources, and produce visual impacts rather than trying many measures superficially. This process facilitates policy learning.
- Each policy requires a well-written specific document (strategies, master plans, etc.) They should support the implementation of the Ten Years Perspective Development Plan in particular areas.

Cross-cutting Issues

- Details of each recommended policy action cannot be given here partly because of space limit and, more fundamentally, because the policy process must be owned, designed and executed by Ethiopian policymakers.
- General advice: for designing any measure, the following points are critical.
  1. Mindset change is the prerequisite.
  2. All stakeholders must be properly incentivized.
  3. Policy support should be conditional and time-bound (rather than unconditional and permanent).
  4. Work with foreign investors/buyers seriously interested in doing business with Ethiopia (rather than just government/ODA projects).

2. FDI Attraction and Linkage Formation

- Domestic capacity building must be accompanied by appropriate FDI attraction and FDI-local firm linkage formation.
- To attract high-quality FDI, the following points should be noted.

1. FDI policy should gradually shift from **quantity** (investment size, job creation, gross exports) to **quality** (technology, management, value creation, GVC). Quantitative targets need not be abandoned, but quality should also receive appropriate incentives.
2. FDI of all sizes, not just large labor-intensive ones, should be invited. High-tech firms are usually smaller.
3. Investor support must respond to the diverse needs of value-creating FDI firms. An effective mechanism to hear their voices must be in place.
4. Policy must be stable and predictable. Any change should be announced well in advance to give sufficient lead-time for adaptation.

Linkage Formation

- FDI-domestic firm linkage includes (i) procurement of materials, components and services, and (ii) long-term business partnership through joint venture, production cooperation, etc.
- Common tools include; (i) trade fairs and exhibitions; (ii) supplier database; (iii) SME product display centers; (iv) FDI-local matching events; (v) individual matching service; and (vi) incentives for partner training, local procurement and technology transfer.
- Government may directly offer linkage creating services, or indirectly subsidize firms that engage in FDI-local linkage and technology transfer. Encourage and guide them, but not force them into unwanted actions.

BUILD Office in Bangkok

Thailand BUILD

- Thailand has a reasonably good (though not perfect) linkage policy. The Board of Investment (BOI) and the Ministry of Industry (MOI) are the key official actors. They have an informal policy network that cooperates with private firms and NPOs.
- The BOI Unit for Industrial Linkage Development (BUILD) specializes in matching FDI with Thai firms. Its functions include:
  - Matching service for sourcing local inputs and finding business partners.
  - Organizing a large annual subcontracting exhibition (SUBCON Thailand).
  - Managing ASEAN Supporting Industry Database which is accessible globally.
  - Subsidizing Thai firms that participate in overseas trade fairs.
- Other players: the MOI Bureau of Supporting Industry Development (BSID), the One Start One Stop Investment Center (OSOS), the Business Opportunity Center (BOC), Industrial Estate Authority, component industry association (A.S.I.A.), private NPO (TPA), and Japan Desks.

3. Industrial Park Management

- Industrial parks are a real estate business with inevitable ups and downs. Ethiopian industrial parks must (i) generate profits, (ii) improve competitiveness, and (iii) prepare against unfavorable times.
- Six suggestions are offered.
  1. Diversify revenue sources (not just land and shed rents).
  2. Provide facilities and services strategically; do cost-benefit analysis.
  3. Customer-oriented investor services and park operation.
  4. Protection against negative shocks; build slowly.
  5. Don’t insist on sector selectivity; accept all.
  6. Offer diverse land and shed choices, including small ones.

(For details see PSI & GRIPS, *Ethiopia FDI Policy Report*, forthcoming in 2022)

4. Productivity-wage Balance

- Wages and labor productivity should move in tandem. If wages rise faster than productivity, competitiveness is eroded. If wages are suppressed below labor productivity, the living standard of workers suffers.
- A two-part strategy is recommended. The idea is simple but actual implementation is often difficult economically and politically.

Strategy 1: Maximize productivity growth

There are many recognized policy measures for this.

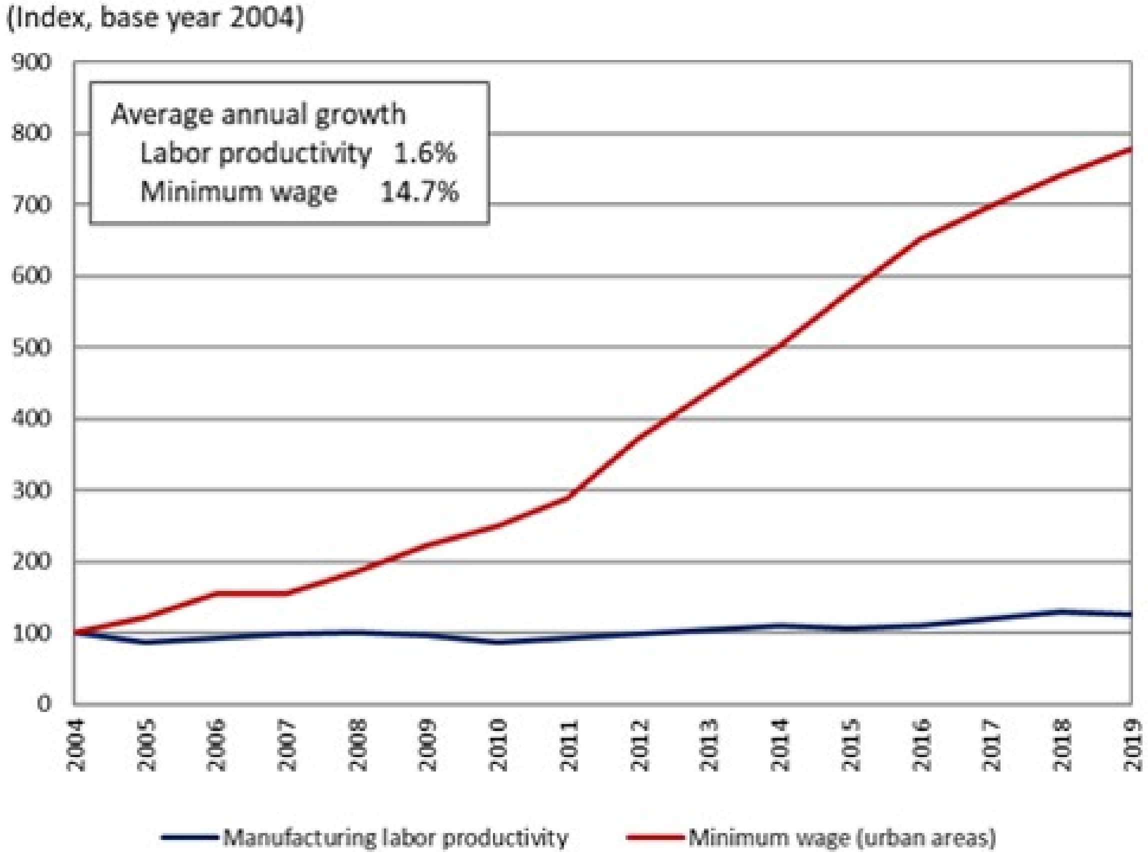
Strategy 2: Set minimum wage growth equal to labor productivity growth

Unless productivity rises sufficiently, this strategy will face political resistance.

- Historically, Japan, Korea and Taiwan generally succeeded in this strategy, but many Southeast Asian countries (Indonesia, Thailand, Vietnam…) faced the situation of $\Delta MW >> \Delta LP$ in recent years.

Japan: 1955-1970

Vietnam: 2004-2019



- During Japan's high growth period (late 1950s-60s), both wage and manufacturing labor productivity rose very fast at about 10% per year.
- In the early 21C, Vietnam's minimum wage rose rapidly while manufacturing labor productivity was stagnant (labor productivity growth was higher during the 1990s).

5. Improving Business Environment

- As explained earlier, the World Bank's Ease of Doing Business (procedural expediency) covers only part of the difficulties enterprises encounter. Improvement effort must be broader than this.
- Ethiopia should eliminate business barriers as soon as possible, and turn to the creation of sources of competitiveness, especially the labor advantage.
- A clean break from the past must be accomplished and publicized. This must be done by issuing a new comprehensive FDI strategy rather than by additional revisions of Investment Proclamations and Regulations.
- Problems FDI face in Asia are different from those in Ethiopia. Difficulties related to foreign currency, power and logistics are rare. Customs and tax problems occur only in some countries. Greatest concerns are about labor quality and cost, market growth and tough competition (market challenges rather than policy failures).

Top 10 Problems Reported by Japanese FDI in Asia and Pacific Region

(2020 survey, multiple answers, 5,976 respondent firms)

	Problem	2019	2020	Change	By sector 2020		By firm size 2020	
					Manufact-uring	Other	Large	SMEs
1	Wage increase of workers	65.8%	56.4%	-9.4%	66.7%	48.2%	57.4%	54.7%
2	Reduced orders from buyers	31.7%	48.2%	16.5%	53.0%	44.2%	44.7%	53.6%
3	Sluggish market demand	35.1%	42.7%	7.6%	44.7%	41.0%	44.9%	39.3%
4	Difficulty in securing new customers	38.9%	41.9%	3.0%	43.8%	37.7%	39.8%	41.5%
5	Quality of employees	43.5%	40.4%	-3.1%	36.4%	46.6%	39.4%	45.8%
6	Emergence of low-cost competitors	47.8%	33.4%	-14.4%	37.6%	29.9%	36.1%	29.3%
7	Price cutting pressure from buyers	32.8%	28.7%	-4.1%	34.3%	23.9%	28.1%	29.5%
8	Complicated customs procedure	26.6%	25.8%	-0.8%	32.7%	20.3%	25.8%	25.9%
9	Tax-related burdens	27.1%	25.7%	-1.4%	29.6%	22.6%	27.7%	22.4%
10	Exchange rate fluctuation	27.8%	24.2%	-3.6%	30.3%	19.4%	26.9%	19.8%

Source: JETRO, *Survey of Overseas Operation of Japanese Firms 2020 (Asia and Oceania)*; this annual survey started in 1988; it now covers 20 economies in the region.

6. Policy Benchmarking and Foreign Experts

- Benchmarking quantifies one's inefficiency by systematic comparison with best performers. However, it does not tell us how the gaps should be filled—that is a separate task requiring another method.
- Benchmark firms and countries must be selected carefully so they are not too different or difficult for domestic firms or organizations.
- In Ethiopia, benchmarking has often been applied to specific production processes (cutting, stitching, etc.) It can also be expanded to policy formulation and the capacity building of ministries, institutes, etc.

In so doing,

1. Foreign models must be adjusted to fit domestic reality ("translative adaptation").
2. Highly competent foreign experts should be invited initially to set content and institution in detail (later, Ethiopians can modify and develop).

Active Initial Use of Competent Foreign Advisors and Models

- **Meiji Japan** (about 150 years ago) hired several hundred Western advisors each year at high cost to build modern infrastructure, factories and institutes. After about 10 years, Japanese engineers took over.
- In the late 20c, **Taiwan, Korea, Malaysia and Thailand** copied many Japanese models (laws, systems, institutions, kaizen, etc.) with local adjustments.
- **Vietnam**'s first successful EPZ in Ho Chi Minh City was built by Taiwan, which immediately attracted many high-quality FDI firms.
- **The Rwanda Development Board**, created in 2008, was a copy of Singapore's Economic Development Board. Dr. Rama Sithanen, Former Vice PM of Mauritius, was invited to assume the first chairmanship (Mauritius also learned from Singapore).
- **The Zambian cabinet** was guided by Mr. Jegathesan, a high Malaysian official, to improve business climate and establish new industrial estates.
- **Myanmar** drafted its first automotive policy with many inputs from Japanese automakers and experts. The new policy prompted Suzuki, Toyota and Hyundai to enter the market or expand capacity.

Ethiopia’s Learning

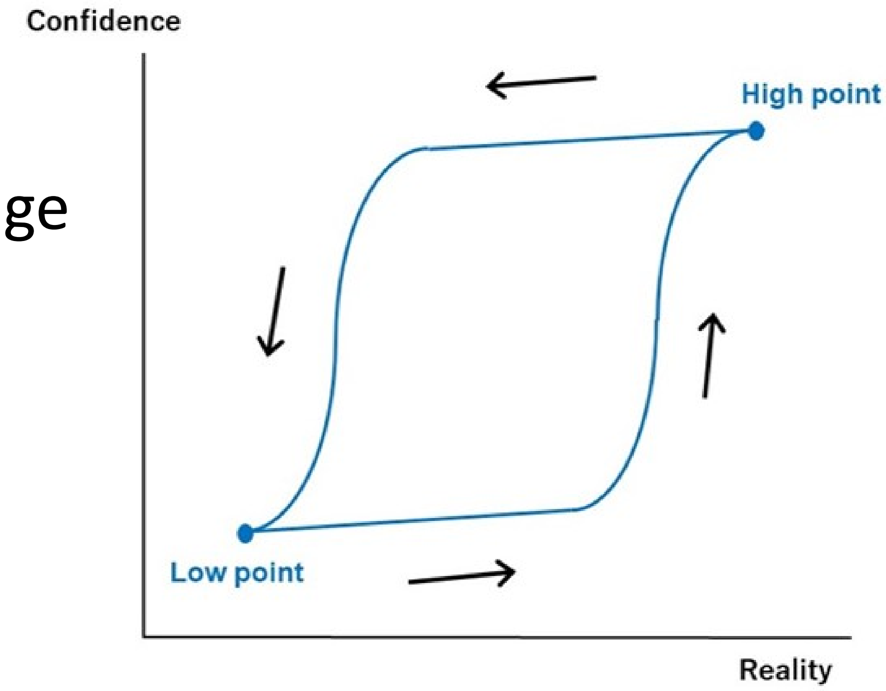
Ethiopia also sometimes lets foreigners do the initial setup, but such cases are not many.

- **Ethiopian Airlines** was established in 1946 with the strong support of America’s TWA. It grew to become the most successful airline in Africa overcoming many challenges along the way (Arkebe & Tesfachew, 2019).
- **Ethiopia Commodity Exchange** (ECX) was proposed and put into practice in 2008 by Eleni Gabre-Madhin, an Ethiopian economist of Swiss nationality.

Establishment of a new system by limited local knowledge alone is precarious. Even if foreigners lead initially, national ownership can easily be regained after Ethiopia masters the core knowledge.

7. Rebuilding Confidence

- Ethiopia needs to augment confidence among investors to fully realize its economic potential. FDI is affected by both concrete facts and investor psychology/perception. Ethiopia must work on both.
- Lost confidence is always recoverable even after a severe crisis or conflict (cf. Cambodia, Rwanda, Vietnam, Sri Lanka, Ethiopia after Derg). But restoration may take a long time (over decades). Policy must accelerate and shorten it.
- Social psychology is not linear but hysteretic. Perception first moves slowly, then begins to change rapidly. Policy effort may not produce immediate results but it must be continued until the critical point is reached. Be persistent and patient.



Working on Investor Psychology

1. Investors evaluate **credible future policies** highly even if the status quo is far from satisfactory. Plan a bright future—large demand, ample skilled labor, rise of targeted sectors, etc.—and back it up with concrete actions.
2. Stage a **big policy regime change** with effective presentation. Various policy components should be offered not piecemeal but in a coherent package with high visibility and clamor. Minor change or gradualism does not impress.
3. Produce **small but visible early results**. Initial results increase policy credibility and justify an investment decision.
4. Know the **differences among investors and nationalities**. Decision-making speed, time scope, technology transfer, etc. differ among Chinese, Indians, Koreans, Europeans, Japanese, etc. and even across individual firms.

In Summary

Once the current political, economic and pandemic crises are overcome, Ethiopia should do the following.

- A path-breaking FDI policy document should be drafted with ambitious but attainable goals and a credible action timeline.
- The top national leader should declare a new economic policy (which includes a new FDI policy).
- Early actions must be put into practice immediately and competently to produce small but quick results.
- Top leaders, ministers, state ministers, commissioners, overseas diplomatic missions, EIC, etc. must engage in a concerted national marketing campaign. The recently decreased capacity of embassies and consulates must be restored.
- Policy benchmarking and active mobilization of competent foreign experts should be considered.