

REPORT ON THE ETHIOPIAN ECONOMY

2018

***Foreign Direct Investment
in Ethiopia: Structure,
Performance, and
Determinants***

Ethiopian Economics Association (EEA)

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ISBN – 978-99944-54-67-9

Printed in Addis Ababa, Ethiopia'
December 2018.

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Foreword

Following the tradition of past years, the Ethiopian Economics Association is pleased to present the 2018 report on the Ethiopian Economy. Following the formats of the previous years this report has also got two parts. Part one focuses on a broader review of the macroeconomic situation and the performance of the economy at the sectoral levels for the period 2016/17. The report has tried to provide professional assessment of the existing policies and strategies and recommends new policy directions wherever appropriate.

Like the previous reports, this year's report has also selected a thematic area, i.e. a sector with significant contribution to national development. The focus this time is on Foreign Direct Investment in Ethiopia: Structure, Performance, and Determinants, which is contained in part two. As before, the publication of this report comes at timely moment and provides a valuable contribution to the understanding of Ethiopia's recent efforts in attracting FDI.

The focus on Foreign Direct Investment is necessitated by several factors. First, FDI is becoming an increasingly important dimension of the development process of least developing countries. Sub Saharan African governments have given considerable attention to attract Foreign Direct Investment as it affects the economic development process in many different ways. FDI affects the local economy directly through generating employment as well as the much needed foreign exchange among others. It also affects the economy by improving the competitiveness of domestic firms resulting from technological spillovers. In the case of Ethiopia there is high ambition to become a

middle income country by 2025. Nevertheless, the gap between domestic saving and investment requirement of the country to meet its target of becoming a middle income country has been widening. In view of this the Ethiopian government has put high emphasis on attracting FDI and has been providing a variety of incentives to attract FDI into the country. There is therefore, a need for an empirical analysis of the sector with the aim of identifying some policy implications.

Second, despite its increasing trend in recent times, FDI flow in Ethiopia has not been sufficiently and comprehensively studied covering all sectors of the economy. The experiences of successful East Asian countries show that appropriate FDI policies and strategies, which are dynamic and change as circumstances require need to be put in place for a country to benefit from foreign direct investment. Thus, this study tries to assess whether the existing policies and strategies are compatible with the development priorities of the country, WTO rules and regulations, etc.

Third, in view of the country's comparative advantage there is huge and growing interest on the FDI sector in Ethiopia. In order to assess the sustainability of FDI in the county's development process, one needs to examine the sectors into which investment has been flowing. In this connection, the study tries to investigate whether the FDI has been flowing into sectors in which the country is considered to have comparative advantage or not. Moreover, it tries to identify which types of FDIs are flowing into Ethiopia, from which countries and why, etc.

Fourth, statistics show that the number of licensed FDIs in Ethiopia has been increasing from time to time but the actual number of investments which become operational is very few. Many FDI companies have been flowing into Ethiopia in order to take advantage of market access opportunities provided by EBA, AGOA, etc. Thus, it is important to assess the trends in the number of licensed and operational FDIs and try to identify the main reasons why many licensed FDIs are not going operational. This helps to improve the implementation status of licensed FDI projects in Ethiopia.

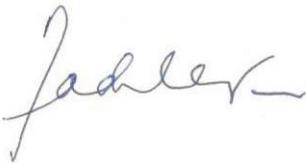
Fifth, there is also the presumption that FDI companies will create jobs, particularly if they are labour intensive investments. The question is are they really creating enough jobs on the ground or are they saving labour because they are technology intensive companies. The result will have serious implications on the generous incentives given based on the assumption that they create jobs. Ethiopia is labour abundant country and needs labour intensive companies to flow into Ethiopia.

Sixth, several industrial parks have been developed in the different parts of the country and some have already started operation. However, the overwhelming majority of those operating in these parks are FDI companies. The question here is why domestic private investors have not entered into these parks. Therefore, it is important to know whether FDIs are competing with local investors in financial, foreign exchange and product markets and crowding out them.

Seventh, Ethiopia's Investment Proclamation allows all foreign investors, whether or not they receive incentives, to remit freely profits and dividends, principal and interest. While these transfers are legally allowed, foreign companies face significant delay in the repatriation of profits, as the NBE does not have enough hard currency. In addition, FDI as a foreign capital was expected to address the foreign exchange problem facing the country. But that seems not to be the case since most of the capitals for FDI companies have been accessed from local Development Bank of Ethiopia (DBE), including foreign Currency. What will happen if all companies, especially those import substituting ones, request transfer simultaneously, what should be done to regulate it?

I hope that the Report would be useful to all readers including policy makers, private business people, civil society organizations, the academia, the media, the international communities and the general public.

Finally, I would like to express my appreciation to all those people whose contribution has made this Report possible.



Tadele Ferede (Ph.D)
President
Ethiopian Economics Association

Acknowledgement

The production of this report is the result of a genuinely collaborative effort of many people. The Ethiopian Economics Association wishes to gratefully acknowledge the valuable contributions made by everyone who was involved in this team effort. The overall work has been led by Dr. Assefa Admassie, who is the Principal Research Fellow at the Ethiopian Economic Policy Research Institute. The chapter on the Macroeconomic Developments is written by Dr. Seid Nuru Senior Research Fellow, Mr. Gashaw Desalegn, Mr. Simon Bayu and Mr. Yetsedaw Emagne while the different chapters on the thematic issue “Foreign Direct Investment in Ethiopia: Structure, Performance, and Determinants” were written by a team of researchers including Dr. Seid Nuru and Dr. Degnet Abebaw Senior Research Fellows, Mr. Amin Abdella, Dr. Samuel G. Selassie, Mr. Kumadebis Tamiru, Mr. Gashaw Desalegn, Mr. Simon Bayu and Mr. Yetsedaw Emagne. They deserve great appreciation and special recognition for their immense intellectual contribution and hard work.

The chapter on the brief assessment of the Performance of the Ethiopian Agriculture has been written by Dr. Samuel Gebre-Selassie. Amin Abdella prepared the chapter on the Manufacturing Industry: Performance during GTP I Period and the first GTP II Implementation Year. Their dedication and hard work made this report possible and their contribution is highly appreciated and recognized.

The report also benefited from many useful comments and suggestions received from the members of the EEA Executive

Committee. The authors received indispensable guidance and support from members of the executive committee. We would like to acknowledge the contributions of Dr. Tadele Ferede, Dr. Gezahegn Ayele, Dr. Tewodros Makonnen, Dr. Hailu Elias, Dr. Atnafu Gebremeskel, W/O Fanaye Tadesse, W/O Sindu Abebe, and Ato Demirew Getachew. The commitment and support as well as the encouragements of all the members of the Ethiopian Economics Association have always inspired those of us working for the Association to keep the momentum in spite of several challenges. We are all proud of them.

Many other people have also made very valuable contributions to this report, and we are grateful to them. W/O Rahel Yilma deserves special thanks for preparing and formatting the manuscript before it is sent to the publisher. The staffs of the Finance and the Administration Divisions as well as the documentation center provided valuable administrative and logistic support during the preparation of the report. Other EEA staffs have also contributed to the successful completion of this project. Their contribution is also highly appreciated.

This report would have not been produced without the generous financial support of EEA's development partners. In particular, the financial and technical support of the Think Tank Initiative (TTI) of the International Development Research Centre (IDRC), and the Friedrich Ebert Stiftung (FES) is deeply appreciated. They deserve special acknowledgment for their trust and confidence on the Ethiopian Economics Association for their continued collaboration.

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Chapter I

Macroeconomic Performance

An overview

Ethiopia had been hailed for its fast growth that was recorded over the twelve years since 2005. Nevertheless, the economy during the last two years has been challenged by incidence of drought, weak performance in export, and threat of high debt servicing. The year 2017 has also witnessed sporadic social unrests triggered by, among others, sense of economic exclusion most importantly unemployment among the youth.

In apparent move to improve balance of payments, the National Bank of Ethiopia tool a measure of devaluation of the Birr against US dollar. This was expected to be less effective given in particular the nature of Ethiopia's exports which are largely primary commodities such as coffee.

Despite the challenges, GDP in the country grew at a rate of 10.9 percent in 2016/17. However, lack of structural change from agriculture and informal services to the manufacturing sector in terms of production, employment, and foreign trade remains to be a key challenge. Ensuring high growth in the manufacturing, agricultural transformation, fostering globalized services through improved trade logistics would critical. Lack of institutional transformation is believed to underline the core problems of ensuring structural transformation in the country.

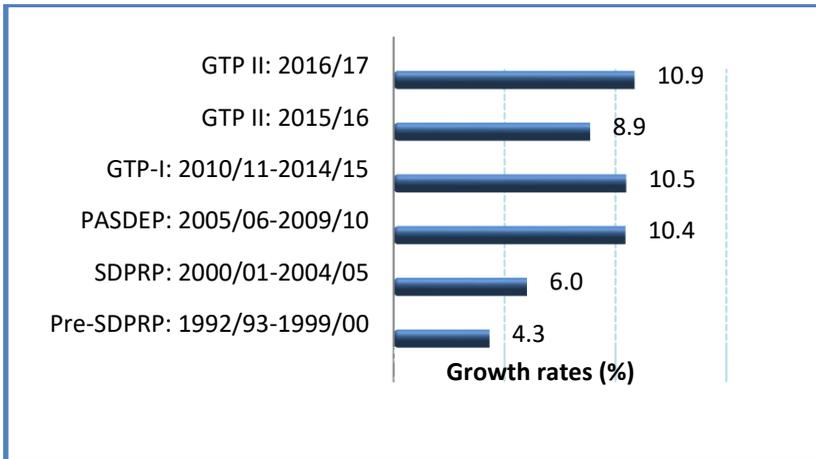
1.1 Growth and patterns of structural change

Official figures from the National Planning Commission (NPC) indicate that real GDP in Ethiopia grew by 10.9 percent in the fiscal 2016/17 despite the political uncertainty the country has faced since 2015/16. Although there is a slight downward deviation in growth compared with 11.1 percent growth envisaged by the Growth and Transformation Plan (GTP II), the performance is relatively better than the last five years average. This was mainly due to the expansion in the construction sector; recovery of the crop sector from the effect of severe drought caused by El Niño in 2015/16, a continued growth in the service sector lead by the wholesale and retail trade, and continued expansion in the manufacturing sector. The construction, crop, wholesale and retail trade, the manufacturing and public administration and defense sectors accounted for 8.5 percentage points (78 per cent) of the 10.9 per cent growth in 2016/17.

Ethiopian GDP measured at current market price stood at 1.7 trillion birr in 2016/17. With an estimate of 93.4 million people, Ethiopia's per capita GDP was estimated at 19,329 birr, which is equivalent to 862 USD at the official exchange rate¹.

¹ Average exchange rate in 2016/17, \$1= Br. 22.1

Figure I.I: Growth rates in real GDP



Source: EEA staff computations using data from NPC.

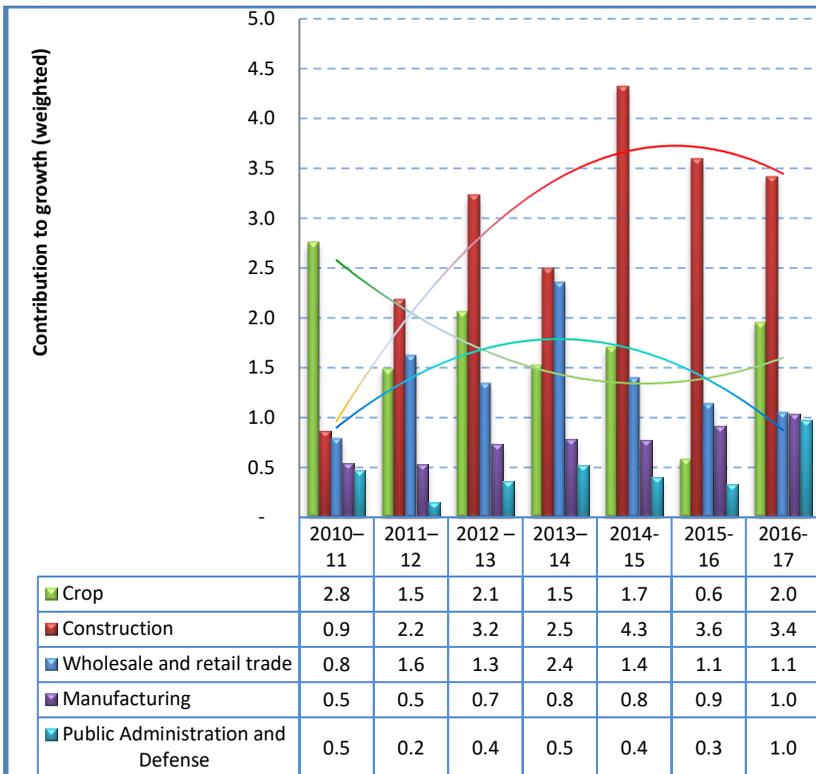
The agriculture, industry and service sectors had a share of 2.5, 4.4, and 4.0 percentage points, respectively, contribution to the 10.9 per cent growth in the total value-added observed in the fiscal year 2016/17. The construction sector alone accounted for 3.4 percentage points (31.2 percent) of the real growth in GDP during the same fiscal year.²

The top five subsectors which lead the growth momentum in 2016/17 are construction, crop, wholesale and retail trade, manufacturing, and

² The new data series showed a significant change in the structure of the economy. Particularly, the static share of industry sector in the GDP was revised from 16.7 percent to 24.4 percent in 2015/16. The revision mainly changed the share of the construction sub sector from 9.5 percent to 16.7 percent in the same year thus increasing both the static and dynamic contributions of the industry sector to the GDP. EEA could not verify the sources of such changes on the national income accounts of Ethiopia.

public administration and defense. Construction and crop subsectors accounted for 3.4 and 2.0 percentage points of the 10.9 per cent growth in GDP. The other three subsectors have shares of 1 to 1.1 percentage points. It is important to note that the dynamic share of manufacturing in GDP growth has been slightly increasing in 2015/16 and 2016/17 while that of trade tended to decline.

Figure 1.2: Leading sectors in growth



Source: EEA staff computations using data from NPC.

Value-added in the agriculture sector has accelerated from its growth of 2.3 percent during 2015/16 to a rate of 6.7 percent in 2016/17 due

mainly to recoveries in the crop subsector. In the year under review (2016/17), value added in the industry sector grew at a robust rate of 18.7 percent, though it is lower by 2 percentage points than the base case scenario targets envisaged by GTP II. In addition, the 18.7 percent growth in the industry sector in 2016/17 is lower than the 20.6 percent growth rate that had been recorded in the preceding fiscal year (2015/16). The declaration of industry growths is partly due to the weak performance in the mining and quarrying sub sector.

The 3.4 percentage points (77 percent) of the 4.4 percentage points contribution of the industrial sector in the GDP came from the construction sector. The low static share of the manufacturing sector limits the contribution of the sub sector to the overall GDP growth despite the high growth rate (17.4 percent) in the value added observed in the sub sector.

Value added in the service sector grew by 10.3 in the reporting fiscal year. About 4.0 percentage points of the 10.9 percent growth rate of GDP in the fiscal year was contributed by the service sector. That means, nearly 36.7 percent of the growth during the period was attributed to the growth in the service sector.

Table I.1: Growth rates

Period	Agriculture	Industry	Service	Real GDP
1991/92-2015/16	5.2	10.8	9.3	7.3
Pre-SDPRP: 1992/93-1999/00	2.4	6.3	7.5	4.28
SDPRP: 2000/01-2004/05	5.6	7.9	5.9	5.87
PASDEP: 2005/06-2009/10	8.3	10.1	14.1	10.86
GTP-I: 2010/11-2014/15	6.6	19.6	10.9	10.08
2015/16	2.3	20.6	8.7	8.0
2016/17	6.7	18.7	10.3	10.9

Sources: NPC (2018) and EEA staff calculations

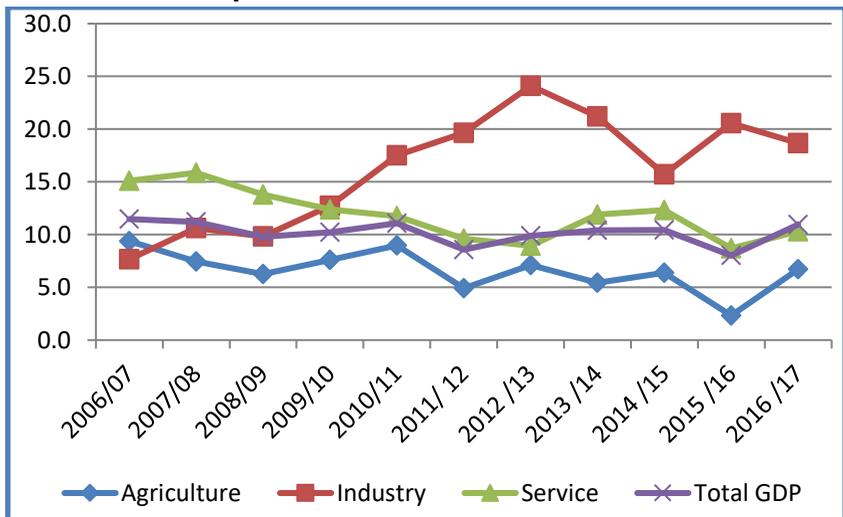
The GTP II anticipated 11.1 of annual GDP growth rate in the fiscal year under review. In this regard, only service sector has showed percentage point margin above the targeted level, whereas, the performance of the agriculture and industry performed at slightly lower rates than the targeted level envisaged by the GTP II. All sectors need to grow at more than the respective target rates in the remaining three years to compensate for the shortfalls in the last two years and achieve the targeted base case scenario growth rates for the GTP II period.

Table 1.2: GTP targeted growth by sector and 2016/17 actual

Sector	GTP II Target (Base case scenario)	Actual	Deviation
Agriculture	8	6.7	-1.3
Industry	20.8	18.7	-2.1
Service	10.2	10.3	0.1
Real GDP	11.1	10.9	-0.2

Sources: NPC (2018) and EEA staff calculations

Figure 1.3: Trends in growth rates of GDP and sectoral components



Sources: NPC (2018) and EEA staff calculations

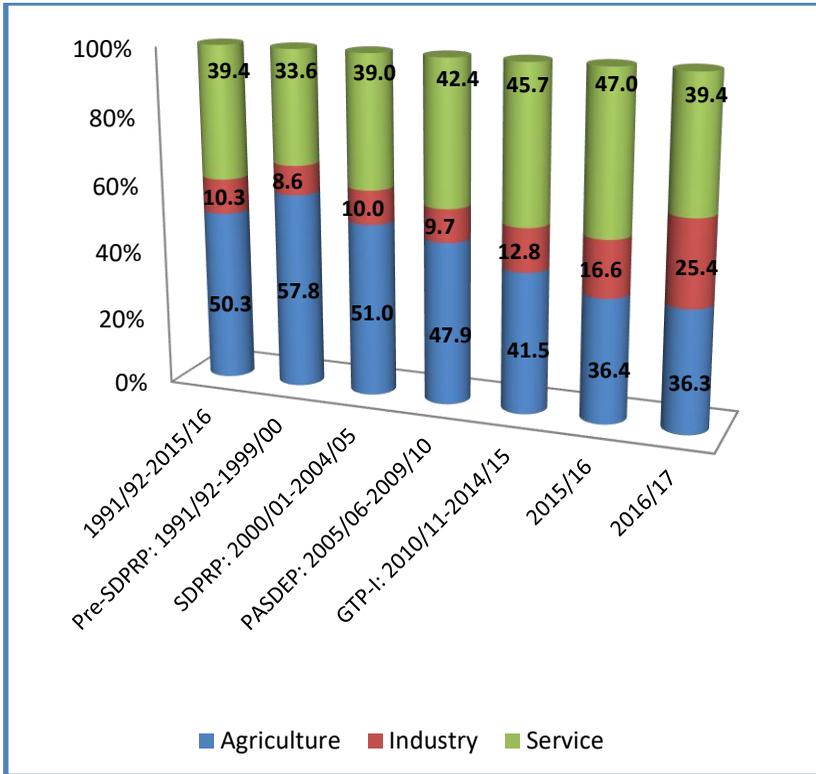
The slower performance of the agriculture sector in terms of growth while it has had the largest share in the GDP by volume during unfavorable climatic conditions had an adverse impact on the growth

of GDP for many years. Even the recent high growth performances were punctuated by adverse climatic shocks. The deceleration in growth of the economy in 2011/12 and 2015/16 was mainly attributable to the weak performance in the agriculture sector. Nevertheless, agricultural transformation calls for fast and robust growth in other sectors mainly the manufacturing sector. Even though, in the last ten years, the industrial sector depicts a high growth path mainly due to expansion in the construction sector, value added in the manufacturing sector was not growing fast enough to compensate for its low base. The need for structural change calls for the overtaking of the manufacturing sector in leading the growth momentum. The limited institutional capacity in term of project management, and limited technological capability that causes the delay of mega industrial projects in the country is believed to partly cause the sluggish structural change in the country.

In the year under review, the share of agriculture and service sector in GDP declined compared with the preceding years, while the industrial share increased. According to the newly revised data, a noticeable pattern that is observed in the structure of the Ethiopian economy during the first two years of the GTP II is that the share of the construction sector increased while that of the service sector declined. A healthy structural change may require that while the industrial sector expands so does the service sector. If both have to grow faster, the share of agriculture sector in the GDP should naturally decline not because it performs badly but because the other two sectors grow even faster. One reason for the decline in the share of the service sector while the industrial sector grows is that there is less complementarity between the construction and service sectors

than the potential co-variation between modern services and manufacturing sector.

Figure 1.4: Structure of the Ethiopian economy



Sources: NPC (2018) and EEA staff calculations

Table 1.3: Growth decomposition by sector

	GTP I: 2010/11-2014/15			2015/16			2016/17		
	Share in GDP	Growth rate	Weighted growth	Share in GDP	Growth rate	Weighted growth	Share in GDP	Growth rate	Weighted growth
Agriculture	43.4	6.6	3.0	37.3	2.5	1.0	35.9	6.7	2.5
Agriculture, Hunting and Forestry	43.2	6.6	3.0	37.2	2.5	1.0	35.8	6.7	2.5
Crop	28.0	6.5	1.9	24.0	2.3	0.6	23.4	8.1	2.0
Animal Farming and Hunting	10.9	7.5	0.8	9.6	3.4	0.3	9.1	4.5	0.4
Forestry	4.3	5.0	0.2	3.4	-1.5	-0.1	3.2	3.5	0.1
Fishing	0.1	3.4	0.0	0.1	2.2	0.0	0.1	0.5	0.0
Industry	16.8	22.3	3.4	23.7	21.8	4.6	25.3	18.7	4.4
Mining and Quarrying	0.4	21.9	0.1	0.4	0.1	0.0	0.3	-29.8	-0.1
Manufacturing	5.3	12.9	0.7	6.0	16.4	0.9	6.3	17.4	1.0
Large and Medium Scale Manufacturing	3.2	19.2	0.6	4.3	22.9	0.9	4.8	23.2	1.0
Small Scale and Cottage Industries	2.1	4.1	0.1	1.7	2.5	0.0	1.6	2.8	0.0
Electricity and Water	0.8	10.8	0.1	0.8	15.0	0.1	0.8	11.4	0.1
Construction	10.4	28.7	2.6	16.5	25.0	3.6	18.0	20.7	3.4

MACROECONOMIC PERFORMANCE

	GTP I: 2010/11-2014/15			2015/16			2016/17		
	Share in GDP	Growth rate	Weighted growth	Share in GDP	Growth rate	Weighted growth	Share in GDP	Growth rate	Weighted growth
Services	39.8	10.1	4.0	39.0	8.5	3.3	38.8	10.3	4.0
Wholesale and retail trade	13.5	11.2	1.5	13.8	8.2	1.1	13.4	7.6	1.1
Hotels and restaurants	1.6	21.9	0.3	2.1	15.6	0.3	2.1	11.1	0.2
Transport and Communications	4.4	12.9	0.6	4.8	13.7	0.6	4.9	12.1	0.6
Financial Intermediation	3.7	11.3	0.4	3.4	9.6	0.3	3.5	14.0	0.5
Real Estate, Renting and Business Activities	5.4	7.6	0.4	4.5	3.7	0.2	4.2	4.1	0.2
Public Administration and Defense	4.6	8.1	0.4	4.4	7.4	0.3	4.8	22.1	1.0
Education	3.1	5.2	0.2	2.7	8.8	0.2	2.7	11.0	0.3
Health and Social Work	0.9	10.6	0.1	1.0	10.8	0.1	1.0	15.0	0.1
Other Community , Social & Personal Services	1.3	8.6	0.1	1.1	3.0	0.0	1.1	3.8	0.0
Private Households with Employed Persons	1.3	7.6	0.1	1.1	4.3	0.1	1.0	2.5	0.0
Total	100	10.5	10.5	100	8.9	8.9	100	10.9	10.9

Sources: NPC (2018) and EEA staff calculations

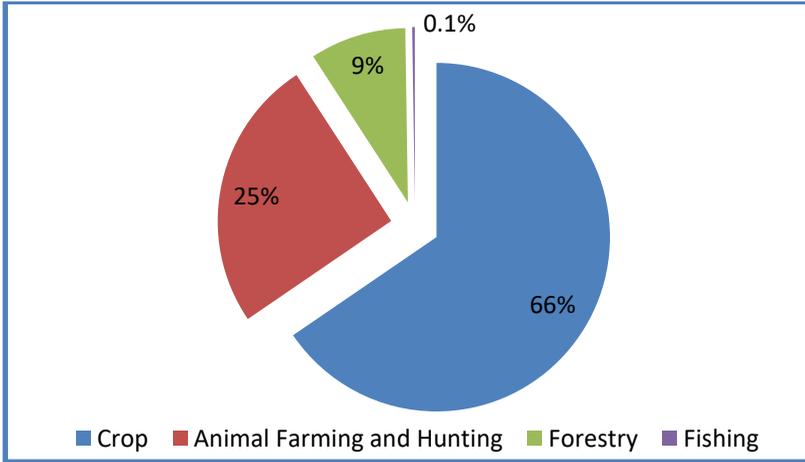
1.1.1 Agriculture

Ethiopian government has given more emphasis to and exerted more effort in the agriculture sector for the last 25 years. Nevertheless, the sector demonstrated appreciable growth only after 2005. The high growth in the sector has been punctuated by recurrent drought and lacked transformation. Three main features that characterize the Ethiopian agriculture are that the sector lacks structural change dominated by crop production, lacks modern physical inputs and skilled labor, and it depends on rainfall despite the country's immense water resource.

In the fiscal year 2016/17, the better performance of agriculture sector was recorded mainly due to recovery in the crop production after two years of drought caused by the El Niño effect. Growth in the value-added of the sector is recorded to be 6.7 percent for the fiscal year under consideration. Crop production alone accounted for 66 percent of the value-added and 80 per cent of the growth in the agriculture sector in 2016/17. The crop and livestock sectors accounted for 90.5 per cent of the value-added in the agriculture sector and 96 per cent of the growth in agriculture. Value added in the crop subsector grew by 8.1 percent which is considerably higher than the growth rate of 2.3 per cent in previous year. Diversification of the rural economy needs to expand towards commercial crops, sideline activities such as rural enterprises, fishery. The country's livestock potential is yet to be harnessed for agricultural transformation.

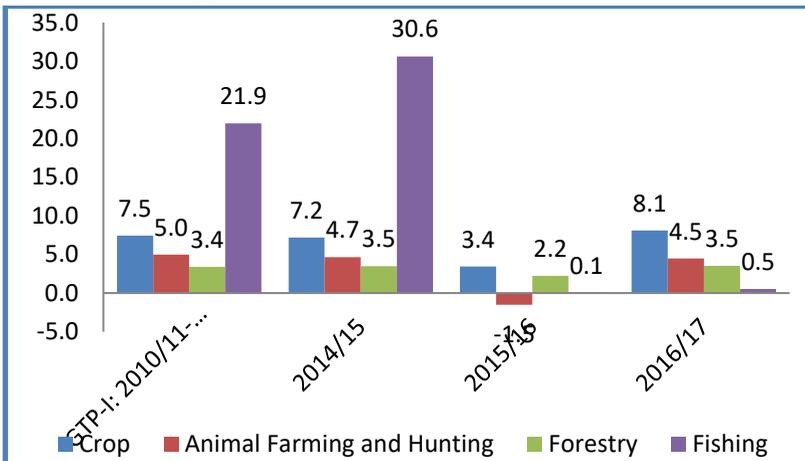
Value added has shown a moderate rise in livestock during 2016/17. It grew by 4.7 and accounted for 9.1 percent of GDP and 25.3 per cent of the value-added in the agriculture sector.

Figure 1.5: Share of sub-sectors in the total value added of the agricultural sector



Sources: NPC (2018) and EEA staff calculations

Figure 1.6: Value-added growth of sub-sectors in the agricultural sector



Sources: NPC (2018) and EEA staff calculations

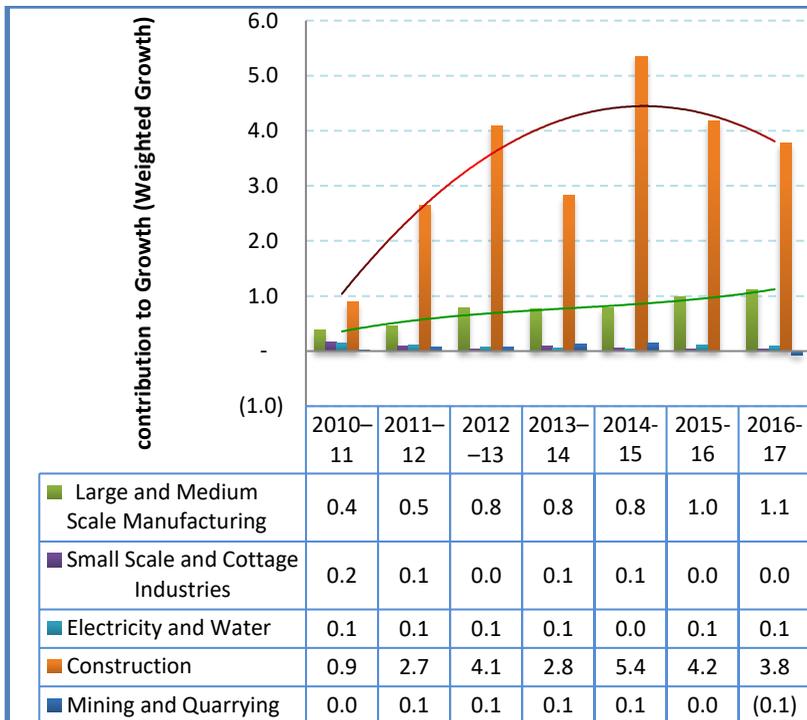
1.1.2 Industry

Among the main objective of the GTP II plan is to promote industrialization by increasing the contribution of the industrial sector to the overall economy. In 2016/17, value-added in the industrial sector grew by 18.7 percent. The sector accounted for 25.3 percent of GDP and 40.4 per cent of growth in GDP. The construction sub-sector dominated the volume of value-added in the industrial sector and led the pace of growth in the sector. It had a share of 71.1 and 18 percent share in the industrial sector, and GDP, respectively. It grew at a rate of by 20.7 percent in the fiscal year 2016/17 and accounting for 77.3 percent of the growth in the industrial sector. It is the leading sector in its contribution to growth in GDP (31.2 percent) and the second highest in its share in the GDP (18 percent) after crop which had 23.4 percent share. The drivers of the fast growth rate in the construction sector are however less obvious given the decline in the value added of the mining quarrying sector and the apparent slowdown in private construction in the country following the political uncertainty observed during the fiscal year

In 2016/17, the manufacturing sub-sector which is the second major contributor to the industrial sector had a share of 6.4 per cent, and 25 percent in the GDP, and value added in the industrial sector, respectively. Value added in the manufacturing sub-sector grew by 17.4 percent in 2016/17 compared to the preceding fiscal year. Among the main component of the manufacturing sector, the large- and medium-scale manufacturing accounted for 75.25 percent of the value added in the manufacturing sub-sector. Value added in the sub sector has been growing at an average rate of 22.4 per cent between

2012/13 and 2016/17. The high rate of expansion in the subsector continued in 2016/17 as value added in the large and medium scale manufacturing grew at a rate of 23.2 per cent. The flow of foreign direct investment towards the manufacturing sector following the expansion of industrial parks in the country is believed to trigger a further growth in the sector.

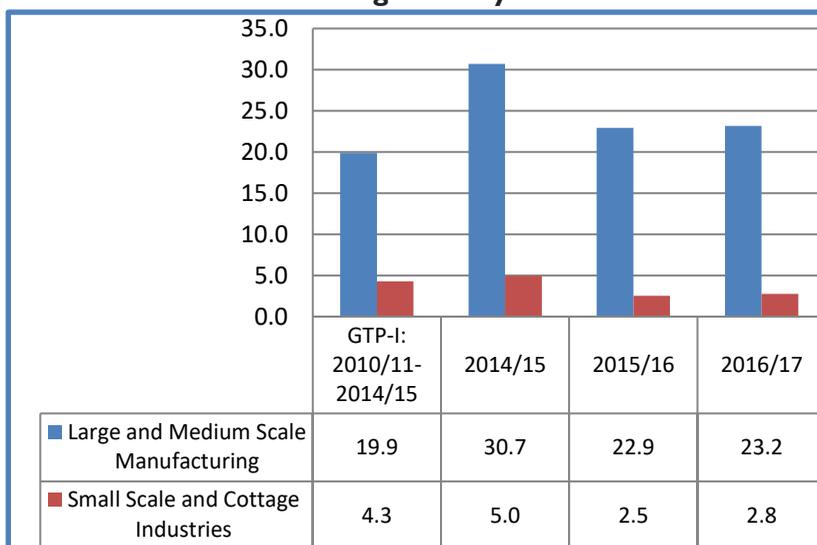
Figure I.7: Contribution of components of the industrial sector to growth in GDP



Sources: EEA staff computations using data from the NPC.

The small-scale and cottage manufacturing had a share of 24.75 percent in the total manufacturing output in the fiscal year under review. The small scale and cottage industries were expected to expand as a basis for broad-based industrialization and create jobs for the urban youth. Nevertheless, value added in the subsector only expanded at an average rate of 2.9 per cent between 2012/13 and 2016/17. The fiscal year 2016/17 was not different for the subsector as value added in the small and cottage industries grew by 2.8 percent. Small and cottage industries could not probably attract as much government attention as the large manufacturing industries and are thus characterized by problems of lack of coordination with heavy industries and access to finance and market.

Figure 1.8: Growth of the sub-sectors in the overall manufacturing industry



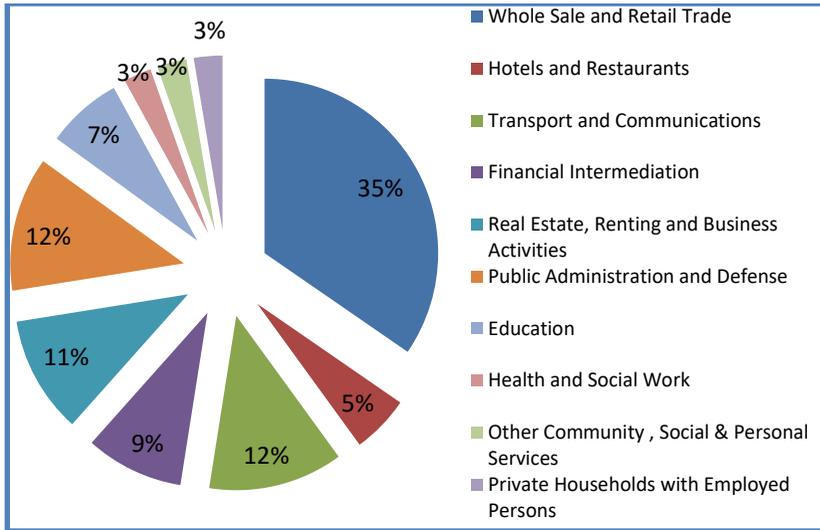
Sources: NPC (2018) and EEA staff calculations

Regarding the other sub-sectors in the industrial sector, the mining and quarrying sub sector did not perform well during the reporting fiscal year as value added in the subsector fell by 29.8 per cent. Until recently, the sector was one of the vibrant sectors along with the construction sector. Value added in the sector grew at an average rate of 25.9 per cent between 2011/12 and 2014/15. Growth in the subsector was flat during the 2015/16 fiscal year until value-added in the sector fell in 2016/17 by significant margin. The low performance is believed to be mainly due to the decline of investment in the sub sector following the unrest in some part of the country that has targeted and threatened mining industries. Value added in the electricity and water subsector grew by 11.4 percent in 2016/17. It has the lowest contribution to in the industrial sector by volume accounting for 6.6 percent of the value added in the industry sector next to the mining and quarrying sub sector. Nevertheless, the indirect contribution of electricity and water to other sector by making them more productive outweighs its direct share in the GDP.

1.1.3 Service Sector

In 2016/17, the value added in the service sector grew by 10.3. According to the new series of the national income accounts of Ethiopia, it accounted for 39.4 of GDP. In 2016/17, the wholesale and retail trade is still the leading contributor sub sector in the value addition of the service sector. This sub sector constituted 13.6 percent of GDP and 35 percent of the total output of service sector. Value-added in the sub-sector grew by 7.6 percent which is low compared to its average growth rate of 10.7 percent over the last six years.

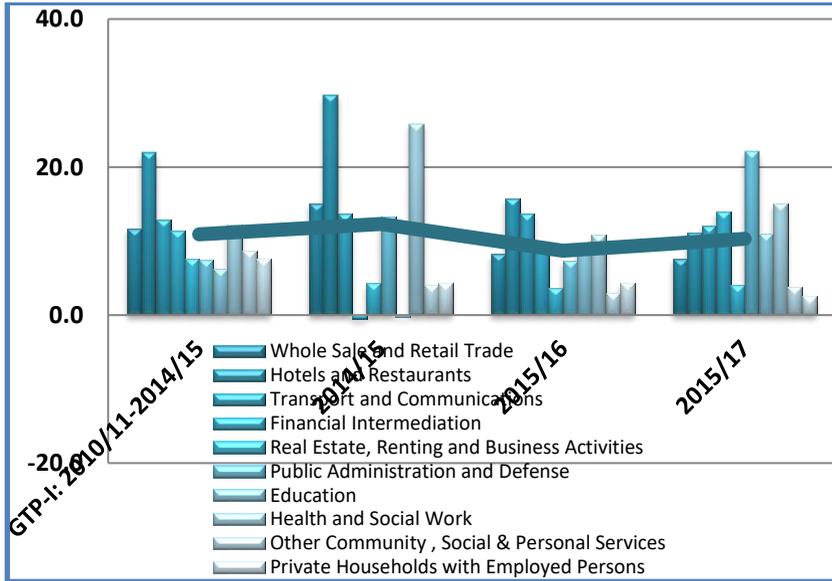
Figure 1.9: Share of sub-sectors in the service sector in 2016/17



Sources: NPC (2018) and EEA staff calculations

Transport and communication, and public administration and defense subsectors which have equal share in the service sector accounted for 24 per cent of the total value added in the service sector in the fiscal year 2016/17. Real estate, renting and business activities, and financial intermediation subsectors followed with a respective share of 11 per cent, and 9 per cent respectively. Value added in the public administration and defense subsector grew by 22.1 which is by far the highest growth rate registered amongst subsectors after large and medium scale industry in the fiscal year. Hotels and Restaurants, Education, Transport and communications, and Health and Social Work grew by 11.1, 11, 12.1 and 15 percent respectively.

Figure I.10: Growth of value-added in the sub-sectors of the service sector



Sources: NPC (2018) and EEA staff calculations

I.2 Saving and Investment

The Ethiopian government has exerted efforts to mobilize domestic resource through policy intervention. GTP II targeted a 30 percent rate of gross domestic saving by the end of the plan period. To achieve this, the interest rate on deposits was revised from 5 percent to 7 percent in October 2017 in addition to other schemes such as the condominium housing project, and the Grand Ethiopian Renaissance Dam (GERD) Bond which were in place before and during GTP I period. The saving rate has exhibited a significant increment from its low base of 9 percent in 2005 to reach 23.8

percent of GDP in 2016/17. While this is an important development towards financing development, quality of saving is an issue to consider. Moreover, the resource gap is still significant as the rate of gross capital formation increased even higher.

The gross national saving as percent of GDP was 32 percent which is above the gross domestic saving by 8.2percentage point. This implies 25.6 percent of the total gross national saving is contributed by the net current transfer from the rest of the world while 74.4 is from the domestic resource.

Government consumption expenditure was 12 percent of GDP in year 2016/17 which was considerably higher than the preceding years. On the other hand, private consumption expenditure which obviously has for the largest share in the GDP declined by 6.7 percentage points to stand at 63.6 percent in 2016/17. Share of both public and private final consumption in the GDP have been declining for the last 10 years and reached 76 percent in 2016/17.

Gross fixed capital formation as percent of GDP was 39 percent in 2016/17. On average, rate of gross fixed capital formation was 37.5 percent over the last five years. The fast rate of expansion in the gross capital formation was not matched by the gross domestic saving rate though the later has also increased significantly. As a result, the resource gap is still as high as 15 per cent of GDP, lower than the rate in the preceding year by 1.1 percentage points.

Table I.4: Expenditure on GDP (as a percentage of GDP)

Period	Absorption			Current Account Balance				
	Consumption			Gross Capital	Gross Domestic Saving	Resource Gap	Export	Import
	Total	government	private					
2010/11	114.9	10.3	72.4	32.1	17.2	- 14.9	16.7	31. 5
2011/ 12	117.9	8.3	72.5	37.1	19.2	- 17.9	13.8	31. 6
2012 /13	116.5	9.0	73.5	34.1	17.6	- 16.5	12.5	29. 0
2013 /14	117.5	9.2	70.2	38.0	20.5	- 17.5	11.6	29. 1
2014 /15	117.5	9.0	69.0	39.4	21.9	- 17.5	9.4	30. 3
2015 /16	116.1	9.7	67.9	38.5	22.4	- 16.1	8.0	27. 8
2016/17	115.0	12.4	63.6	39.0	24.0	- 15.0	7.7	23. 7

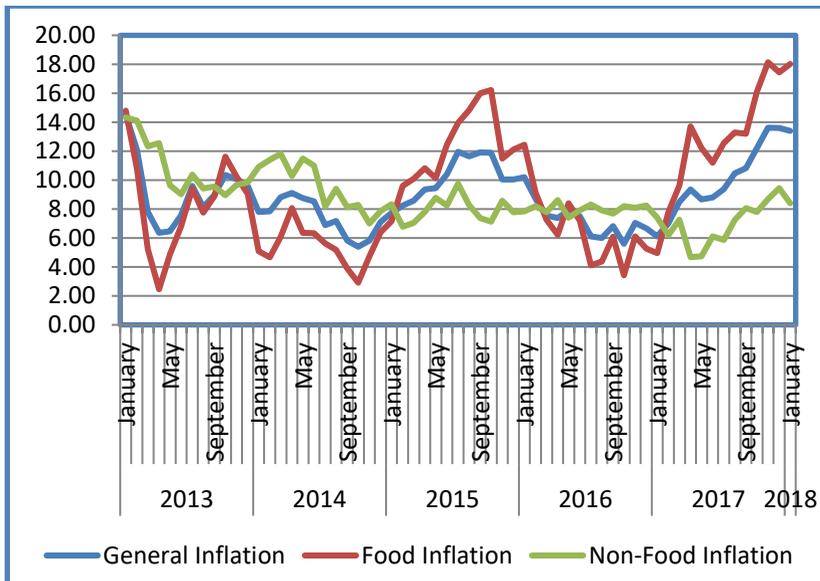
Sources: NPC (2018) and EEA staff calculations

On the current account side, imports of goods and non-factor services as a percentage of GDP was about 23.7 percent which is by far greater than value of exports which was 7.7 percent of GDP. Merchandise exports have been experiencing weak performance showing a declining trend over the last four years.

1.3 Price Developments

Inflation has relapsed and remained outside single digit policy target of the National Bank of Ethiopia since august 2017. According to the report, published by the Central Statistical Agency (CSA) the January 2018 general year-on-year inflation increased by 13.4 percent over the figure registered in January 2017, due to an escalation in the prices of both food and non-food items. Food inflation spike (18%) is observed in the same month mainly due to price rises in items such as bread and cereals, fruits, vegetables, meat and food products. Food price escalation is observed against expectation of coming down due to the harvest season. Non-food inflation is relatively stable increasing by 8.4 percent.

Figure 1.11: Trends of inflation from 2013-2018



Source: CSA

Since February 2016 inflation shows no downward trend in Ethiopia. Oftentimes inflation is taken as an indicator of macroeconomic stability of a certain economy. Macroeconomic imbalance between demand for and supply of goods, and low productivity in agriculture are believed to be the main source of inflation in Ethiopia. Expansion in broad money and devaluation of the Birr against the USD are also believed to put pressure on the price level.

1.4 Monetary Development

Liquidity in the economy has expanded in the fiscal year 2017/18 by 28.9 percent and reached 573.4 billion Birr. The expansion of both domestic credit and foreign asset has contributed to the expansion of broad money. Domestic credit has expanded by 28.7 percent relative to the previous fiscal year.

Table 1.5: Monetary survey

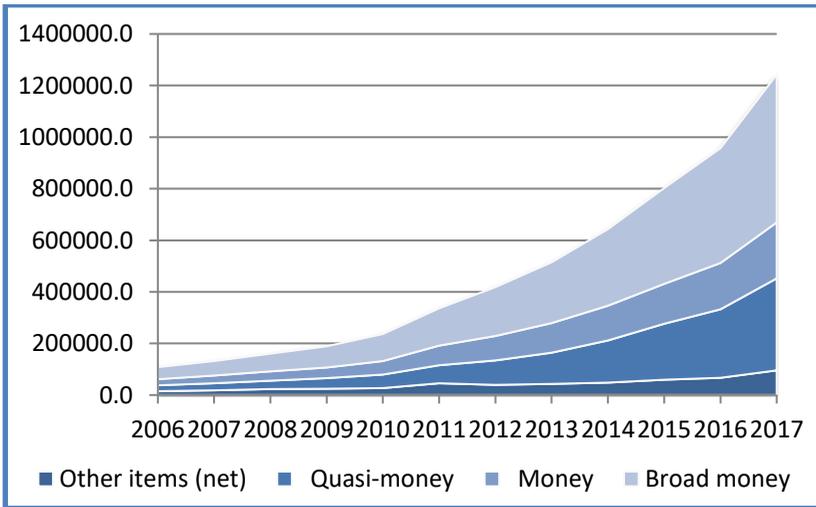
Particulars	2011	2012	2013	2014	2015	2016	2017
Foreign assets (net)	104.2	-28.4	14.7	0.9	-18.5	-42.7	76.7
National Bank	113.6	-35.3	16.0	8.8	-	-	128.2
Commercial Banks	92.1	-18.3	13.3	-8.3	-	-	27.6
Domestic credit	29.8	39.5	23.4	28.4	31.3	24.6	28.7
Claims on Govt	-13.2	-24.8	1.9	21.2	15.4	54.7	79.7
National Bank	15.2	0.0	22.1	16.0			27.2
Commercial Banks	163.5	42.7	40.5	12.5	-	-	-25.4
Claims on other sectors	49.7	56.7	26.2	29.2	32.8	22.0	23.3
Broad money	39.2	30.3	24.2	26.5	24.7	20.0	28.8
Money	45.3	24.5	21.0	16.8	15.3	15.5	21.4
Currency outside banks	34.6	18.3	18.5	16.4	13.8	10.2	10.8
Demand deposits	54.4	29.2	22.7	17.1	16.3	19.0	27.6
Quasi-money	33.1	36.6	27.5	35.8	32.3	23.1	33.7
Savings deposits	34.3	27.8	28.8	37.2	19.8	24.2	35.2
Time deposits	18.0	158.5	18.5	25.1	134.3	18.5	27.3
Other items (net)	68.2	-13.7	10.8	9.9	24.5	11.1	44.0

Source: National Bank of Ethiopia

Currency in the hands of the public and demand deposit has also expanded by 10.8 and 27.6 percent respectively. As a result narrow money has grown by 21.4 percent. Both saving and time deposits increased by 35.2 and 27.3 percent respectively.

This fiscal year witness an increase in foreign asset for both of National Bank of Ethiopia and commercial banks. Foreign asset increased by 76.7 percent. However, it was rather a recovery from the sharp decline in the preceding two years.

Figure 1.12: Trends in money supply and its components

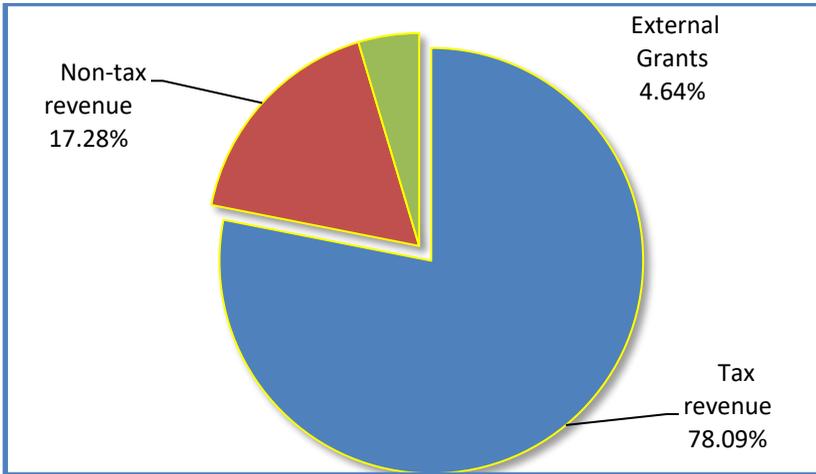


1.5 Public Finance and Public Debt

The government of Ethiopia managed to collect 291 billion Birr during the fiscal year 2016/17. The performance shows a 10 percent increment relative to the previous fiscal year. From the total revenue

and grants, tax revenue takes the lion share (78.percent), followed by non-tax revenue (17.28 percent) and external grant covers 4.64 percent.

Figure 1.13: Components of government revenue



The performance in tax revenue shows consistent growth over past years which show higher performance of tax collection. However, the momentum is decreasing over time. The non-tax revenue component of government income is the most erratic in performance over time. Tax authority may find it important to take consistent measure in collection of nontax revenue. The fluctuation may result from the fact that this type of revenue is collected by different government offices such as fees and charges by sector organization which may have less interest and ability to control and collect those payments.

Table 1.6: Growth of federal government revenue and expenditure from 2010/11-2016/17

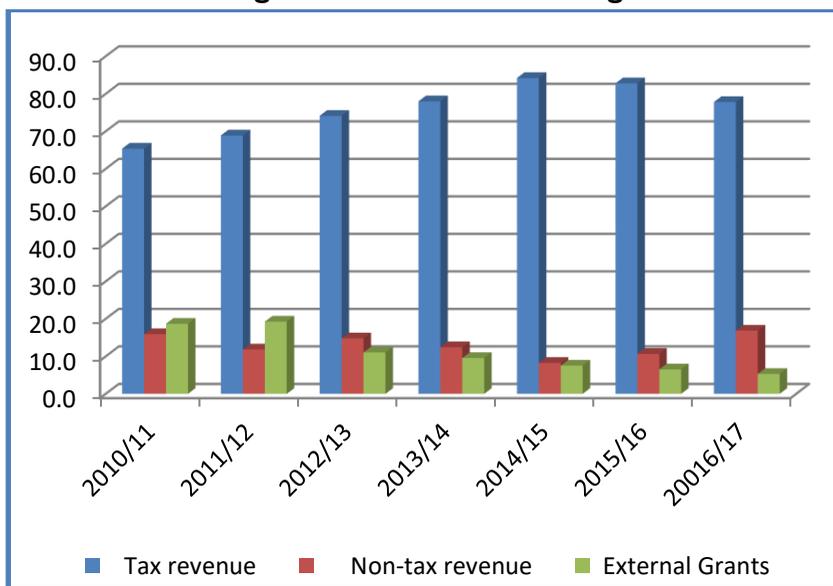
Fiscal Year ending July 7	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Tax revenue	36.2	45.4	24.8	24.4	24.2	15.2	10.3
Non-tax revenue	-3.9	68.9	-0.3	-23.5	63.2	93.8	12.6
External Grants	33.2	-22.4	2.5	-9.2	9.4	0.0	-4.1
Total Revenue and Grants	29.2	35.1	18.6	15.2	26.3	22.6	9.9
Expenditure	31.5	32.6	23.7	20.5	24.3	21.9	17.2
Current expenditure	26.6	26.9	22.0	24.4	45.2	20.6	29.3
Capital expenditure	35.5	36.9	25.0	17.8	9.1	23.1	5.8
Financing	86.8	6.5	91.1	63.7	12.7	16.8	66.8

Source: MoFC

One of the most important components of government revenue is external grants; two things are peculiar in this account, one it fluctuate over times and the overall performance is decreasing particularly in recent years. External grant decreased by 4 percent in the fiscal year 2016/17 compared to the preceding year. Probably the political landscape has contributed for the decline in external grants. Recently the domestic political unrest may affect the inflow of external grants to Ethiopia. However, there is a hope that this will improve in the coming years following political reforms that are being hailed by the major development partners. However, in the long run government shall strengthen its capacity in mobilizing and using

domestic resources along with diversifying its export base. Total revenue and grant increased by 10 percent in the fiscal year under review.

Figure 1.14: Share of tax, non-tax revenue and grants from total government revenue and grants

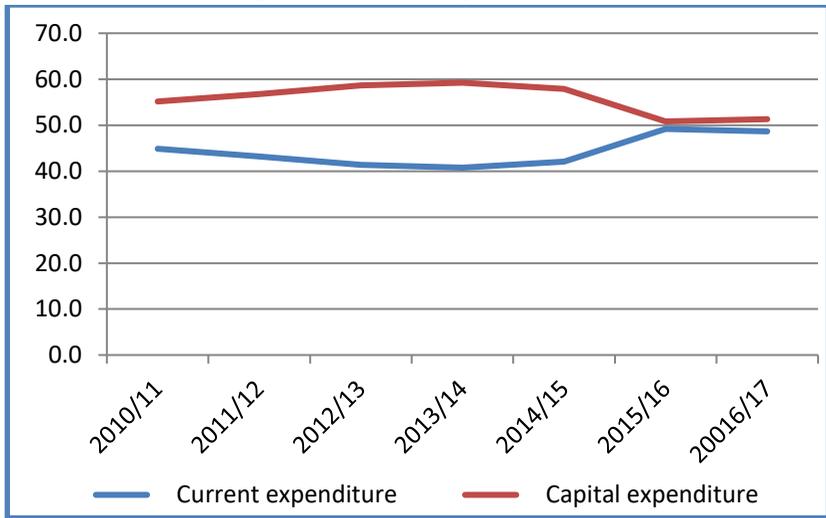


The share of tax revenue is dominant and is increasing over time for the fiscal year 2016/17. It had 78 percent share in the total revenue while non-government tax has 17 percent. The balance is the share of external grant.

Even though performance in total expenditure shows increasing trends, it has been decelerating over the last few years following partly the trend in revenue collection. Among the general

components, current expenditure is on a rise at a higher growth rate than the capital expenditure. In the fiscal year under review current expenditure grew by 29 percent whereas capital expenditure expanded by 6 percent. Following them is match between government revenue and expenditure the deficit increased by 67 percent.

Figure 1.15: Share of current and capital expenditure from total government expenditure



Source: National Bank of Ethiopia

Though capital expenditure had in the past been larger than the recurrent expenditure by more than 10 percentage points, recurrent expenditure grew faster surpass the capital expenditure. The share of current expenditure in the total government expenditure was 53.7 per cent in 2016/17.

Table 1.7: Government revenue and expenditure in Millions of Birr.

Fiscal Year ending July 7	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	20016/17
Tax revenue	43315	58981	85740	107010	133118	165312	190520	210136
Direct Taxes	14903	19550	28858	36393	47021	60154	71844	81410
Indirect Tax	28412	39431	56882	70618	86098	105158	118676	128725
Domestic indirect taxes	10727	15705	23326	32440	40499	52368	55953	62523
Import duties and taxes	17685	23726	33556	38177	45599	52790	62723	66202
Non-tax revenue	10546	10139	17124	17067	13055	21306	41285	46493
Total revenues	53861	69120	102864	124077	146173	186619	231805	256629
External Grants	12376	16491	12795	13115	11904	13020	13014	12477
Grants in kind/earmarked	5561	6859	8089	9699	9394	10154	12724	11889
Untied cash & CPF/grants	6816	9633	4706	3416	2510	2866	291	588
Total Revenue and Grants	66237	85611	115659	137192	158077	199639	244819	269106
Expenditure	71335	93831	124417	153929	185472	230521	280893	329287
Current expenditure	32012	40535	51445	62746	78087	113376	136709	176703
o/w: defence	4000	4750	6486	6493	7489	8814	9498	11940
Interest & charges	1587	1913	2230	2931	3794	5338	7232	8248

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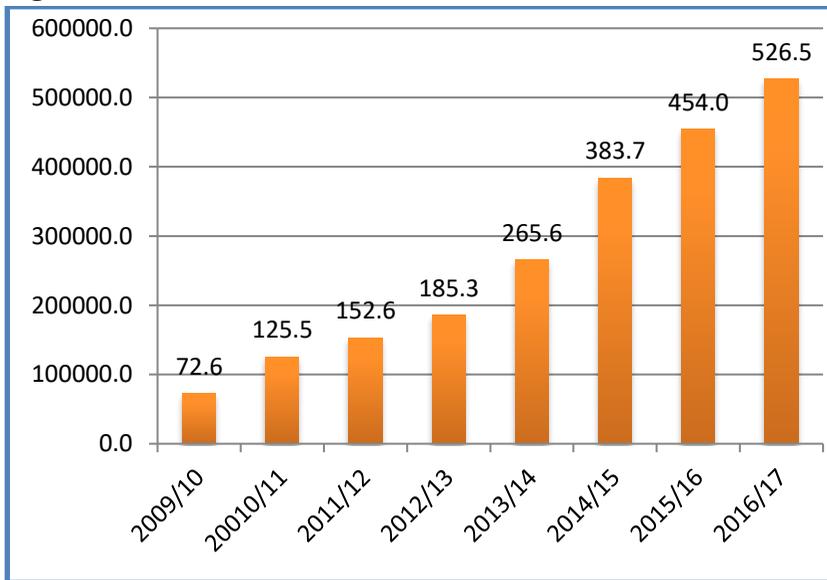
Fiscal Year ending July 7	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Capital expenditure	39322	53297	72971	91183	107385	117146	144184	152584
Central Treasury		38326	57439	68552	82175	91887	109236	115332
External assistance 2/	631	6521	8089	9699	9394	10154	12724	11889
External loans		8436	7443	13013	15816	15105	22225	25362
Overall balance including grants	-5097	-8220	-8758	-16736	-27395	-30882	-36073	-60181
Overall balance excluding grants	-17473	-24712	-21553	-29851	-39299	-43902	-49088	-72658
Financing	4400	8220	8758	16736	27395	30882	36073	60181
External (net)	4131	7798	6530	16846	20493	18734	26034	28953
Domestic(net)	1758	111	3793	1764	13510	18466	24704	34629
Banking system	1382	-3040	-3826	-3245	2218	10739	9208	18652
Non-bank sources	375	3151	7619	5009	11292	7728	15496	15978
Privatization Receipts		1458	2764	1200		485	500	10883
Other and residual	-1489	-1146	-4328	-3074	-6608	-6803	-15164	-14284

Source: MoFC

Public Debt

Ethiopia’s external debt reached 26 billion USD in 2016/2017. Given in particular the weak performance of the export sector and the ensuing low level of foreign reserve, Ethiopia’s foreign debt is rated high risk. In 2016/17 total export was 2.8 billion USD in sharp contrast to the total import bill of 15.8 billion USD. According to IMF, stagnant exports performance in 2016/17, weak external environment, delays in completing key export-oriented mega projects, and maturity of non-concessional borrowing contracted during the previous years have put the country’s Debt Sustainability Analysis (DSA) at high risk.

Figure 1.16: Volume of external debt in Billions of Birr



Source: National Bank of Ethiopia

Table 1.8: Trends and patterns of external debt in Ethiopia

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
External debt	72627.3	125449.0	152631.0	185315.0	265592.7	383662.4	454000.2	526,545.8
Drawings (gross)	10859.3	25807.9	25393.8	44498.8	54919.1	128994.7	72697.2	63,957.5
Repayments	-1222.1	-3159.1	-6623.3	-7744.0	-11963.8	-14468.2	-16139.7	-18,504.8
Debt servicing	15736.8	3168.4	6761.1	7855.2	11975.1	19598.6	23655.1	27,980.1
Principal	834.0	2316.1	5213.2	5812.5	9331.2	14468.2	16139.7	18,504.8
Interest	386.7	852.3	1547.9	2042.6	2643.9	5130.4	7515.4	9,475.4
Debt servicing to export ratio (%)	2.3	7.1	12.2	13.8	19.3	32.1	34.9	37.3
Ratio of external debt to GDP (%)	19.0	24.4	20.4	21.4	25.4	29.6	29.5	29.0

Source: National Bank of Ethiopia

As the debt accumulates, the country's debt servicing reached 28 billion Birr (about one billion USD) in 2016/17. This was equivalent to 37.3 per cent of receipts from export of goods.

In particular, the country was projected to be a high risk country in terms of debt sustainability by the measure of debt – export ratios in 2017/18. The present value of public and publicly guaranteed external debt to GDP ratio, and external debt servicing to export ratio were, respectively, 272 and 21, in contrast to the thresholds for medium policy strength of 180, and 15, respectively. Debt sustainability measures based on GDP and domestic revenue mobilization are still well below the threshold.

The debt burden threatened to cause serious macroeconomic imbalances. In particular, it would have consequences on the country's foreign reserve, strategic and necessary imports, delay in the major development projects, and eventually on the overall economic growth. A default would also have repercussions on the country's hope of successful structural transformation and escape from underdevelopment.

Table 1.9: Trend of the three deficits

Period	Resource Gap as percentage of GDP	Trade Balance as percentage of GDP	Share of budget deficit to Revenue
2010/11	-14.9	-14.8	-35.8
2011/ 12	-17.9	-17.8	-21
2012 /13	-16.5	-16.5	-24.1
2013 /14	-17.5	-17.5	-26.9
2014 /15	-17.5	-20.9	-23.5
2015 /16	-16.1	-19.8	-21.2
2016/17	-15	-16	-28.3

Source: NBE

Ethiopia has been running a deficit in all three macro variables namely investment and saving gaps, trade, and budget balances (Table 1.9). Despite the fact that gross domestic saving dramatically increased in the last six years, resource gap is still high. This is mainly due to the disproportional increase in gross fixed investment in Ethiopia. Trade balance is persistently widening throughout the periods. The insufficient even declining trend in Ethiopia's export is the major reason for the increasing trade deficit despite the fact that import is increasing over time.

In the short run, Ethiopia need to renegotiate the terms of loan from major lenders in particular China and at the same time give assurance to its people and development partners by successfully completing the much delayed mega projects. The long-run perspective should rely on diversifying export and give priority to import substitution

strategy counting on the high demand that have been created over the last 15 years.

1.6 External Sector Developments

Agriculture is still the mainstay and backbone of the Ethiopian economy contributing 36.3 percent of GDP while the share of services has substantively increased to 39.3 percent and that of industry reached 25.6 percent. Agricultural (primary) commodities are the sources of the country's export accounting for more than 75 percent of the total merchandise export.

The export sector holds promising potential and is witnessing progress particularly on coffee, oilseed and pulse products that cover above 50 percent of the total export earnings despite the fact that challenges such as supply side constraints related to inadequate infrastructure (roads, telecom, electricity), high cost of transportation, limited participation in the regional and multilateral trading systems and insufficient knowledge about international trade remain. Majority of Ethiopian merchandise exports are low value-added agricultural products and unprocessed goods which have minimal impact on substantially increasing export earnings, and bringing in the required technology development in the domestic economy. Hence, price volatility in world agricultural markets have a serious impact on the value of merchandise exports, Ethiopia benefited from coffee price increment under the review year. Moreover, the performance of the export sector was also affected by weaknesses in accessing niche markets due to entry barriers, lack of appropriate information, and limited financing capacity of exporters.

Due to these constraints Ethiopia has not yet fully benefited from its export potential and available market access opportunities except the marginal benefit from coffee price increment under the review year.

1.6.1 Balance of Payments

The balance of payment deficit for the year under review was 12.9 billion USD that showed a 6.9 percent improvement over the preceding fiscal year 2015/16. The improvement was mainly due to go-slow in total import bills joined with a marginal increase in total export by 1.4 percent. It registered a surplus of 658.6 million USD compared with the previous year balance of payment. The surplus was attributed to the current account balance and the Capital account. The fall in current account balance was mainly due to a high growth in merchandise imports 15.802 billion USD and low exports performance 2.9 billion USD that makes trade deficit to stand at 12.89 billion USD. As it did before, the service sector still did show a negative balance of (564.9 Million USD) in spite of the fact that it has an improvement compared to last year's performance.

Table I.10: Balance of payments in (Millions of USD)

Particulars		2013/14	2014/15	2015/16	2016/17
		D	E	F	G
1	Exports, f.o.b.	3,254.8	3,019.30	2,867.70	2,907.50
	Coffee	714.4	780.5	722	883.2
	Other	2,540.4	2,238.80	2,145.00	2,024.30
2	Imports	13,721.9	16,458.60	16,725.20	15,802.60
	Fuel	2,543.2	2,040.90	1,339.00	1,823.60
	Cereals	351.7	601.6	1032.7	554.1
	Aircraft	35.4	190.6	162.9	150.3
	Imports excl. fuel, cereals, aircraft	10,791.6	13,625.50	14,190.60	13,274.50
3	Trade Balance (1-2)	-10,467.2	-13,439.30	-13,857.50	-12,895.10
4	Services, net	559.5	-341.4	-712.7	-546.9
	Non-Factor services, net	712.2	-78.9	-459.1	-61.3
	Exports of non-factor services	3,174.2	3,028.40	2,930.00	3,331.10
	Imports of non-factor services	2,461.9	3,107.30	3,389.00	3,392.50
	Income, net	-152.8	-262.5	-253.6	-485.6
	O/w Gross office. int. payment	143.5	249.2	255.9	455.2
	Dividend	-17.9	-23.7	-10.9	-48.9
5	Private transfers	4,042.5	4,881.60	6,013.00	5,485.30
	O/w: Private Individuals	2,971.4	3,796.70	4,006.20	4,427.50
6	Current account balance excluding official transfers (3+4+5)	-5,865.2	-8,899.10	-8,557.24	-7,956.80

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Particulars		2013/14	2014/15	2015/16	2016/17
		D	E	F	G
7	Official transfers, net	1,161.6	886.5	1493	1,428.30
8	Current account balance including official transfers (6+7)	-4,703.7	-8,012.60	-7,064.20	-6,528.40
9	Capital account	3,901.6	7,030.60	6,245.40	6,831.50
	Off. Long-term Cap., net	1,287.4	2,566.00	1,510.10	1,401.60
	Disbursements	1,374.1	2,653.70	1,599.80	1,512.20
	Amortization	86.7	87.7	89.7	110.6
	Other pub. Long-term cap.	1,082.9	2,228.00	1,146.20	626.3
	Foreign Direct Investment(net)	1,467.0	2,202.20	3,028.18	4,170.80
	Short-term Capital	64.3	34.3	110	130
10	Errors and omissions	710.7	460.6	-12	355.5
11	Overall balance (8+9+10)	-91.4	-521.4	-830.9	658.6
12	Financing	91.4	521.4	830.9	-658.6
13	Reserves [Increase (-), Decrease (+)]	94.9	521.4	830.9	-658.6
14	Central Bank (NFA)	-48.0	-92.9	975.6	-555.7
	Asset	-95.2	-663.1	-152.6	204.7
	Liabilities	47.2	570.2	1128.2	-760.4
15	Commercial banks (NFA)	142.9	614.3	-144.7	-103
16	Debt Relief	-3.5			
	Principal	2.9			
	Interest	0.6			

The capital account has registered a 9.4 percent raise compared to the same period of 2015/16 fiscal year. Conversely, the private transfers have recorded an 8.8 percentage decline relative to the 2015/16 fiscal year which shows a surplus of 5,485 million USD compared with the surplus of 6,013 million USD in the year 2015/16. The components of private transfer, Private Individuals has escalated from 4006.20 million of USD to 4427.5 million USD in the reviewed period.

1.6.2 Exports

Though the government takes export as one of the priority sector, Ethiopian export performance remains undiversified and not fulfilling the target set by the government. The composition of exportable commodities is yet dependent on those usual primary agricultural products such as coffee, oilseeds, pulses, chat, gold, fruits and vegetable, live animal.

Export revenue from coffee increased by 14 percent compared to the year 2015/16. Both volume and International price augmentation are accounted for the boom in which volume of coffee exported increased by 13.6 percent and 7.5 percent rise for the international coffee price. In spite of the fact that coffee export volume increased by 8 percent, Revenue generated from Coffee export dropped by 7.4 percent due to 14.3 percent decline in international price. As a result, the share of coffee in total export was 28.7 percent which is higher than that of 25.2 percent registered a year before. Similarly, earnings from pulse increased by 20.5 percent more than 5.2 percent increase of last years. The value of pulse export went up to 279.9 million USD.

This escalation was accounted for both volume and price where amount of export volume increased by 4.6 percent and international pulse price increased by 15.1 percent. Therefore, the share of pulse from the total export earning becomes 9.6 percent.

In the contrary, oilseed export earnings reduced by 26.4 percent and reached 351 million USD because of the fall in the world's oilseed price by 3.7 percent and a 23.6 percent decline in the export volume. Due to this the share of oilseed in total merchandised export was 12.1 percent than 16.8 percent a year before. Likewise, gold export generated 208.8 million USD which is 28.2 percent lower than 2015/16 performance 290.7 million USD. Gold revenue generation was accounted for a 30.4 percent in export volume despite a rise in international gold price by 3.2 percent. Regarding chat export revenue, it increased by 4 percent as the exported volume enhanced by 3.9 percent though the international price shows a decline by 1 percent relative to last year. Hence, the share of chat export in the total export revenue rose to 9.4 percent.

The total merchandise export revenue generated in 2016/17 increased by 1.4 percent mainly accounted to coffee 22.2 percent, pulse 20.5 percent, fruit and vegetable 4.5 percent, chat 4 percent, meat and meat products 2.3 percent and other export items 33.4 percent excluding electricity export revenue.

Export, one of the priority sectors that have got focuses by the government was almost stagnant under the review year despite the 1.4 percent improvement and a decline of the import bill.

Table I.11: Values of major export items (in Millions of USD)

Particulars	2012/13	2014/14	2014/15	2015/16	2016/17	Percentage change			
	A	B	C	D	E	B/A	C/B	D/C	E/D
Coffee	746.6	714.4	780.5	722.7	833.2	-4.3	9.3	-7.4	15.3
Oilseeds	443.5	651.9	510.1	477.2	351	47.0	-21.8	-6.4	-26.4
Leather & Leather products	121.1	129.8	131.6	115.3	114	7.2	1.4	-12.4	-1.1
Pulses	233.3	250.7	219.9	232.4	279.9	7.5	-12.3	5.7	20.4
Meat & Meat Products	74.3	74.6	92.8	96.4	98.7	0.4	24.4	3.9	2.4
Fruits & Vegetables	43.9	45.9	47.6	53.7	56.1	4.6	3.7	12.8	4.5
Live Animals	166.4	186.7	148.51	147.8	67.6	12.2	-20.5	-0.5	-54.3
Chat	271.3	297.3	272.42	262.45	273	9.6	-8.4	-3.7	4.0
Gold	578.8	456.2	318.7	290.7	208.8	-21.2	-30.1	-8.8	-28.2
Flower	186.7	199.7	203.1	225.3	218.5	7.0	1.7	10.9	-3.0
Others	215.4	247.4	294.2	212.3	283.2	14.9	18.9	-27.8	33.4
Total	3,081.20	3,254.80	3,019.43	2,836.25	2,907.50	5.6	-7.2	-6.1	2.5

Coffee is still the leading commodity to generate foreign currency earnings. The values earned from coffee under the review year stood at 833.2 million dollar which exhibits a positive shift compared to the year before by 15.23 percent and 30.4 percent contributing to the total export. This was due to a 7.5 percent rise in the international price and a 13.6 percent increase in volume. Though oilseed is the second most exportable product of the country next to coffee to generate foreign currency, the share of oilseed in the total merchandise export was down to 12.1 percent. Revenue from oilseed declined by 26.4 percent and reached 351 million dollars. The reason to drop was a fall in international price and dramatic drop of export volume by 23.6 percent compared to the year 2015/16. Correspondingly gold generated 208.8 million dollars, which is 28.2 percent lower than the previous year performance. Lower export volume was the main cause for the decline of gold revenue earnings apart from the rise in the international price by 3.2 percent.

Similarly, flower export decreased both in volumes by 2.5 percent and international price 0.5 percent in the fiscal year. Hence the share of flower in the total merchandise export earnings drops to 7.5 percent from 7.9 percent performance of a year before.

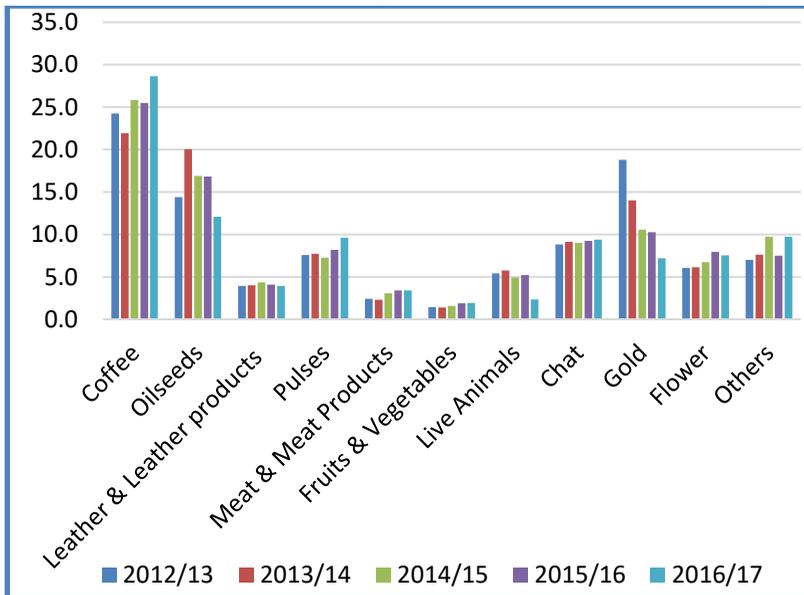
Receipts from meat and meat products raised by 2.4 percent annual growth compared to the same period of the previous year. The growth was accounted for a 3.2 percent escalation on export volume despite the decline of international price by .0.8 percent.

Chat export revenue increased by 4.0 percent as the export volume rose by 3.8 percent despite the fact that international chat price declined by 1.2 percent. However, its share from the total

merchandise export earnings grew to 9.4 percent compared to a 9.2 percent share in 2015/16.

Pulse was the top performing export commodity to generate foreign currency than ever where it increased by 20.5 percent from 232.4 million dollars to 279.9 million dollars. The rise accounts 15 percent in export volume and 4.7 percent due international price rise. The share of pulses export in the total merchandise export revenue earning increased to 9.6 percent. The escalation of the overall export is not only due to the rise in volume but also because of the international price went up for most of the commodities.

Figure 1.17: The share of export items from the total export



The Ethiopia's foreign exchange and earnings is led by primary agricultural products exports apart from the services sector -

primarily the state-run Ethiopian Airlines. While the entire commodity export sector is dominated by coffee, oilseeds, pulse, gold and chat, Livestock and horticulture products are also becoming important. In the year 2016/17 coffee have a share of 28.7 percent, oilseeds (12.1), gold (7.2), pulse 9.6 percent and chat 4 percent in value earning.

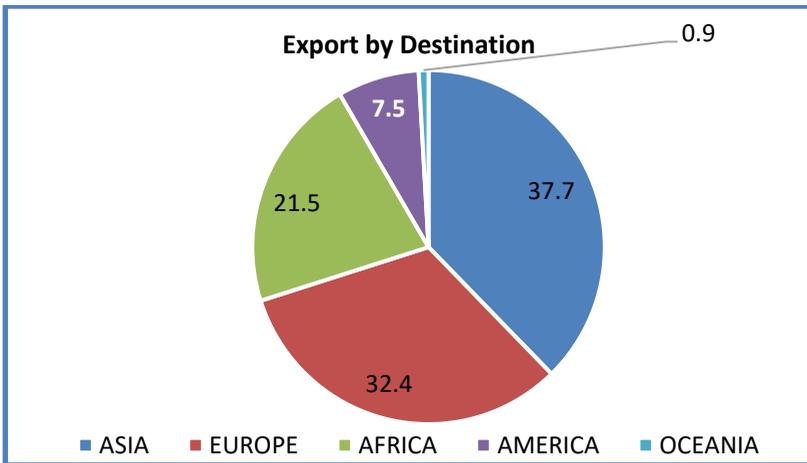
Export by destination

According to the national bank of Ethiopia, and based on the share of values that the country gets from main export items, Asia, Europe Africa and America were the main destinations of the Ethiopian Merchandise export. Asia yet take the lead to be the first country by taking 37.7 percent of the merchandise commodity 0.5 percent improvement compared to the year before. Europe, the second destination partner and it takes 32.4 percent the Ethiopian products. Africa takes the third place by importing 21.5 percent of the commodity, as a destination for Ethiopian commodity export. USA is sustained as a trade partner of Ethiopia, registered an improvement of the 1.3 percent performance by importing 7.5 percent from the total merchandise export.

Asia, Europe, Africa and America were the main destinations of Ethiopian export items. Among those countries, china still has a lead by importing 20.7percent of the Ethiopian export and the main products exported to china includes oilseeds, leather & leather products, mineral products, coffee, textile materials and natural gums. Saudi Arabia largely imported from Ethiopia coffee, meet and meet products, live -animals, flower, oilseed and spices. While exports to the US were 87.3 percent share from the total which America imports

from Ethiopia. The main products exported to the US constituted coffee, leather & leather products, oilseed, textile and garments, flower, food and mineral products. Within Europe, Switzerland constituted 22.3 percent, the Netherlands' continues as a trade partner of Ethiopia by importing 19.7 percent, Germany 18.6 percent and Belgium 9.3 percent. The major commodities exported to Switzerland gold, coffee, oilseed, textile and garment food and beverage while the main products exported to the Netherlands includes flower, pulses, vegetables, coffee, fruits and textile & garments. Likewise, Germany mostly imported coffee, textile & garment, flower, oilseed, natural gum and pulses. While coffee, flower, pulses, oilseed and beeswax are the main products exported to Belgium.

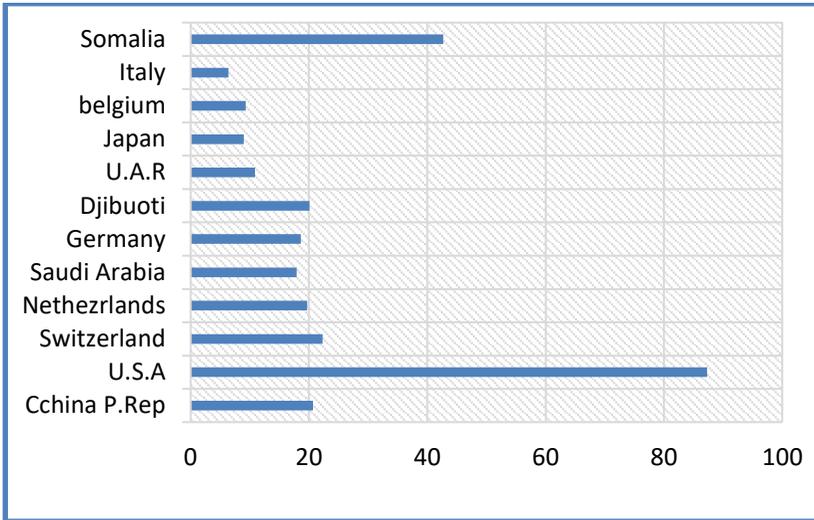
Figure 1.18: Value share of the export by destination continents



Somalia takes the lead by importing 42.7 percent of the Ethiopian export to the African countries. The major exports to Somali were

chat, live-animals, fruits and vegetables, fruits and pulses. While chat live-animals, vegetable and fruits went to Djibouti.

Figure 1.19: Value share of the destination countries



Source: Own computation from National Bank Data.

1.6.3 Imports

In the year 2016/17, the total import bill has decreased from 16.7 billion dollars to 15.8 billion dollar which has a 5.5 percentage drop down compared to the same period of a previous year. The total import to GDP ratio went down to 19.6 percent 23.1 percent a year before. From the import commodity Raw Materials import failed by 15.9 percent which is significant decline compared to the same previous year. Among the component the import particulars the total capital goods fell down to 6.03 billion dollar which is an 11.4 percent compared to the same year of last year. Import of fuel increased in

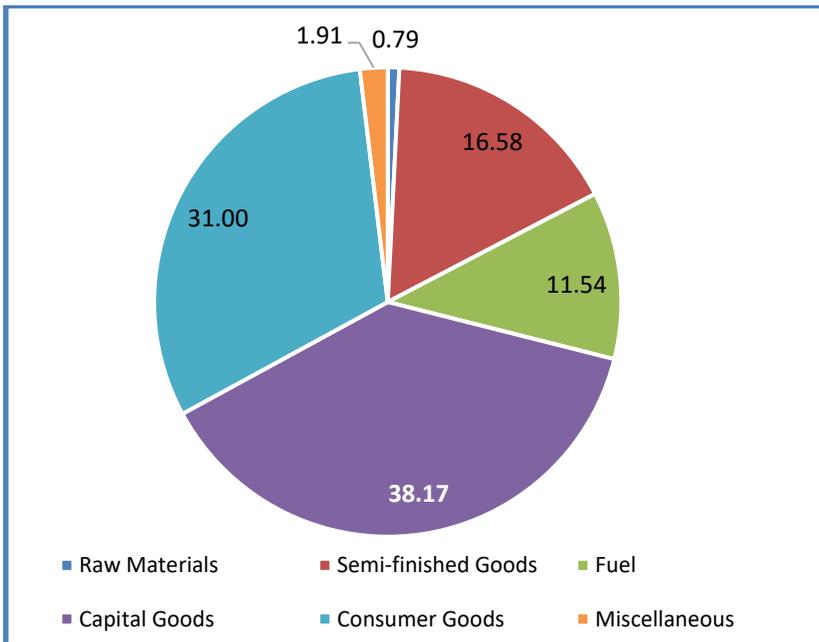
the review year in relative to a year before and stood at 1.82 billion dollars. The escalation was about 36.2 percent than 34.4 percent performance in the year 2015/16. In contrast, the import bill of semi-finished goods decreased by 9.5 percent and the bill went down to 2.62 billion USD compared with the value of 2.89 billion USD in 2015/16. The imports of consumer goods were 4.89 billion USD that registers a 7.0 percent dropdown because of the lower import bill of non-durable consumer goods (13.7 percent) while durable goods increased by 9 percent compared to the same previous year.

Table I.12: Value of imports by end use (in Millions of USD)

Particulars	2012/13	2013/14	2014/15	2015/16	2016/17	Percentage change			
	A	B	C	D	E	B/A	C/B	D/C	E/D
Raw Materials	145.6	165.2	170.5	149.3	125.6	-27.1	3.2	-12.4	-15.9
Semi-finished Goods	1753.9	2098.1	2578.4	2895.5	2620.6	-10.4	22.9	12.3	-9.5
Fertilizers	291.8	398.9	502.9	430.0	367.9	-51.7	26.1	-14.5	-14.4
Fuel	2163.9	2543.2	2040.9	1339.0	1823.7	1.8	-19.8	-34.4	36.2
Petroleum Products	2128.2	2494.9	1966.7	1280.1	1743.7	2.4	-21.2	-34.9	36.2
Others	1236.1	48.4	55.9	58.9	80.1	2564.0	15.5	5.4	36.0
Capital Goods	3572.6	4500.3	6882.3	6829.4	6032.1	20.6	52.9	-0.8	-11.7
Transport	903.1	1084.3	1699.1	1535.6	1429.7	11.5	56.7	-9.6	-6.9
Agricultural	129.9	166.8	71.6	83.4	75.8	8.7	-57.1	16.5	-9.1
Industrial	2539.6	3249.2	5111.6	5210.4	4526.7	24.9	57.3	1.9	-13.1
Consumer Goods	3452.4	3834.1	4510.9	5264.3	4898.3	-2.2	17.7	16.7	-7.0
Durables	1089.8	1501.1	1608.0	1567.3	1707.8	-1.4	7.1	-2.5	9.0
Non-durables	2362.6	2333.0	2902.9	3697.0	3190.5	-2.6	24.4	27.4	-13.7
Miscellaneous	378.9	581.0	275.6	247.8	302.3	32.3	-52.6	-10.1	22.0
Total Imports	11467.3	13721.9	16458.6	16725.3	15802.6	3.7	19.9	1.6	-5.5

Ethiopia’s import is dominated by capital goods (38.17 percent), from the import of capital goods industrial product accounted for 28.65 percent and transport 9.05 percent. Consumer goods (31 percent) has a decomposition of 20.19 percent non-durable goods and 10.81 percent durable goods. Semi-finished goods also contribute (16.558 percent) and fuel (11.54 percent) in the fiscal year 2016/17. Fuel import increased dramatically in the year under review and it grew by 36.2 percent.

Figure 1.20: Share of major imported commodities from total imports



Source: Own computation using NBE data

The Recent Devaluation

Government of Ethiopia has undertaken devaluation hoping to get relief of the acute shortage in foreign earnings. In an attempt to promote export and discourage imports of goods and services, the value of Birr against USD was devalued by 15 percent in October 2017. The proponents of devaluation mainly the World Bank and the International Monetary Fund believe that devaluing the Birr would improve the balance of payments. Specifically, the World Bank argues that devaluing the Birr by 10% against USD would increase Ethiopia's exports by 5% and add 2 percentage points to the economy's growth rate (WB Report, 2017).

However, in developing economies such as Ethiopia the fact on the ground reveals a different picture. In the Ethiopian case, its major exports are primary agricultural commodities with long gestation period such as coffee and hence are inelastic to changes in exchange rates. At the same time, imports are fundamentally necessities with small component of luxury items so that devaluation increases import prices and can succeed to narrow balance of payment deficits at the expense of key domestic investments.

Devaluation of domestic currency will increase export and discourage imports under some assumptions. If either all of them or one of these assumptions is not meet the expected impact of devaluation will be highly compromised.

1. The relative price change due to devaluation should redirect exportable goods and services previously sold to domestic

- consumer to international consumer. (Price elasticity of exportable items)
2. There should be unutilized production capacity for exportable. Such productive capacity should be utilized if following devaluation leads to attractive domestic prices for exportable.
 3. There are no other obstacles (issues in logistics, the bureaucracy, the banking system, etc.) hindering the efforts of market participants from taking full advantage of the increased prices of exports which devaluation will bring about.

Technically, the Marshal- Learner condition that the sum of exchange rate elasticity of imports and export should exceed unity in order exchange rate policy in the form of devaluation meets expectations. In reality, Ethiopian export is characterized by structural problems and hence none of these assumptions seems to be realistic. The prices of primary agricultural goods are determined in the international market. Individual country like Ethiopia accepts the prices set by the market and try to supply those products. Amidst devaluation, Ethiopia cannot influence the international prices, however, the price of those items increases in terms domestic currency. As a result, it may cutback domestic consumption and/or increase production.

Coffee takes more than a quarter of Ethiopia's exports following oilseeds and gold combined takes more than 30 percent share of total exports (Table I.13). The three items combined accounts nearly 60 percent of total exports. Will the rise of export price increases the export share of these items? Oilseeds production depends on rain-fed agriculture and productivity in the sector is also low. Coffee even takes several years from the plantation to the first harvest. Therefore, it would be difficult to respond in increasing supply to devaluation in

the short term even in the medium term. Gold is one of the major export items of Ethiopia. Increasing production in gold to take advantage of domestic price devaluation will require huge investment in expansion of current producers and exploration of other deposit which is unlikely to happen. Thus, the impact of current devaluation in increasing export earnings will take several years if it would be materialized.

Table 1.13: Share of major export items

Particulars	2010/11	2011/12	2012/13	2014/14	2014/15
	A	B	C	D	E
Coffee	30.6	26.4	24.2	21.9	25.8
Oilseeds	11.9	15.0	14.4	20.0	16.9
Leather & Leather products	3.8	3.5	3.9	4.0	4.4
Pulses	5.0	5.1	7.6	7.7	7.3
Meat & Meat Products	2.3	2.5	2.4	2.3	3.1
Fruits & Vegetables	1.1	1.4	1.4	1.4	1.6
Live Animals	5.4	6.6	5.4	5.7	4.9
Chat	8.7	7.6	8.8	9.1	9.0
Gold	16.8	19.1	18.8	14.0	10.6
Flower	6.4	6.2	6.1	6.1	6.7
Others	8.0	6.6	7.0	7.6	9.7
Total	100.0	100.0	100.0	100.0	100.0

Source: National Bank of Ethiopia.

The remaining products such as fruits and vegetables, live animals and flowers are not that much significant individually in the Ethiopia's export menu. They are not price elastic products. It is hardly expected production increases in the short to medium term.

In a countries like Ethiopia with low manufacturing base and imports most of its factor inputs and raw materials, devaluation will fuel inflation due the domestic price increases in tradable goods. Contrary to expectation in improving balance of payment, food and non-food inflation is spiking after the aftermath of devaluation in October 2017.

On the import side in the previous five years on average Ethiopia's import was dominated by import of capital goods, fuel and semi-finished goods. These items are very crucial for investment and to maintain the economy in its current growth trajectory. Besides devaluation makes Ethiopia's import very expensive and yet cutting back on such imports will significantly hamper investment and growth of the economy.

Considering the import of consumer goods which are believed to be price elastic, it only covers less than 30 percent of total imports of Ethiopia. The details of disaggregated data reveal that many of the import items under this category of consumer goods shows that, it is dominated by imports of grains, pharmaceuticals and food. On one hand, the share of consumer goods is not as such big as widely shared views of many and on the, other hand; they are necessary goods, it is difficult to decrease their imports. Therefore, devaluation is expected to worsen the balance of payment due to the fact that prices of imports are expensive and volume is hard to decrease.

Table I.14: Share of imports

Particulars	2010/11	2011/12	2012/13	2013/14	2014/15
	A	B	C	D	E
Raw Materials	2.2	1.8	1.3	1.2	1.0
Semi-finished Goods	14.9	17.7	15.3	15.3	15.7
Fuel	20.1	19.2	18.9	18.5	12.4
Capital Goods	33.4	26.8	31.2	32.8	41.8
Consumer Goods	27.8	31.9	30.1	27.9	27.4
Durables	10.5	10.0	9.5	10.9	9.8
Non-durables	17.3	21.9	20.6	17.0	17.6
Miscellaneous	1.6	2.6	3.3	4.2	1.7
Total Imports	100.0	100.0	100.0	100.0	100.0

Source: National Bank of Ethiopia.

Generally, devaluation rarely seen as an export promotion tool, except in a country where export of manufacturing goods constitutes higher share. In countries like Ethiopia, where almost all of its exportable items are primary agricultural products, the immediate impact of devaluation would be escalating price. Instead policies shall focus on increasing productivity of different sectors, establishing strong manufacturing base and reducing bureaucratic, logistic problems in the export sectors among others.

Chapter II

Performance of the Agricultural Sector

2.1 Background

Ethiopia is the second-most populous country in Sub-Saharan Africa with an estimated population of over 107.5 million people, representing 1.41% of the global population, and increased by 2.46% (by 2.58 million) annually³. The majority of this population depends on agriculture both for livelihood and food. In terms of agro-ecology and agricultural resources base (mainly land, labor, livestock and water/irrigation), Ethiopia is also a large and diverse country.

Agriculture is dominated by subsistence farming providing employment for about 80 percent of the population, using few inputs and characterized by low but growing productivity.

Ethiopia has made a tremendous improvement in the performance of its agricultural sector. Due to investments by the GOE and its development partners, the agriculture sector has witnessed consistent growth of over 8 to 10 percent per annum over the past decade (EEA, 2016). Grain production; for instance, grew by 55 million quintals (or by close 22%) from 251.5 million qt. to 306.1 million qt. in four years period between 2013/14 and 2017/18 (CSA, reports). This indicates an average annual growth of 5.5% which is far

³World meters: www.worldometers.info

higher than the negative impacts associated with the decline in the average farm size⁴ and the annual population growth.

It is, however, difficult to extrapolate the impact of such rosy statistics on smallholders' grain production to national food supply in general and food security in particular. First, due to the subsistence nature of the producers, only one fifth of the production left the farm for market. This hinders the prospect of transformation of subsistence agricultural production into a commercially oriented system which could generate a range of multiplier effect on the economy. Second, food security is basically defined at individual level in terms of the capacity to access to sufficient food (both in quantity and quality) at any time. Third, the impact of the reported official fast growth in grain production (including wheat production which is reported to double every ten years) is not reflected much in the country's wheat import bill which has become a growing chronic problem⁵.

Ethiopia's policy and strategy on the smallholder agricultural sector could be largely described as intensification of smallholder agriculture through supply of fertilizers and other modern inputs. The existing strategy of intensive agriculture, however, meet with tangible constraints like high population growth, declining access to farm land, etc. that contributed for the irony discussed above. It is, therefore, important to complement it with programs that focused on the

⁴ The average farm size, for instance, declined by 7.8% from 0.88 ha to 0.81 ha (between 2017/18 and 2013/14) but the average grain production increased by 9.6% from 17.8 qt./farm household to 19.5 qt./household during the same period (CSA reports).

⁵ This problem could partly attribute to the quality of the national grain production data.

productive use of water and land resources in the sparsely populated low lands of the country. Similarly, systematic and broad interventions that focused on the transformation of the sector should be strengthened and expanded.

This chapter tries to update the performance of the Ethiopian agriculture especially the performance of the grain sub-sector in terms of production, productivity, use of modern farm inputs and related agricultural activities in 2017/18 including food security and trade. Though publications from other sources are primarily used, data for this report basically comes from the annual agricultural survey reports of the Central Statistical Agency (CSA).

2.2 Grain Production

Grain refers to the major crop category that includes cereals, pulses and oilseeds, which constitute the major food crops for the majority of Ethiopians and cash crops especially in the case of pulses and oilseed. During the last agricultural year (in 2017/18), about 14.2 million ha (which is about 20% of the 71 million potentially arable land)⁶ is cultivated by smallholder farmers for the production of grains and other temporary and permanent food and cash crops.

⁶ Out of Ethiopia's estimated 1.1 million square kilometres (110 million ha) total land area, 65% (about 71 million hectares) is believed to be suitable for agricultural purposes (EEA, 2016)⁶, indicating the potential for farming. However, population settlement and geographical distribution of this land resource is skewed which creates difficulty to efficiently utilize and manage its land resource. The Ethiopian highlands represent about 36% of the total land area, while the remaining 64% is in the lowlands (below 1,500 m. a. s. l). The bulk of the human and livestock population, about 85% and 70%, respectively, resides in the highlands (EEA, 2016).

Grain accounted for 12.68 million ha or 90% of the land cultivated by smallholder in 2017/18, while the remaining 10% (1.54 million ha) of the cultivated land is covered by crops like vegetables, root crops, fruit crops, coffee, chat, hops and sugar cane (CSA, 2018).

Between 2017/18 and 2013/14, the number of small grain producers increased by 11 percentage points and reached 15.7 million in 2017/18 (see Figure 2.1). During the same period, grain production increased by 22% to 306.1 million qt. This significant progress is reported to have been realized from marginal increase in farm land. As indicated in Figure 2.1 below, only 2% of the total cultivated area was new farmland brought to grain production. This disparity between the cultivated farm land and the grain produced indicates the relative rapid growth in grain productivity during this period.

Figure 2.1: Progress in grain production between 2013/14 and 2017/18

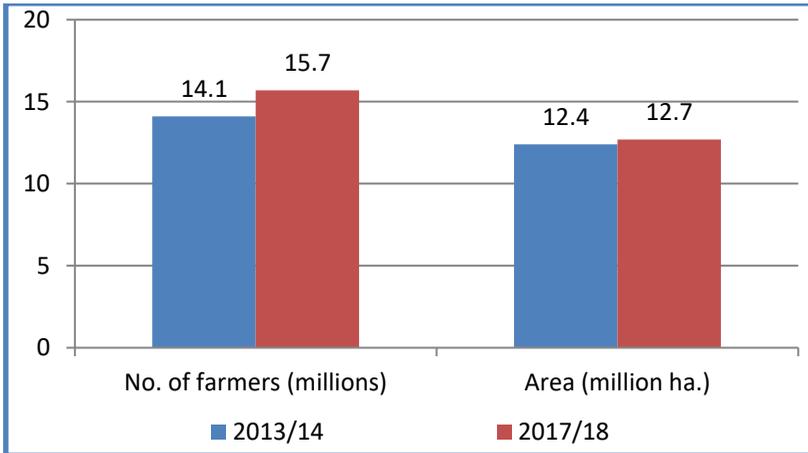
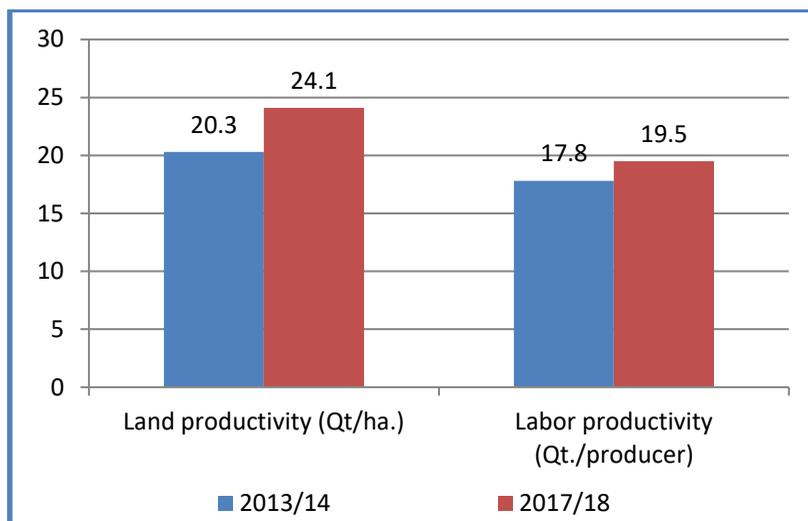


Figure 2.2: Progress in land and labor productivity between 2013/14 and 2017/18



Source: Computed based on data from CSA annual reports.

The average land and labor productivity in grain production has increased by 19% and 10% to 24 qt/ha and 19.5 qt/producer, respectively, in four years period between 2013/14 and 2017/18⁷. Along with the high growth in aggregate grain production, such rapid growth in land and labor productivity should have been reflected in grain price in a way that pass on part of the happiness experienced at farm level to the kitchen of the average grain consumers. As a country where the average consumer is reported to spend close to 60% of his/her income for food, large increase in grain

⁷ It is important to note the assumption made regarding the makeup of the grain crops produced in 2013/14 and 2017/18. It is assumed that there is no much or significant difference in the makeup of the different crops considered as grain crops.

production and the subsequent supply to market is normally expected to lower the inflation rate. But official statistics indicates that the general price and food price index has increased by 52 and 57 percentage points, respectively, between 2013/14 and 2017/18. All these inconsistency could be either explained by problems in the official grain statistics or/and other Ethiopia's peculiar macro-economic factors that are not considered in this study.

Within the category of grain crops, cereals are the major food crops both in terms of the area they are planted and in the volume of production harvested. They are produced in larger volume compared with other crops because they are the principal staple crops. Of the three crops, cereals contributed about 80% (10.2 million ha) and 88% (267.8 million qt.) to total grain area and production harvested in the 2017/18 crop year, respectively (Figure 2.3 to 2.5).

Between 2013/14 and 2017/18, farmland allocated to cereals production increased by 4 percentage points, while the total harvest grew by 24 percentage points, indicating the relative fast growth in land productivity (compared to area expansion).

In terms of the land allocated to the different crops that make cereals, teff, maize, sorghum and wheat took up 23.9% (about 3,023,284 hectares), 16.8% (about 2,128,949 hectares), 15.0% (1,896,390 hectares) and 13.4% (1,696,907 hectares) of the grain crop area, respectively (CSA, 2018). Similarly, in terms of production, Maize, teff, wheat and sorghum made-up 27.4% (83,958,872.4 quintals), 17.3% (52,834,011.6 quintals), 15.2% (46,429,657.12 quintals) and 16.9% (51,692,525.40 quintals) of the grain production, in the same order (CSA, 2018).

Figure 2.3: Progress in cereals production between 2013/14 and 2017/18

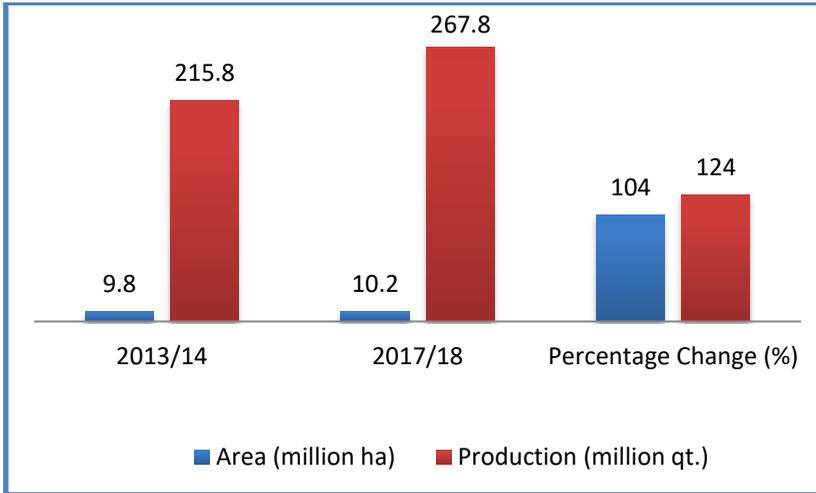


Figure 2.4: Progress in production of pulses between 2013/14 and 2017/18

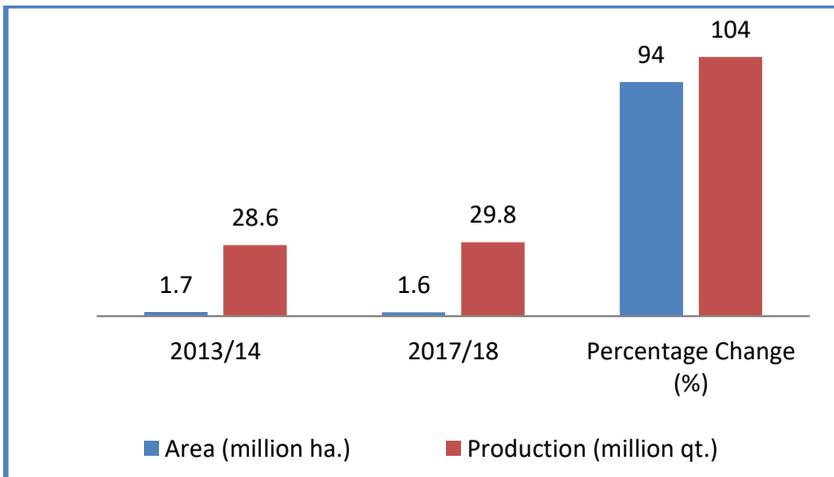
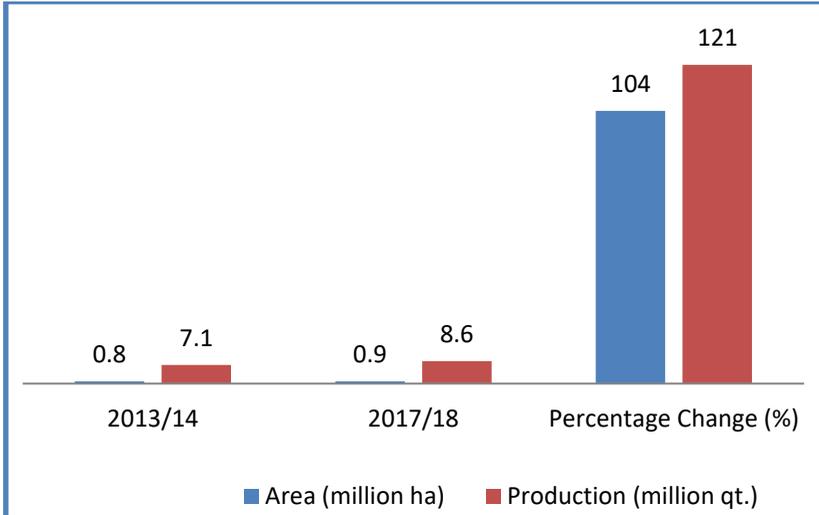


Figure 2.5: Progress in production of oil crops between 2013/14 and 2017/18



The second most common grain crops are pulses which are grown in different volumes across the country. Pulses grown in 2017/18 covered 12.6% (1,598,807 hectares) of the grain crop area and 9.7% (about 29,785,880.9 quintals) of the grain production. Faba beans, haricot beans (white), haricot beans (red), and chick peas were planted to 3.5% (about 437,106 hectares), 0.7% (about 89,382.7 hectares) 1.7% (about 216,803.9 hectares) and 1.9% (about 242,703.7 hectares) of the grain crop area. The production obtained from faba beans, haricot beans (white) haricot beans (red) and chick peas was 3.1% (about 9,217,615.4 quintals), 0.5% (about 1,482,128.4 quintals), 1.2% (3,727,664.9 quintals) and 1.6% (4,994, 255.5 quintals) of the grain production, in that order (CSA, 2018).

Oil crops accounted for 6.7% (about 846,493.5 hectares) of the grain area and 2.8% (about 8,550,738.16 quintals) of the grain produced in 2017/18 crop year (CSA, 2018). Over the past four years, area allocated to oil crops increased by 4 percentage points, while production increased by five times or 21%, indicating similar growth trend in land productivity of oil crops production. Neug, sesame and linseed covered 2.3% (about 290,494.9 hectares), 2.9% (about 370,141.1 hectares) and 0.62% (about 79,044.5 hectares) of the grain crop area and 1.1% (about 3,233,448.8 quintals), 0.8% (about 2,559,034.3 quintals) and 0.3% (about 882,096) (CSA, 2018).

2.3 Agricultural Input Use

A range of factors affect grain production and productivity. Apart from weather conditions, use of modern farm inputs like fertilizers, improved seeds, pesticides as well as irrigation and modern farm management practices are important to enhance production and productivity. The efficiency of output markets in terms of transmitting the fair share of consumers' price to producers is very important. In this section, the performance of the sector in terms of the use of some of these agricultural inputs is discussed.

2.3.1 Fertilizer

Fertilizer is one of the major agricultural inputs that help Ethiopian smallholders to increase their production. The use of fertilizer has also increased over time as suitable farmland has increasingly become scarce due to population pressure, lack of alternative non-farm employment opportunities and other factors like land degradation.

Official report indicates that in 2017/18 agricultural year a total of 12.3 million quintals of fertilizers was applied on 6.9 million hectares of farmland cultivated by different crops. Of all the quantity of fertilizers used, 1.4 million quintals was Urea & DAP, 8 million quintal was that of NPS & Urea, about 1.9 million quintal was NPS, about 500 thousand quintal was DAP, and about 428 thousand quintals was Urea.

Most of the fertilizer used was applied to cereal crops (about 10.4 million quintal) of which teff accounted 3.2 million quintals, wheat 2.4 million quintals and maize 3.4 million quintals. The largest area to which fertilizer was applied was that of teff (about 2.4 million hectares) followed by Maize (about 1.7 thousand hectares) and wheat (nearly 1.5 million hectares) crops (CSA, 2018b).

As shown in Figure 2.6, compared to five years ago, the number of fertilizer users increased by 19.6% point in 2017/18 crop year when 86.2% of the 15.7 million smallholders were reported to apply fertilizers on their crop land. Similarly, the intensity of fertilizer use has increased slightly during this period. In 2012/13, the average farmer applied only 1.08 qt. of fertilizers on a hectare of farmland, which has been increased by 65% in 2017/18 when the average application rate reached 1.78 qt/ha. However, there is no change in terms of fertilizer use per farm household. The average fertiliser used was only 0.51 qt/household both in 2012/13 and 2017/18, indicating the impact of declining farm size during the same period (Figure2.8).

Figure 2.6: Changes in fertilizer users over the past five years

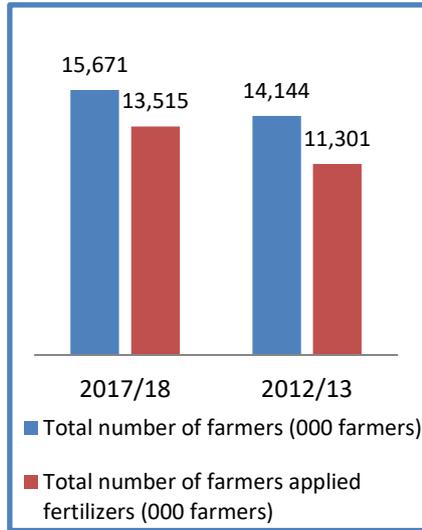


Figure 2.7: Inorganic fertilizers application

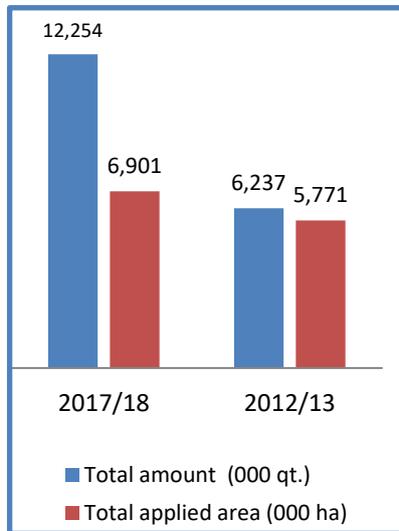
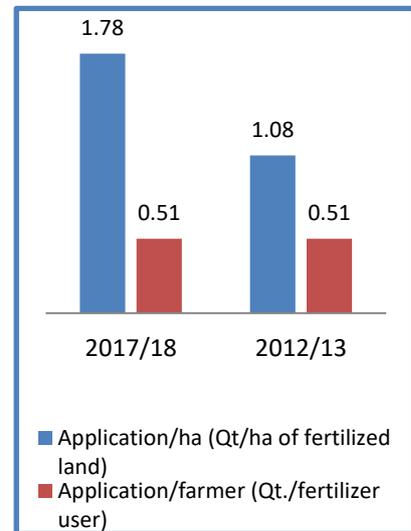


Figure 2.8: Intensity of improved seeds use



Source: Computed based on data from CSA (2018b) and CSA (2013)

2.3.2 Improved Seeds

Improved seeds are important inputs in terms of increasing agricultural productivity. They also play central role in rising and optimizing the benefits associated with the use of fertilisers. Though the use of improved seeds in Ethiopia has been growing over the past few years, it is still low.

The total volume of improved seeds used in 2017/18 was estimated to be about 833 thousand quintals which was applied on 1.4 million hectares of farmland (Figure 2.10). Close to 4.5 million of farmers which represent about 29% of the total number of farmers are reported to have used improved seed in the reporting year (Figure 2.9). Compared to the situation five years ago, the use of improved used (in 2017/18) increased by 62% and 140% in terms of the number of improved seed users and area on which seeds applied, respectively. The share of improved seed users has increased from about 20% to 29% over the past five years, indicating an average annual growth of 1.8%. The average amount of seed applied on a hectare of farmland was 58.6 Kilogram in 2017/18, which marginally improved from 57.7 Kg/ha reported five years ago.

Maize and wheat are the two most important crops in terms of improved seeds usage. The two crops accounted 61% in terms of quantity and 92% in terms of area covered by improved seeds (CSA, 2018b). Official report indicates the larger volumes of improved seeds used were that of wheat and maize which amounted 316 thousand and 196 thousand quintals, respectively. The largest area to which improved seeds applied was under maize and wheat estimated

about 1.2 million hectares and 111 thousand hectares, respectively, of the total 1.4 million hectares of farm land planted with improved seeds in 2017/18 crop year (2017/18) (CSA, 2018b).

Despite some improvements over recent years, the use of improved seeds in Ethiopia is in general very low. As indicated above only 29% of Ethiopian farmers use improved seeds in the reporting year, which is very low even to the 86% of farmers who applied inorganic fertilizers in the same year. Such wide gap in the use of these two important inputs has important implications as it significantly impacted the complementarity of the combined use of the two inputs.

Figure 2.9: Number of farmers using improved seeds

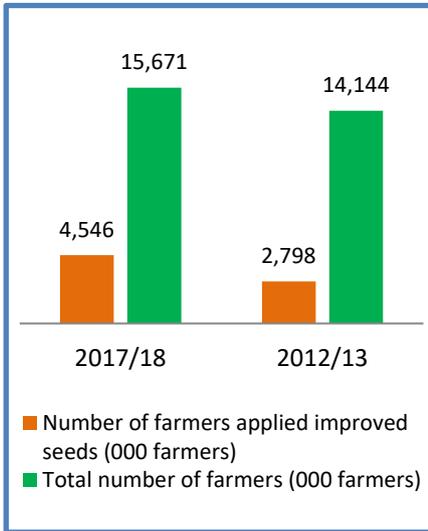


Figure 2.10: Amount of improved seeds used

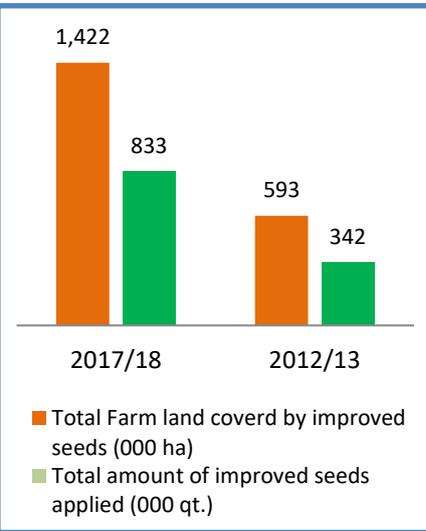
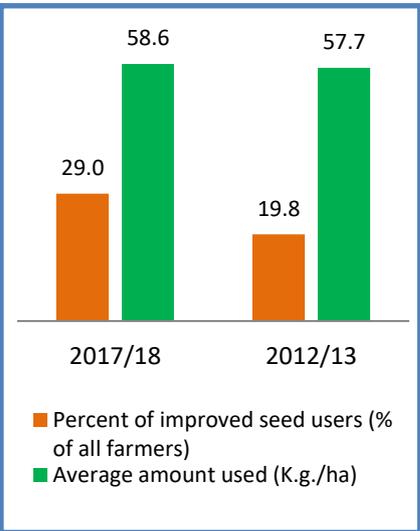


Figure 2.11: Intensity of improved seeds use



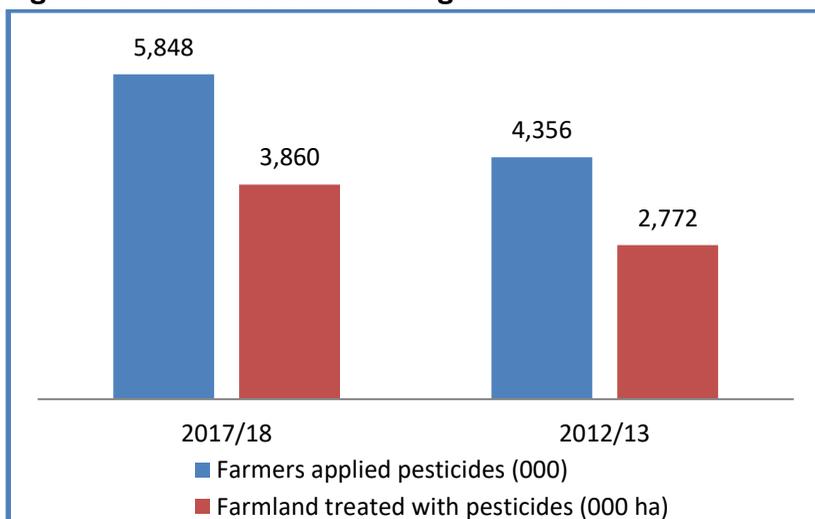
Source: Computed based on data from CSA (2018b) and CSA (2013)

2.3.3 The Use of Pesticides

At times when rampant pests and weeds damage crops, the use of pesticides is indispensable. In areas where crop damage caused by pests and weeds was reported the application of pesticides is more evident in the survey results. CSA report indicates that pesticides applied on more than 3.9 million hectares in 2017/18 (CSA, 2018b). The number of holders who applied it was about 5.8 million. Most of the crop area to which pesticide was applied was under teff (1.5 million hectares) and wheat (948 thousand hectares).

As indicated in Figure 2.12, below, the use of pesticide increased by 34% and 39% in terms of the number of farmers and farmland treated with pesticides over the past five years.

Figure 2.12: Pesticide use among small farmers



Source: Computed based on data from CSA (2018b) and CSA (2013)

2.3.4 Irrigation

As it enables to increase the frequency of crop production and alleviate water shortage caused by poor rains /dry seasons, irrigation is important in improving productivity and income of farmers. But because of constraints like capital and technical know-how only small number of farmers applied irrigation on their farm. CSA survey report shows that the practice of irrigation in the country has a long way to go to bring about the desired change (CSA, 2018b).

The total irrigated crop area in the country within the private peasant holdings was estimated around 181 thousand hectares. The farmers who practice irrigation were estimated 1.4 million. This indicates that 1.4% of farmland cultivated by small farmers was irrigated in 2017/18. In terms of number of farmers, out of the estimated 15.7 million small farmers, 8.9% were irrigation users (CSA, 2018; CSA, 2018b).

The progress over time is also slow. Over the past five years, only 30,000 ha were brought into irrigation in the smallholder sector (CSA, 2013; CSA, 2018b). In other words, the reported 181,000 irrigated farmland in 2017/18 exceeds the 2012/13 estimated 151 thousand irrigated land by only 20%. Most of the area irrigated was under maize, sorghum and teff estimated 25,281 hectares for Maize, 24,914 hectares for sorghum and 10,400 hectares for teff (CSA, 2018b).

2.4 Livestock Population and Production

Ethiopia's livestock population is the largest in Africa. The livestock sector is important for Ethiopia both in terms of its contributions to agricultural value-added, national gross domestic product (GDP) and export. Livestock sector represented about 25.3% of the agricultural GDP in 2016/17. During the same year the livestock sector grew by 4.5% (NBE, 2016/17).

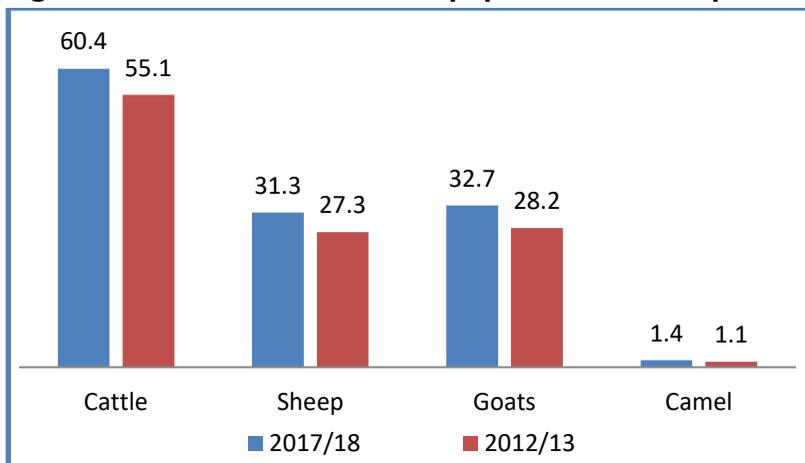
In 2014/15, the livestock population was estimated at about 60.4 million heads of cattle, 31.3 and 32.7 million heads of sheep and goats, respectively, and 1.4 million heads of camel (CSA, 2018)⁸. Compared to the population size five years ago, cattle, sheep, goats and camel population increased by 9.6%, 14.7%, 15.9% and 27.3%, respectively in 2017/18 (Figure 2.13). Despite high population size, livestock productivity in Ethiopia, however, is very low, even compared to some neighboring countries like Kenya (EEA, 2016).

In terms of production system, livestock is produced under two major production systems in Ethiopia: the sedentary mixed crop-livestock production system and the nomadic pastoral or agro-pastoral production system. The other less important, but growing, livestock production systems are small-scale peri-urban and urban production systems and medium- to large-scale commercial livestock production systems. The pastoral system, which has huge potential for development is practiced in arid or semi-arid lowland (i.e. below 1,500

⁸ The Annual Livestock Sample Survey of CSA covered the rural agricultural population in all the regions of the country except the non-sedentary population of three zones of Afar & six zones of Somali region.

meters) areas, which experience strong seasonal fluctuations in feed availability and quality. The pastoral production system and commercial livestock production system demand concerted policy support. Policies and institutions that help to mitigate the impact of environmental challenges and that are suitable for the life style and socio-economic conditions of pastoralists are crucial for any sustainable exploitation of this particular production system.

Figure 2.13: Estimated livestock population of Ethiopia



Source: CSA Reports

In terms of competitiveness, Ethiopian livestock export sector is less competitive globally. Similar, to the case of coffee productivity, livestock productivity in Ethiopia is low when compared to its competitors. The average meat carcass weight for cattle, goat, sheep and chicken in Ethiopia is 108 kg., 8.5 kg., 10 kg. and 800 grams. This is far lower than the global average as well as the average for Africa as well as East African countries (Table 2.1).

Table 2.1: Livestock productivity in Ethiopia and Africa (yield per carcass weight)

	Ethiopia	Kenya	Africa
Cattle	1081	2125	2013
Sheep	100	140	141
Goat	85	120	120
Camel	1700	3000	1575
Chicken	8000	12011	11885

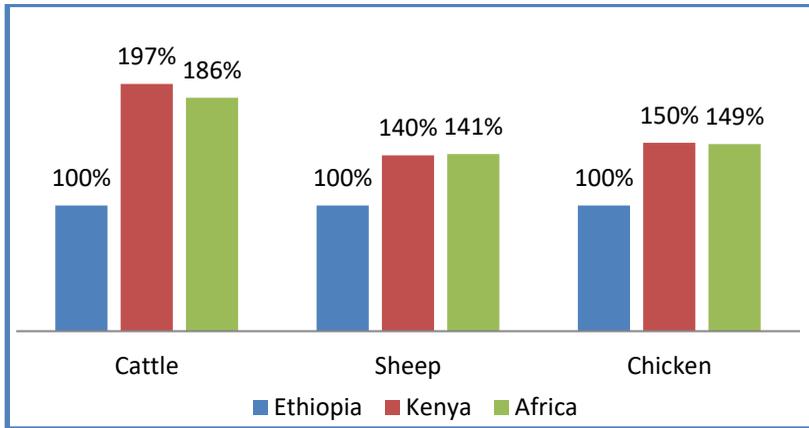
Source: FAO database

Note: Except for chicken carcass yield is measured in hectogram per animal, for chicken, the 0.1gm/animal. 1 hectogram is equal to 100 gram.

As shown in Table 2.1 below, the average carcass yield weight of cattle, sheep and chicken in Kenya exceeds their Ethiopian counterparts by 97%, 40% and 50% respectively. Similarly, the average African country significantly outperforms Ethiopia's livestock meat productivity (measured in terms of yield/carcass weight).

As indicated in Figure 2.15 below, dairy cow productivity is far worse in Ethiopia. The average Kenyan and African cow produced 5,868 and 5,343 hectogram milk per cow while their Ethiopian counterpart dairy cow produced far less than half of this yield (only 2,649 hg/cow). Part of such difference could be attributed to genetic disparities in the livestock breeds, but significant part of the disparity in the reported livestock yield is attributed to gaps in supply and quality of animal feed, veterinary services and the livestock management system between Ethiopia and its counterpart African countries.

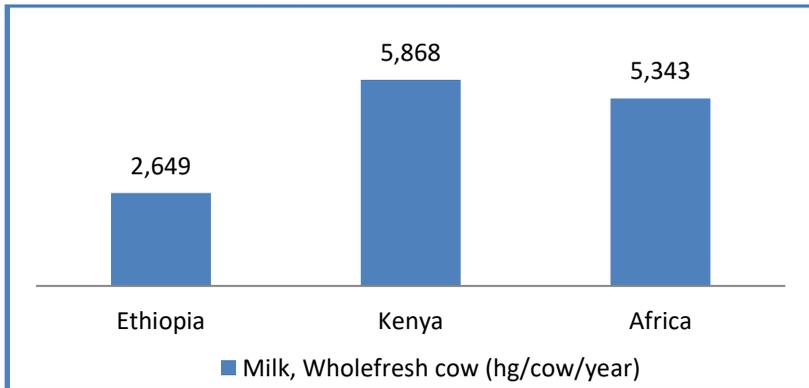
Figure 2.14: The relative performance of Ethiopia's livestock productivity in comparison to Kenya and Africa.



Note: The bar for Ethiopia represents the reference point for the comparison of the country’s livestock productivity (measured as yield/carcass weight of the respective livestock types) with the productivity level in Kenya and the average of African country.

Source: Computed based on FAO data.

Figure 2.15: Average productivity of dairy cow (2016)



Source: Computed based on FAO data.

Ethiopia has huge population of livestock but the livestock production system is in general low-input and small-scale activity. This

deters the potential the country has in terms of production, domestic supply of animal protein and export revenue.

The general very low productivity of livestock in Ethiopia should get proper attention by policy makers. Potential interventions should be comprehensive and address critical factors along the whole value chain - at pre-production (especially feed, water and genetic factors), production stage (enterprise size, management and input supply) and post-production (marketing, transport and processing). It is also important to consider potential interventions at high potential areas, and to scale up through gradual learning approach. Albeit different level of emphasis, any intervention should aim to target the whole value chain and actors working at pre-production, production and post-production stages of the value chains.

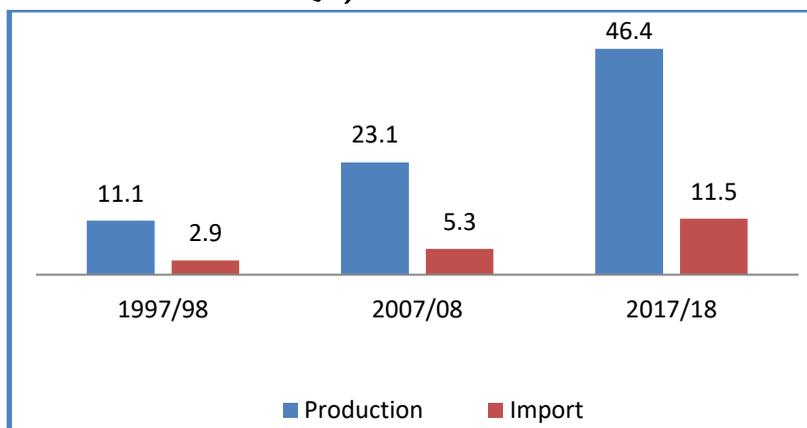
2.5 Food Security and Import

Food security is a key policy strategy for the Ethiopian government. Ethiopia has also great potential in producing sufficient grain at least for domestic consumption. However, data reveals conflicting progress and government's success in terms of translating government policy strategy into practice.

Official statistics on grain production indicates that the country managed to produce 30.61 million metric tons of grain in 2017/18 year (CSA, 2018). The net production available for domestic consumption and/or export after deducting the 14.4% of the total grain production that is estimated to be utilized either for seeds (by producers themselves for their next crop season) or animal feed will

be 26.2 million metric tons⁹. After deducting 7.7 million quintals of grains, which is estimated to be exported this year (assuming it as par to the level exported last year)¹⁰, the net amount available for domestic consumption will be 25.43 million metric tons, indicating a per capita grain production of at least 2.3 quintals¹¹, which is still above a food/grain self-sufficiency level at national level¹².

Figure 2.16: Volume of wheat production and import (in Millions Qt.)



⁹ This allowance for seeds and animal feed comes from CSA report on crop utilization by smallholders.

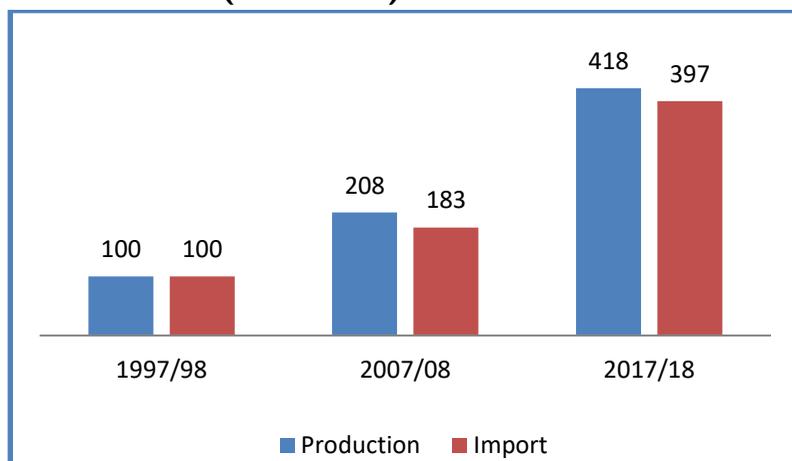
¹⁰ FAO data indicates that Ethiopia exported 13,726 tons, 461,196 tons and 296,156 tons of cereals, oilseeds and pulses in 2016 crop year.

¹¹ Per capita grain production was estimated based on estimated 110 million populations. The 2.3 qt. per capita grain production is higher than the 2.1 qt./capita grain that is considered internationally as a benchmark for the minimum dietary energy requirement of a given person.

¹² Though CSA’s production estimate is made for post-harvest period, which could consider loss of grain during harvest (on field and may be on producers’ store), but any loss once produce left farmers store is not considered in this estimation.

Despite such reported high level of production, and the notion that food production is the base for food security in a country like Ethiopia where the livelihood of over 80% of the population depends on agriculture, Ethiopia continue to import considerable amount of food grains especially wheat to meet the food demand of its growing population.

Figure 2.17: Wheat production and import index (1997/8=100)



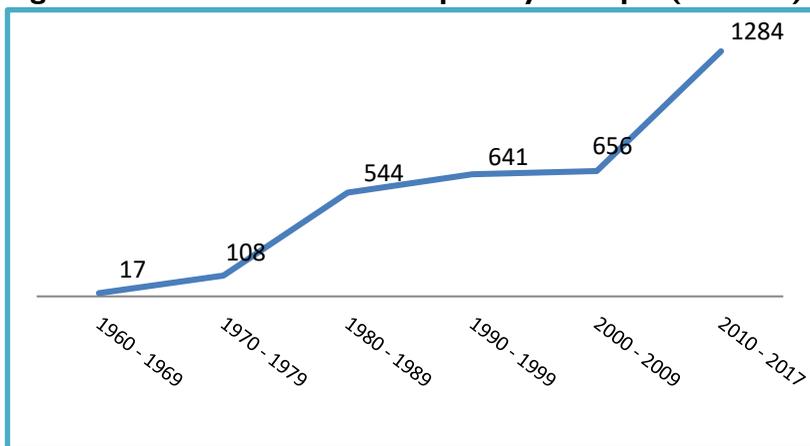
Source: Computed based on CSA data (production) and FAO data (Import)

CSA annual agricultural production statistics, for instance, indicate that wheat production was doubled every ten years, indicating an average growth rate of 10% per annum)¹³ and this shows the domestic potential to increase wheat production even further. Wheat import

¹³ CSA annual report indicates that aggregate wheat production was 11.1 million, 23.1 million and 46.4 million quintals in 1997/8, 2007/8, and 2017/18 in the respective agricultural years.

has also increased by similarly percentage points during the same period (Figure 2.17), which has forced the country to spend a considerable amount of its foreign currency for wheat import (Figure 2.18).

Figure 2.18: Trends in wheat import by Ethiopia ('000 MT)



Source: <https://www.indexmundi.com/agriculture/?country=et&commodity=wheat&graph=imports>

Ethiopian policy makers spend more than half a billion USD per annum for wheat import over the past decades which seems a puzzle, at least under such demonstrated capacity to increase domestic wheat production, and growing problem of foreign currency shortage for the development of the economy.

A fast growth in import with a corresponding fast growth in production is an unprecedented event. Though part of the story could be explained by the fast growing population and other macro-

economic variables, this very rare trend also raises questions on the national production statistics. It also implies the importance of defining food security in its wider meaning that recognize the wide gap in production and entitlement, and its implication for the ongoing food security programs in rural areas as well as the urban wheat subsidization to continue.

Food Security Status

Though the level of undernourishment has declined by about 22% over the past two decades, about 28 million Ethiopians (about 27% of the population) are undernourished in 2016/17 (see Table 2.2). As a result millions of Ethiopians depend on food security programs. Over 7 million rural people in Ethiopia are chronically food-insecure and receive support to meet their food requirements annually through the rural productive-safety net program (RPSNP). Malnutrition rates are very high with over one-third of Ethiopia's *woreda's* officially classified as facing a food-security and nutrition crisis (FAO, 2016).

Though food security is more than production¹⁴, increased domestic cereals production has helped to offset the negative effect of the very high population growth. As shown in Figure 2.19, per capita cereal production grew from a little less than 100 kilogram in 1993 to a little over 250 kilogram in 2017. This level of per capita grain production is sufficiently high to indicate food/grain self-sufficiency at national level, even after considering an estimated 15% of grain use for non-

¹⁴ Food security is defined as a situation that exists when all people, at all times, have physical, social and economic access to sufficient, safe and nutritious food that meets their dietary needs and food preferences for an active and healthy life (Alexandratos, N. and J. Bruinsma, 2012).

consumption purposes (that include grain use as seed by farmers themselves and for animal feed)¹⁵. FAO statistics on food security has also indicated that Ethiopia’s domestic food production is on average sufficient to satisfy the average dietary energy supply requirement of the country¹⁶.

Table 2.2: Food security status in Ethiopia (3-year average)

Year	Prevalence of undernourishment (%)	Number of people undernourished (millions)
1999-2001	51.9	34.5
2000-2002	49.0	33.5
2001-2003	46.7	32.9
2002-2004	44.2	32.0
2003-2005	42.0	31.3
2004-2006	39.7	30.4
2005-2007	38.5	30.3
2006-2008	37.2	30.1
2007-2009	35.6	29.6
2008-2010	33.7	28.8
2009-2011	32.1	28.1
2010-2012	31.0	27.8
2011-2013	30.2	27.9
2012-2014	29.4	27.8
2013-2015	28.5	27.6
2014-2016	28.8	28.6

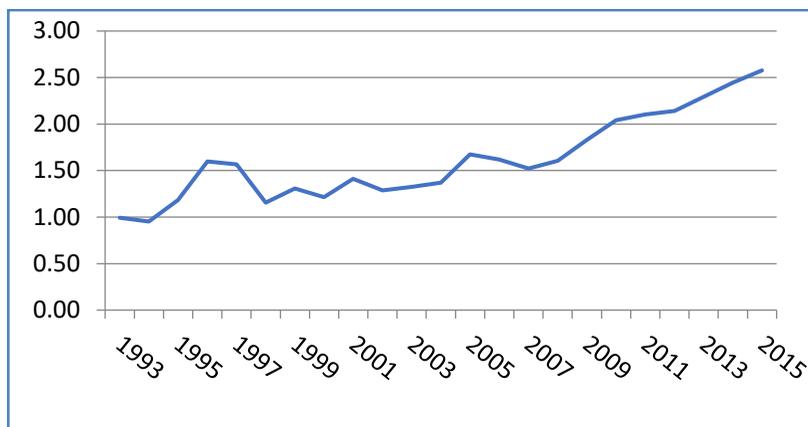
Source: FAO databases. <http://www.fao.org/faostat/en/#country/238>.

Figure 2.19: Cereals production, per capita (qt/person)

¹⁵ Loss of grain during harvest (on field and may be on producers’ store) is not considered in such estimation.

¹⁶ According to FAO, the average dietary energy supply adequacy ratio for Ethiopia reaches 99% since 2014 (<http://www.fao.org/faostat/en/#country/238>).

PERFORMANCE OF THE AGRICULTURAL SECTOR



Source: Computed based on FAO data.

While the above rosy statistics indicates the food supply situation at nationally aggregate level, food security is basically defined at personal level in terms of the capacity of individuals to access sufficient food (both in quantity and quality) at any time. While acknowledging the significant progress the country achieved over the past decades, data from international sources indicates relatively high level of food insecurity in the country.

Cereals Import

Ethiopia is a major importer of food crops. Cereals import has been tripled over the past twenty years, from 585,190 tons per annum during the 1993-1997 period to 1.9 million tons during the 2008-2013 period. During the same period, total import bill for cereals import has been growing from a little over 125 million USD to 677 million USD, indicating an increase of over five times. Part of this increase is attributed by the rise in the value of cereals imported. The country

spent about 214 USD per ton of cereals imported in the mid-1990s, but this value increased to 400 USD/ton in late 2000s and early 2010s, indicating 85% increase in the value the country forced to spend to import the same amount of cereals.

Table 2.3: Cereals import to Ethiopia

Period	Quantity (tons/annum)	Value per annum (1000 US\$)	Unit Value (USD/ton)
1993 - 1997	585,190	125,462	214
1998 - 2002	873,669	133,759	153
2003 - 2007	913,946	248,225	272
2008 - 2013	1,898,611	677,124	357
2014 - 2016	1,638,023	654,540	400

Source: FAO database

The growing trend of wheat/cereals import has become a chronic problem and seems to have reached a level where one would be forced to question the country’s food security and development strategy. It is not only the growing wheat import that drains the nation’s limited foreign currency; the country also pays a large sum of its foreign currency to import a range of processed foods that appear in the country’s growing supermarkets.

It is high time for the country to find mechanisms that enable its smallholders to produced sufficient amount of wheat that will save the country from the growing import bill. It is important to note that agricultural producers (both smallholders and otherwise) demands three basic things to operate successfully, i.e. *adequate incentives* to

produce, a secure *resource base* (farmland and water) and *access* to markets for outputs and inputs, including technology. Most of agricultural policies implemented over the past decades either undermine key-ingredients of development policies (e.g. incentives and motivations) or biased to one or more of these elements (farm land productivity over agricultural labor productivity; or the role of the public-sector over the role and support given to the private sector).

Chapter III

The Large and Medium Scale Manufacturing Industries: Performance during the first GTP II Implementation Year (2015/16)

3.1 Introduction

Manufacturing industry plays crucial role in the economic transformation process of a country, mainly due to the fact that the sector generates technologies and produce machinery that would help to enhance the productivity of its own sector and other sectors of the economy. Ethiopia has embarked on the process of economic transformation, which aimed at shifting the structure of the economy from largely agrarian dominance towards manufacturing industry. This study tried to assess the performances over the period (2009/10-2015/16) but focusing on the first GTP II implementation year (2015/16).

3.2 Manufacturing Industry Contribution to the Economy

Agriculture, industry and service sectors have, an average, contribution of about 41.5 percent, 12.7 percent and 45.8 percent, to the Gross Domestic Product (GDP) of the country, respectively for

GTP I implementation period(2010/11-2014/15). Compared to the base case (2009/10) figures, the contribution of agriculture, on average, declined, while those of industry and service sectors have increased during GTP I implementation period the same period. During the first GTP II implementation year (2015/16), the share of agriculture, industry and service sectors has reached about 33.8 percent, 15.4 percent and 43.6 percent, respectively indicating slight change in the structure of the economy.

Despite the preparation and execution of Growth and Transformation Plan (GTPs), promotion of industrial development and exerting of various efforts to attract private domestic and foreign investment into the manufacturing sector, no significant results was achieved over the last several years. The contribution of the manufacturing industry sector in the total economy has only increased from 3.9 percent in 2009/10 to 5 percent in 2015/16. During the same period, the share of the large and medium scale manufacturing industry has shown slight increase from year to year while the share of the small and cottage industries kept declining over time. This, in turn, is contrary to the expectation given the utmost government attention to the small and cottage so as to absorb the growing number of youth unemployment (Table 3.1).

Table 3.1: Contribution in the total value added by sectors, share in %

Sectors	Base Year, 2009/10	GTP I						1st GTP II year, 2015/16
		2010/11	2011/ 12	2012 /13	2013 /14	2014 /15	(Period average)	
Agriculture	45.2	44.4	42.9	41.8	39.9	38.5	41.5	33.8
Industry	9.8	10.4	11.5	12.9	13.7	15.1	12.7	15.4
Manufacturing	3.9	4.0	4.1	4.3	4.6	4.8	4.4	5.0
Large and Medium Scale	2.5	2.6	2.7	3.1	3.4	3.7	3.1	4.0
Small Scale and Cottage	1.4	1.4	1.3	1.2	1.2	1.1	1.2	1.0
Services	45.0	45.2	45.7	45.3	46.4	46.3	45.8	43.6

Source: MOFEC, National Accounts Directorate (Various Issues)

3.3 The Structure of the Manufacturing Industries

Two types of linkages are very critical: the manufacturing–agriculture sector and the intra manufacturing industry linkages. The industry–agriculture linkage entails one providing inputs for the other so that each sector’s dependence on import declines. Similarly, intra–manufacturing industry linkage envisions the existence of sub- sectors producing finished consumer, intermediate and capital goods so that each subsector is getting what it needs from the other sub-sectors. Thus, the manufacturing sector needs to be structured in such a way that it has to establish strong linkages with the agriculture sector and within itself. This linkage can be strengthened, among others, by establishing missing manufacturing industries, such as fertilizer industry and manufacturing industries which produce critical chemical inputs, machinery and spare parts. Given the high capital intensity of these missing manufacturing industries, private sector may not find them attractive and hence government has come into picture.

CSA data shows that the structure of the manufacturing industry sector has remained more or less the same over a long period of time, dominated by consumer goods producing sub-sectors. The share of food and beverage, textile and leather subsectors altogether account, on average, for over half of the total value added of the sector over the period (2010/11-2014/15). Compared to the base year (2009/10) of 43.6 percent and the first GTP II implementation year of 46.4 percent, the concentration of the sector in these three subsectors was higher during GTP I period (Table 3.2). This is contrary to the expected move towards intermediate and capital

goods production away from consumer goods production, which, in turn, could have helped to strengthening the interdependence with the manufacturing industry sector.

There have been variations from a sub-sector to another. With regards to the priority subsectors, despite the various generous incentive scheme the share of value added of the textile and leather has consistently declined overtime, which could be due to the relatively higher increase in the value added of the food and non-metal subsectors.

The overall structure of the manufacturing industry has shown no marked change for long being dominated by consumer goods producing light industries, and the relative value added share of the exporting manufacturing industry subsector has been declining thereby indicating increased import substituting enterprises.

Table 3.2: The structure of manufacturing industries, of sub-sector in VA, share in %

	Base year, 2009/10	GTP I Period					period average	GTP II, 1st Year (2015/16)
		2010/11	2011/12	2012/13	2013/14	2014/15		
Food & Beverages	34.95	53.97	32.46	32.73	37.91	49.21	41.26	42.22
Tobacco	(0.14)	1.52	1.30	1.45	1.14	1.50	1.38	2.35
Textile	6.26	1.52	0.51	1.57	0.33	2.43	1.27	2.28
Wearing Apparel	1.69	1.45	1.72	(0.05)	1.61	0.64	1.07	3.50
Leather	2.34	7.68	6.21	8.84	7.53	3.99	6.85	1.92
Wood	0.07	0.81	0.04	0.24	0.09	0.45	0.33	0.64
Paper & Printing	4.89	5.03	3.64	3.38	3.56	2.39	3.60	1.87
Chemical	8.10	8.89	8.76	11.30	9.01	5.41	8.67	6.38
Rubber & plastic	7.38	5.07	5.88	5.86	7.72	1.56	5.22	7.34
Other Non-metal	19.24	14.17	22.70	17.24	18.73	12.94	17.16	13.34
Basic Iron	1.52	3.55	2.95	2.33	2.10	3.97	2.98	5.46
Fabricated Metal	6.93	(7.15)	7.57	7.50	6.18	7.37	4.29	5.73
Machinery & Equipment	0.49	0.45	0.02	0.18	0.74	(0.12)	0.25	2.70
Motor Vehicle	2.33	1.06	2.87	5.49	1.42	8.45	3.86	2.63
Furniture	3.96	1.98	3.35	1.94	1.93	(0.19)	1.80	1.63

Source: CSA, Large and Medium Scale Manufacturing Industries (Various Issues)

3.4 The Growth in the Number of Enterprises

Over the GTP I implementation period, the number of manufacturing industries has been growing, on average, by 7.9 percent per annum. The achieved growth was higher compare to the base case (2009/10) when the growth rate declined by -1.4 percent and the first GTP II implementation year the growth of 4.6 percent. The relatively lower performance registered during the first GTP II implementation year could well be explained among others by the protest movements and political instability in the investment concentrated areas of the Oromia regional state. During the first GTP II implementation year (2015/16), the highest growth in the number of enterprises was observed in the wearing apparel and machinery and equipment subsectors. While the least growth rates were observed in the leather and other non-metal sub-sectors. The shares of food and beverage, other non-metal, and furniture sub-sectors in the total manufacturing sector in 2015/16,wereabout 24.1 percent, 17 percent and 12.7 percent, respectively (Table 3.3).

Table 3.3: Trends in the growth and share of enterprises

Industrial group	Base year, 2009/10	GTP I Period					GTP I, Period average	1st year of GTP II
		2010/11	2011/12	2012/13	2013/14	2014/15		
growth in %								
Food & Beverages	1.8	19.9	-6.7	7.3	9.6	23.1	10.7	-14.5
Tobacco	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Textile	-7.0	-7.5	75.7	35.4	-21.6	17.4	19.9	233.3
Wearing Apparel	24.4	-21.6	-2.5	-41.0	34.8	174.2	28.8	15.3
Leather	28.1	23.7	-7.1	10.7	-3.4	-26.4	-0.5	-13.6
Wood	12.5	59.3	-18.6	27.1	7.9	0.0	15.1	-32.3
Paper & Printing	-3.1	-0.8	0.0	2.5	17.6	23.8	8.6	-22.0
Chemical	28.0	-21.9	32.0	48.5	-15.0	-9.6	6.8	-21.2
Rubber & plastic	59.8	-23.7	27.4	14.1	-0.6	54.2	14.3	30.1
Other Non-Chemical	-20.7	-15.1	29.8	5.3	19.7	-10.9	5.7	-6.0
Basic Iron	116.7	0.0	-30.8	40.7	0.0	76.3	17.3	143.3
Fabricated Metal	28.3	-8.4	47.5	-12.5	-4.9	17.9	7.9	29.4
Machinery & equipment	275.0	-60.0	-66.7	500.0	75.0	104.8	110.6	-41.9
Motor Vehicle	-8.3	-27.3	0.0	37.5	-18.2	55.6	9.5	-35.7
Furniture	-22.6	-3.6	38.0	5.3	-15.5	20.4	8.9	4.2
Total	-1.4	-0.2	13.1	8.3	3.9	14.2	7.9	4.6

THE LARGE AND MEDIUM SCALE MANUFACTURING...

	Share in %							
Food & Beverages	26.34	31.64	26.10	25.88	27.30	29.44	28.07	24.08
Tobacco	0.05	0.05	0.04	0.04	0.04	0.03	0.04	0.03
Textile	1.84	1.71	2.65	3.31	2.50	2.57	2.55	8.20
Wearing Apparel	2.35	1.85	1.59	0.87	1.12	2.70	1.63	2.98
Leather	5.25	6.50	5.34	5.46	5.08	3.27	5.13	2.70
Wood	2.49	3.97	2.85	3.35	3.48	3.05	3.34	1.97
Paper & Printing	5.66	5.63	4.98	4.71	5.33	5.78	5.28	4.31
Chemical	4.42	3.46	4.04	5.54	4.53	3.59	4.23	2.70
Rubber & plastic	6.40	4.89	5.51	5.80	5.55	7.49	5.85	9.32
Other Non-Chemical	22.19	18.87	21.66	21.05	24.26	18.93	20.95	17.01
Basic Iron	1.80	1.80	1.10	1.43	1.38	2.13	1.57	4.95
Fabricated Metal	7.09	6.50	8.48	6.85	6.27	6.48	6.92	8.02
Machinery & equipment	0.69	0.28	0.08	0.45	0.76	1.37	0.59	0.76
Motor Vehicle	0.51	0.37	0.33	0.41	0.33	0.44	0.38	0.27
Furniture	12.94	12.50	15.25	14.84	12.07	12.73	13.48	12.69

Source: CSA, Large and Medium Scale Manufacturing Industries (Various Issues)

3.5 Investment in Manufacturing Industries

Investment in manufacturing industries normally goes either to finance the repair and maintenance of existing enterprises or establish new ones. The size of investment in the manufacturing sector has grown, on average by 56.4 percent during GTP I implementation period (2015/16). This was lower than the growth in investment registered in the base year (2009/10), but far higher than the negative growth of -31.2 percent in the first GTP II implementation year. If one considers the size of investment in real terms taking into account effects of inflation, the picture could turn very gloomy. The overall performances of the majority of the sub-sectors during first GTP II year was dismal, which could again be attributed to the then political unrest in the investment concentrated region of the country (Table 3.4).

Table 3.4: Investment in manufacturing industries, growth and share in %

Industrial Groups	Base year, 2009/10	GTP I Period					GTP I, period average	GTP II, 1st Year
		2010/11	2011/12	2012/13	2013/14	2014/15		
growth in %								
Food & Beverages	74.9	43.6	-17.0	116.1	-14.1	137.2	53.2	11.6
Tobacco	32.5	-16.9	-100.0		0.0	-7.2	-31.0	4.0
Textile	4876.0	-88.2	596.0	67.1	-43.1	15.8	109.5	-51.0
Wearing Apparel	-75.4	-17.6	213.9	33.4	-37.9	-42.5	29.8	204.8
Leather	165.0	11.2	-11.5	-7.7	43.8	55.9	18.3	-53.7
Wood	1625.4	-85.1	311.4	-42.3	-42.7	36.8	35.6	-49.0
Paper & Printing	126.1	23.5	9.7	138.7	-33.3	59.0	39.5	-34.2
Chemical	48.9	65.2	44.0	54.5	19.5	-7.8	35.1	-11.5
Rubber & plastic	10.6	50.7	122.0	-9.7	1.6	126.2	58.2	10.6
Other Non-Chemical	-6.6	11.0	617.9	-82.8	11.7	731.6	257.9	-86.2
Basic Iron	280.7	100.3	114.8	-42.7	67.0	79.3	63.7	71.2
Fabricated Metal	302.5	-13.7	66.4	227.7	-43.7	-54.2	36.5	191.1
Machinery & equipment	3600.8	-55.0	-38.0	-15.9	989.2	180.1	212.1	113.4
Motor Vehicle	-58.9	165.2	331.5	174.2	-32.5	760.7	279.8	-82.8
Furniture	-30.8	188.7	34.5	57.2	31.7	12.4	64.9	180.1
Total	90.8	-1.7	136.9	-7.1	-12.9	167.0	56.4	-31.2

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	Share in %							
Food & Beverages	30.08	43.92	15.39	35.78	35.31	31.37	32.35	50.91
Tobacco	0.89	0.75	0.00	1.23	1.41	0.49	0.77	0.74
Textile	25.27	3.02	8.89	15.98	10.45	4.53	8.57	3.23
Wearing Apparel	1.23	1.03	1.37	1.96	1.40	0.30	1.21	1.33
Leather	6.26	7.08	2.65	2.63	4.34	2.53	3.85	1.70
Wood	2.34	0.36	0.62	0.38	0.25	0.13	0.35	0.10
Paper & Printing	3.53	4.44	2.06	5.28	4.04	2.41	3.64	2.30
Chemical	4.10	6.89	4.19	6.96	9.56	3.30	6.18	4.25
Rubber & plastic	3.68	5.65	5.29	5.14	5.99	5.08	5.43	8.16
Other Non-Metal	15.12	17.08	51.76	9.59	12.30	38.31	25.81	7.69
Basic Iron	1.90	3.87	3.51	2.17	4.15	2.79	3.30	6.94
Fabricated Metal	4.18	3.67	2.58	9.09	5.87	1.01	4.44	4.27
Machinery & equipment	0.74	0.34	0.09	0.08	1.00	1.05	0.51	3.26
Motor Vehicle	0.16	0.43	0.79	2.33	1.80	5.82	2.23	1.46
Furniture	0.50	1.47	0.83	1.41	2.13	0.90	1.35	3.65

Source: CSA, Large and Medium Scale Manufacturing Industries (Various Issues)

Of the total investment in the manufacturing sector during the first GTP II implementation year, about 51 percent went into the food and beverage sub-sector alone thereby indicating availability of small financial resources to be distributed to the remaining 14 sub-sectors, which produce intermediate and capital goods, which could have played critical role in the transformation of the sector and country's economy at large.

3.6 Employment

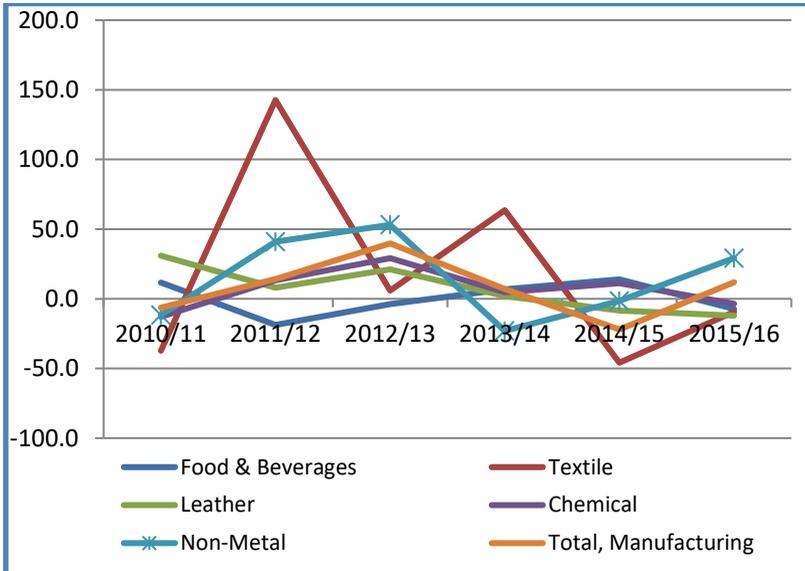
The overall trends in employment by manufacturing industry shows that the sectors has not been absorbing significant share of the labour force which has been released from the rural agriculture sector and universities.

The growth in the number of employees in the manufacturing industry has grown, on average, by 5.9 percent per annum over the period (2009/10- 2015/16). Large decline in the number of employees was witnessed in 2015/16 compared with the preceding year; which, in turn, was mainly due to the huge decline in the number of employment in the major employing sector including food and beverage, leather, etc. This could be attributable to the political unrest the country experienced in the main manufacturing locations during the year under review. Overall, there has been no consistent increase in the generation of employment by the subsectors of the sector.

As can be seen from section 3.7 below, significant size of mid and senior level works has been held by expatriates, especially in the FDI companies

limiting locals to semiskilled and unskilled jobs. This, in turn, tends to slow the technology transfer rate into the local firms and hence hamper the advancement of the country’s economy (Figure 3.1).

Figure 3.1: Trends in employment, growth in %



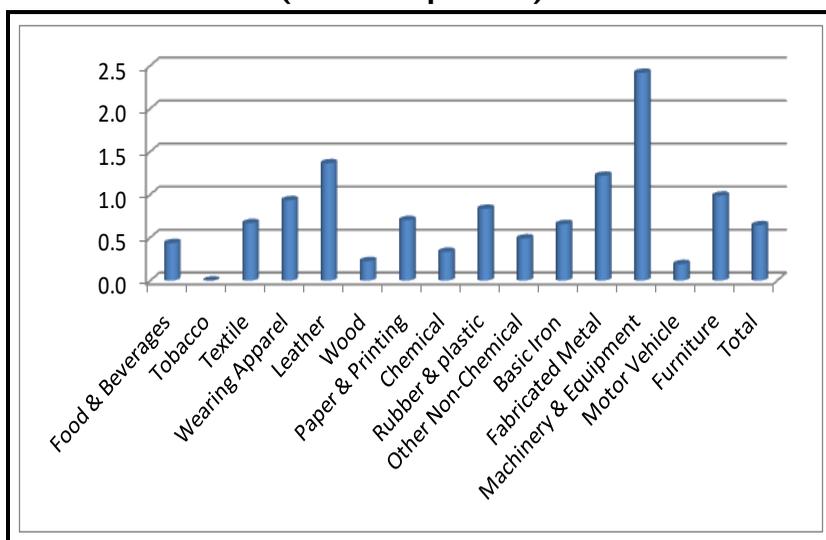
Source: CSA, Large and Medium Scale Manufacturing Industries and Electricity Survey (Various Issues)

3.7 Engagement of Foreigners

Foreigners are engaged in the various activities ranging from management positions to low level work of the manufacturing industries in the country. According to Figure 3.2, of the total persons engaged in the manufacturing industry sector in 2015/16, about 0.6 percent were foreigners. The key sub-sectors in which concentration

of foreigners were witnessed include machinery and equipment (2.4 percent), leather (1.4 percent) and fabricated metals (1.2 percent), respectively during the same year. The relatively higher share of foreigners ‘engagement in the fabricated metals and machinery and equipment were mainly due to the high technology intensity of capital good producing sub-sector for which recruiting skilled labour force from the local labour market remained difficult. The presence of higher proportion of foreigners in the leather sector could be attributable to the presence of world class footwear and other leather products producing companies in the country. In fact, most foreign workers are engaged at mid and senior managerial positions (Figure 3.2).

Figure 3.2: Foreign persons engaged in the subsector, in 2015/16(% of total persons)

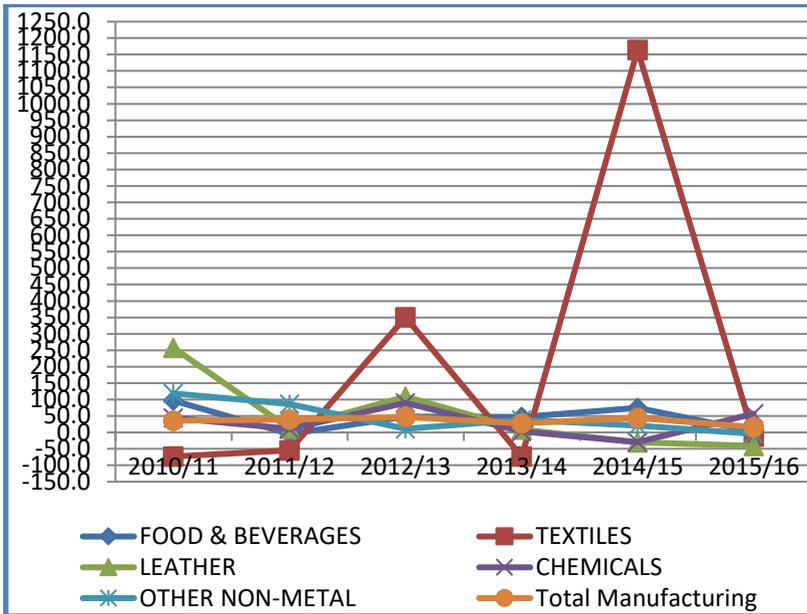


Source: CSA, Large and Medium Scale Manufacturing Industries and Electricity Survey (Various Issues).

3.8 Value Added

Overall, the value added of the manufacturing industry sector has been growing, on average, by 38.6 percent per annum in nominal terms during the GTP I implementation period, which was greater than the growth registered in the first GTP II implementation year of 15.9 percent. The registered growth in the nominal value added of the sector in 2015/16 was higher than the inflation rate of 9.7 registered during the same year thereby indicating positive real growth in the value added of the sector. There has been significant fluctuation in the value added of sub-sectors from year to year. The fluctuations in the growth of the value added of the priority exporting textile and leather sub-sectors has been remarkable during the period (2009/10-2015/16). In 2014/15, for instance, the growth in value added of the textile sub-sector was more than 200 percent but it immediately declined significantly in the next fiscal year. The overall, assessment shows that there has been no sustained growth in the value added of the sector, even the priority exporting sub-sectors for which much attention was given by the government and the country wants to be an industrial hub in Africa (Figure 3.3).

Figure 3.3: Trends in value added, growth in %



Source: CSA, Large and Medium Scale Manufacturing Industries and Electricity Survey (Various Issues)

3.9 Export Receipt

The manufacturing industry’s strategy is orienting towards producing for export. The question here is whether export earnings from the sector has been growing over the last several years? According to CSA data, export earnings from the manufacturing sector have increased from USD 92.1 million in 2009/10 to USD 472.7 million in 2012/13 but declined to USD in 2015/16 indicating continued decline in earnings since 2012/13 (Table 3.5).

Table 3.5: Export receipts, performance versus planned export earnings

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
GTP I Plan, in Million USD							
Textile & Garment	21.8	100.0	200.0	450.0	700.0	1000.0	
Leather	75.73	190.5	296.2	352	416.8	496.9	
Performance, in Million USD							
Textile & Garment	21.4	12.6	90.5	100.0	98.3	26.1	63.2
Leather	38.6	99.4	161.9	236.8	197.0	113.1	84.1
Total manufacturing	92.1	222.0	386.3	472.7	404.6	267.8	236.4
Performance/Plan share, in %							
Textile & Garment	98.0	12.6	45.2	22.2	14.0	2.6	
Leather	50.9	52.2	54.7	67.3	47.3	22.8	

Source: Figures for target is MOFED GTP I, data on export performance is obtained from CSA, Large and Medium Scale Manufacturing Industries and Electricity Survey (Various Issues)

GTP targeted earning US 1 Billion dollars and US 496.9 billion dollars from exporting textile & garment and leather manufacturing industries at the end of the plan period in 2014/15, respectively. But the actual performance at the end of the plan period showed only 2.6 percent and 22.8 percent, respectively indicating a dismal performance which, in turn, could be attributable to supply-side problems facing the export sector (Table 3.5).

If export earnings from manufacturing industries has not been significant enough as planned to finance the development of the country, the next questions raised here is whether it has managed to cover its basic raw material import cost. According to data from CSA, annual export earnings from manufactured products have not been

able to cover the bill¹⁷ for importing the raw materials the sector need. As can be seen from Table 3.6, the total manufactured export receipts which covered about 31.3 percent of its total import bill for raw materials in 2009/10 has continually declined and covered only about 14.8 percent in 2015/16 thereby indicating the balance 85 percent of the bill being financed by export receipts from other sectors or other types of financings (Table 3.6).

In fact, export receipts to bill for importing raw materials ratio vary from one sub-sector to the other. During the year 2015/16, for instance, the priority sub-sectors, i.e., food, textile and leather, have registered about 19 percent, 21.2 percent and 252 percent, respectively. The three sub-sectors have registered better performance compared with the base year (2009/10). As shown in Table 3.6, except for the year 2011/12, the leather subsector has been covering its entire import bill. The textile subsector; however, has shown deterioration during the last two years mainly due to importing of its main input cotton from overseas.

¹⁷ **NB:** The bill considered here includes only expenditure on importing raw materials, not spare parts and machinery and equipment.

Table 3.6: Export receipt to import bill for raw materials

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Food & Beverages	16.29	50.83	25.88	23.78	21.38	29.57	19.02
Tobacco	12.41	1.41	1.41	0.58	0.58	0.41	2.68
Textiles	47.60	53.29	30.67	44.80	112.02	21.95	21.22
Wearing Apparel	55.10	23.56	19.86	178.66	18.79	12.27	321.55
Leather	172.86	337.71	68.38	126.34	286.96	252.40	252.18
Wood & Products of Wood	0.39	0.00	0.00	0.05	0.77	23.06	0.02
Paper & Printing	0.00	0.00	13.89	5.58	0.02	0.65	2.43
Chemicals	2.30	7.46	3.68	2.50	1.76	3.36	0.44
Rubber & Plastic	0.27	24.29	0.22	17.73	4.92	0.47	0.49
Other Non-Metallic Minerals	0.26	9.72	1.25	2.15	23.17	15.11	15.06
Basic Iron & Steel	4.25	2.69	0.00	0.00	0.00	0.01	1.91
Fabricated Metal, Except Machinery & Equipment	2.92	0.17	0.28	0.63	2.12	2.98	14.52
Machinery & Equipment N.E.C.	4.25	0.00	0.00	0.00	31.21	2.17	2.65
Motor Vehicles, Trailers& Semi-Trailer	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Furniture; N.E.C.	0.01	0.00	0.07	7.14	0.03	15.08	1.80

Source: CSA, Large and Medium Scale Manufacturing Industries and Electricity Survey (Various Issues)

3.10 Import Intensity

Import intensity measures the sector's dependence on import for its raw materials. Import intensity, which had started to decline from 0.51 in 2009/10 to 0.37 in 2011/12. But, it picked up again in 2015/16 to reach 0.49. This indicates that the manufacturing industry has weak intra-sectoral linkage and with agriculture sector. The rising of import dependency in recent years can be explained by the entry of relatively higher import dependent manufacturing industries into industrial parks compared to existing manufacturing industries (Table 3.7).

In 2015/16, while the *other non-metal* subsector was the least import-dependent, machinery & equipment happened to be the most import-dependent. Of the priority agro-processing sub-sectors, the textile sub-sector happened to be the most import dependent while the food sub sector is the least import dependent. The government has to exert its utmost effort to at least produce critical raw materials required for the priority sub-sectors locally (Table 3.7).

Table 3.7: Import intensity in the LMSMI, over 2009/10-2015/16

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	Annual average (2009/10- 2015/16)
Food & Beverages	0.248	0.181	0.206	0.304	0.297	0.311	0.334	0.269
Tobacco	0.055	0.533	0.533	0.780	0.780	0.470	0.451	0.515
Textile	0.370	0.388	0.244	0.277	0.457	0.642	0.499	0.418
Wearing Apparel	0.503	(0.092)	0.166	0.341	0.719	0.516	0.577	0.385
Leather	0.344	0.206	0.186	0.248	0.338	0.276	0.353	0.277
Wood	0.211	0.434	0.061	0.152	0.352	0.207	0.262	0.256
Paper & Printing	0.595	0.733	0.584	0.563	0.722	0.655	0.671	0.658
Chemical	0.705	0.749	0.822	0.705	0.778	0.697	0.749	0.751
Rubber & plastic	0.923	0.930	0.870	0.849	0.777	0.834	0.667	0.850
Other Non-Chemical	0.581	0.255	0.297	0.322	0.158	0.249	0.194	0.280
Basic Iron	0.791	0.786	0.778	0.805	0.976	0.638	0.788	0.796
Fabricated Metal	0.846	0.524	0.571	0.591	0.520	0.623	0.418	0.620
Machinery & Equipment	0.851	0.870	0.109	0.668	0.827	0.958	0.799	0.753
Motor Vehicle	0.985	0.866	0.766	0.409	0.490	0.480	0.359	0.661
Furniture	0.501	0.360	0.435	0.511	0.795	0.208	0.424	0.474
Total	0.510	0.441	0.372	0.443	0.509	0.490	0.488	0.473

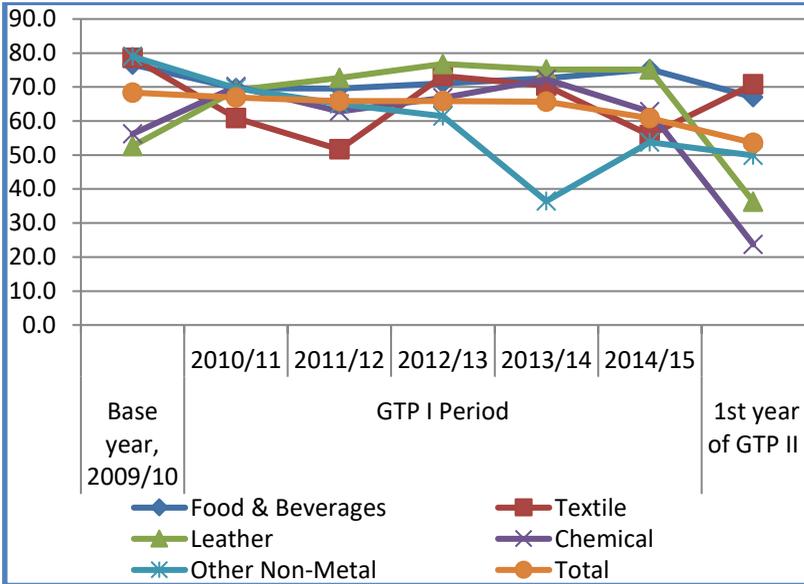
Source: CSA, Large and Medium Scale Manufacturing Industries and Electricity Survey (Various Issues)

3.11 Capacity Utilization

Capacity utilization is another important performance indicator for manufacturing industries. Capacity underutilization could emanate from a variety of factors, including shortage of raw materials, lack of market, power interruption, breakage of machinery, etc. Although the GTP I targeted to raise capacity utilization to 90 percent at the end of the plan period, the overall capacity utilization rate was found to be 53.6 in the first year of GTP II which were lower than the base case(2009/10) of 68.4 percent indicating significant deterioration over time. By addressing problems which gave rise to capacity underutilization, it is possible to double contribution of the sector to the overall economy without increasing number enterprises (Figure 3.4).

Of the priority sub-sectors, only leather and chemicals industries showed significant increases in capacity utilization at the end of the plan period of 2014/15 compared to the baseline (2009/10) figure while food, textile, and non-metallic sub-sectors have depicted lower rates. The significant drop in the capacity utilization registered by textile and non-metallic mineral industries is subject to further investigation by the relevant public body (Figure 3.4).

Figure 3.4: Trends in capacity utilization, in %



Source: CSA, Large and Medium Scale Manufacturing Industries and Electricity Survey (Various Issues)

PART TWO

Foreign Direct Investment in Ethiopia: Structure, Performance, and Determinants

Chapter IV

Review of Theories of FDI and Empirical Evidences

4.1 Introduction

This section attempts to review theories on foreign direct investment (FDI) and empirical literature on the effects of FDI on host economies, including its impacts on growth and development, technology capability, productivity of local firms, employment, etc. It focuses on the theoretical underpinnings of FDI promotion of Ethiopia and draw lessons that can help the country to maximize its benefit from FDI flows.

4.2 Review of Theories of FDI

According to IMF, Foreign Direct Investment (FDI) is defined as international investment made by an economy's resident entity, in the business operations of an entity resident in a different economy, with the intention of establishing a lasting interest IMF (1993). FDI occurs, according to WTO (1996), when an investor based in a country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset. The management dimension is what distinguishes FDI from portfolio investment in foreign stocks, bonds and other financial instruments. Alternatively, FDI can be considered as the ownership of 10 percent or more of

the ordinary shares or voting stock of an enterprise which is usually considered to indicate 'significant influence' by an investor (IMF, 2000). This varies from an economy to another and can even be determined by their policies, some of which restrict the levels of shareholdings of foreigners in local firms.

The World Bank (2004) defined FDI as foreign investment that establishes a lasting interest in or effective (active) management control over an enterprise. OECD (2008) defined FDI as the net inflows of investment undertaken to acquire a lasting management interest (10% or more of the voting stock) in a firm conducting business in any other economy except the investor's home country. For investment to qualify as FDI, emphasis is placed on the fact that the investor must meet the 10% voting share threshold commonly referred to, which as the recommended mainly to ensure statistical consistency across countries (UNCTAD, 2009).

In 1960, Hymer introduced FDI theory on a micro-level which focused on international production rather than international exchange. Hymer (1976) based upon industrial organization theory, argued that multinational enterprises (MNEs) exist due to ownership advantages created by market imperfections. Structural market imperfections lead to a divergence from perfect competition and result in ownership advantages enjoyed by specific firms vis-à-vis other firms. Such firm-specific advantages may include privileged access to resources, economies of scale, intangible assets such as brands and patents, etc. Hymer asserted that for firms to operate value-adding activities abroad, they must possess some kind of advantages specific to their firm, be it innovatory, human capital, financial or organizational advantages. These advantages should be

large enough to outweigh the disadvantages they face in the competition with the indigenous firms in the foreign markets. Hymer's theory was criticized to have comprised of only a necessary but not a sufficient condition for FDI (Dunning & Rugman, 1985) (Casson, 1987). Since firms with ownership advantages may choose to supply a foreign market by exporting or licensing a local firm, ownership advantages alone cannot fully explain why, how and where firms choose to use FDI to supply a foreign market.

In the mid-1970s, the theory of internalization set in to provide a more encompassing explanation for emergence of MNE and FDI (Buckley & Casson, 1976), Hennart, 1982; Casson, 1983). The central tenet of this theory is that market imperfections prevent efficient trade and investment across national border, so that MNEs would try to overcome these market failures by internalizing the foreign markets through FDI. Market imperfections in the product or factor markets may arise from government interventions such as legal restrictions, or other market failures like asymmetric information dissemination.

Internalization theory enjoy a dominant position in related international economics literature during the last two decades for it gives a better insight to the question why firms choose to organize international production within its own hierarchy instead of between individual firms in the open market advocates (Rugman, 1981). Hennart (1994) regards this theory as sufficient explanation for the emergence of MNEs while some questioned that even though ownership specific advantages and internalization advantages are necessary for FDI to occur, it still does not offer a complete picture (Dunning, 1981). Dunning's OLI paradigm suggests that not only

internalization but also ownership and location advantages should be taken into account in order to analyze FDI.

Vernon (1966) suggests that there are four stages in a product's life cycle, namely introduction, growth, maturity and decline. The production location and the form of entry into foreign market depend on which stage the product is in. During the stages of growth and maturity, when the firms gradually lose market shares at home, or when foreign demands for its products increase beyond certain point, firms will respond by moving production to foreign sites with lower costs. The theory offers a plausible explanation for FDI; however, it does not explain why firms choose to undertake FDI rather than exporting or licensing a foreign firm.

The most widely received framework of FDI is the eclectic paradigm, or the OLI paradigm, published by John H. Dunning (1980). He attempted to synthesize several strands of FDI theories from both macro- and micro-level, and integrate them into a single analytical framework. The central thesis of the paradigm is that decisions about international production financed by FDI are determined by the configuration of three sets of advantages (Dunning, 1977, 1981, 1988); namely, the ownership-specific advantages, location-specific advantages and internalization advantages as perceived by multinational enterprises. According to the paradigm, in order for firms of a nationality to supply any particular market, they must possess net competitive advantages over another, and the firms must perceive that internalizing the markets is of their best interest, while the choice of location depends on the relative advantages perceived by the firms.

Industrial organization approach theory, which was developed by Stephen Hymer (1960, 1968 and 1970) and C.P. Kindleberger (1969), was an earliest theory explaining investment flows in oligopolistic market situations. It focuses on the means through which transnational corporations (TNCs) could mobilize its unique capabilities and trans-border assets to overcome perceived operational and informational deficiencies with respect to domestic rivals. According to this theory, the possession of proprietary resources and unique capabilities such as differentiated products, proprietary technology, managerial skills, and favourable access to capital and government imposed market distortions confer TNCs with competitive advantage over indigenous firms in the host country and help them to offset the disadvantages of operating in a foreign country.

The essence of Hymer's theory is that firms operating abroad have to compete with domestic firms that are in an advantageous position in terms of culture, language, legal system and consumer's preference. Furthermore, foreign firms are also exposed to foreign exchange risk. These disadvantages must be offset by some form of market power in order to make international investment profitable. The sources of market power – the firm-specific advantage in Hymer's terms or monopolistic advantage in Kindleberger's terms – are in the form of patent-protected superior technology, brand names, marketing and management skills, economies of scale and cheaper sources of finance. According to Hymer, technological superiority is the most important advantage as it facilitates the introduction of new products with new features. Moreover the possession of knowledge helps in developing other skills such as marketing and improved production process.

Graham and Krugman (1989) stated that in the past it was the technological advantage possessed by European firms that had led them to invest in the United States. Sodersten (1970) also argued that willingness to increase profits by taking advantage of technological superiority or superior organizational structure were the main reasons for direct investment. However, Robock and Simmond (1983) argued that possessing firm-specific advantages did not necessarily mean investment abroad as firms might very well exploit their advantages through exporting or licensing.

Building on the organizational learning perspective, Hedlund and Ridderstrale (1997) suggested that the dominant theoretical perspectives in international business research to be exploitation rather than exploration (creation) perspective. They argued that due to neglect of aspects of asset exploration, the traditional theories of MNE have not successfully explained how MNEs can create innovation through international expansion and activities. In asset exploration or asset seeking perspective, FDI is viewed as a means to acquire strategic assets (i.e. technology, marketing and management expertise) available in the host country. The rise of MNEs from emerging markets like India, China, Brazil, Turkey, Taiwan have challenged the asset exploiting perspective of FDI which fails to explain how firms that start small, lack key resources and are distant from major markets challenge and displace the incumbents, which are highly advanced and competitive.

The transaction cost approach pioneered by R. H. Coase and generalized by Williamson (1979) views FDI as an organizational response to imperfections in intermediate goods, knowledge and capital markets faced by TNCs. The theory asserts that external

market which is available to a TNC fails to provide an efficient environment in which firm can profit by using its technology, know how, brand name or production processes. The firm therefore produces an internal market via investment in multiple countries and thus creates the needed market to achieve its objectives.

Makino et al (2002) proposed two distinctive and complementary perspectives of FDI: Asset Exploiting and Asset Seeking. Traditional theories of FDI explained FDI from asset exploiting perspective. In the asset exploitation perspective, FDI is viewed as the transfer of firm's proprietary assets across borders. This perspective postulates that FDI would occur when firms possess proprietary resources and skills that give rise to a monopolistic (or competitive) advantage in a host country (Caves 1971, Hymer 1976).

Of the new species of firms is the Dragon Multinationals, as coined by John A Mathews. He (2002, 2006) used the term to describe firms that emerged from the peripheral areas of Asia – Pacific region. These are the firms that start from behind and overcome their inefficiencies to emerge as industry leaders, in sometimes astonishingly short periods of time, without having any of advantages of the incumbent industry leaders. They rise up as challengers to the existing large MNEs without initial resources, skills and knowledge, proximity to major markets and social capital. Their accelerated internationalization can be attributed to the manner in which they leverage their way into new markets through partnerships and joint ventures.

Capital market theory, also known as the “currency area theory”, postulated that foreign investment in general arose as a result of

capital market imperfections. According to Aliber (1970; 1971), weaker currencies have a higher FDI-attraction ability and are better able to take advantage of differences in the market capitalisation rate, compared to stronger country currencies. He further adds that source country MNCs based in hard currency areas can borrow at a lower interest rate than host country firms because portfolio investors overlook the foreign aspect of source country MNCs. This gives source country firms the borrowing advantage because they can access cheaper sources of capital for their overseas affiliates and subsidiaries than what local firms would access the same funds for. Lall (1979) criticized Aliber's theory stating that the theory does not apply in less developed countries with highly imperfect or non-existent capital markets, and those with heavily regulated foreign exchange rates. Nayak and Choudhury (2014) said that Aliber's theory does not explain investment between two developed countries with similar strong currencies, and how developing country MNCs with weaker currencies are able to invest in developed countries with much stronger currencies.

Although FDI location is influenced by firm behaviour (a microeconomic element) insofar as the motives of its location, that is whether it is resource seeking, market-seeking, efficiency-seeking or strategic asset seeking; the overarching decision is in fact taken on the basis of economic geography, which is a macroeconomic decision as it takes cognisance of country-level characteristics (Popovici & Calin, 2014). According to them, the Location-based approach to FDI theory explained the success of FDI among countries based on the national wealth of a country, such as its natural resources endowment, availability of labour, local market size, infrastructure and Government policy regarding these national resources.

The gravity approach to FDI assumed that FDI flow between two countries is highest, if those two countries are similar geographically, economically and culturally. Gravity variables such as size, level of development, distance, common language and additional institutional aspects such as shareholder protection and trade openness were regarded as important determinants of FDI flows (Popovici & Calin, 2014).

Institutional FDI Fitness theory developed by Wilhems and Witter (1998), states that a country's ability to adapt, or to fit to the internal and external expectations of its investors, which gives countries the upper-hand in harnessing FDI inflows. The theory itself attempts to explain the uneven distribution of FDI flows between countries. The theory rests on four fundamental pillars – government, market, educational and socio-cultural fitness. At the base of the pyramid are socio-cultural factors which according to Wilhelms and Witter (1998) are the oldest and most complex of all institutions. Above that is education, which the authors affirm to being necessary in ensuring an attractive environment for FDI as educated human capital enhances R&D creativity and information processing ability. The actual level of education does not seem to matter much for FDI as the requirements are dependent on the various skills needs of projects to be undertaken. However what is certain is that basic education may impact on the productivity and efficiency of FDI operations, making formative education such as the ability to speak, hear, understand, interpret and implement instructions are key for attracting FDI.

The third pillar, markets, accounts for the economic and financial aspects of institutional FDI fitness, in the form of machinery (physical

capital) and credit (financial capital). Developed and well-functioning financial markets are a prominent feature in the MNC's investment decision-making process. The fourth pillar is the Government. The role of a country's political strength plays the biggest role in FDI. Government fitness requires the adoption of protective regulation to manage market fitness. Popovici and Calin (2014) add that government fitness is considered to include economic openness, a low degree of trade and exchange rate intervention, low corruption and greater transparency. If policies are hostile and unfavourable towards investors, MNCs shies away as the political instability increases risk (Wilhelms & Witter, 1998). Although the pyramid is presented in a specific order, the four institutional pillars are inter-related and interact in unison in different forms (Wilhelms & Witter, 1998).

Lipsey (2004) states that the microeconomic FDI theories view examines FDI motivations from the investor's perspective, which would take a firm level or industry-level perspective in making a decision. This micro-view thus examines the consequences to the investor, and to home and host countries, of the operations of the multinationals or of the affiliates created by these investments, rather than the size of the flows or the value of the investment stocks or investment position. Many of these microeconomic FDI theories are all based on the existence of imperfect markets.

According to the firm-specific advantage theory, developed by Hymer (1976), the decision of an MNC to invest abroad rests on certain advantages at its disposal, such as access to raw material, economies of scale, access to labour, low transaction costs, intangible assets in

the form of brands and patents, amongst others. It is in fact a firm-level (firm-specific) decision, rather than a capital market one.

The Eclectic Paradigm is probably the most well-known theory of FDI. Dunning (1980) integrated the various FDI theories such as the international trade, imperfect markets (monopoly) and internalization, and complemented these theories with the location theory. According to Dunning (2001), in order for a firm to engage in FDI, it must simultaneously fulfil three conditions. Firstly, possess net ownership advantages over other firms serving particular markets. These ownership advantages are firm specific and exclusive to that firm. It can be both tangible and intangible assets such as trademarks, patents, information and technology, which would result in reductions in the production cost of the firm. Secondly, it must be more profitable for the firm possessing these ownership advantages to use them for itself (internalization), rather than to sell or lease them to foreign firms through licensing or management contracts (externalization). Finally, assuming that the preceding conditions are both met, it must be profitable for the firm to exploit these advantages through production, in collaboration with additional input factors such as natural resources and human capital, outside its home country. Because of the interrelatedness of the three conditions, it is important that they occur simultaneously, otherwise FDI cannot occur. The context and application of the Ownership, Location and Internalization (OLI) paradigm differs from firm to firm, and hence the theory cannot be considered in isolation of theories which affirm the importance of the host country characteristics.

Boddewyn (1985) praised Dunning's theory for explaining the initial FDI decision by MNCs, but however laments the lack of explanation with regard to subsequent FDI increases, which may only require

changes only in some but not necessarily all the OLI factors. In addition to this, Shin (1998) questions the applicability of the theory to LDCs which generally do not monopolistic firm-specific advantages such as high knowledge content. Another criticism of the eclectic theory is that it incorporates so many variables that it ceases to be operationally practical as it does not explain FDI at the firm, industry and country levels.

With the view to address its criticisms, Dunning (1981) came up with the Investment Development Cycle or Path (IDP) theory, in which he proposed a link between a country's level of economic development and its investment positions. The IDP had four stages: introduction, growth, maturity and decline.

Forssbaeck and Oxelheim (2008) questioned the menial role assigned to financial aspects in the FDI decision by Dunning's OLI paradigm. Dunning (1993) acknowledged the existence of a "financial asset advantage" which is a firm's knowledge of and access to foreign sources of capital, but points out that this is merely a by-product of the size, efficiency and knowledge of MNCs, and not necessarily a standalone advantage. Forssbaeck and Oxelheim (2008) argue that a strong financial strategy enables a firm to minimise its cost and maximise availability of capital; thus by lowering the discount factor of any investment, firm's likelihood to engage in FDI increases as a result of the financial advantage. To this end, they hypothesized that a firm will engage in FDI when, amongst other things, it has access to competitively priced equity, it cross-lists its shares on a larger more liquid stock market, it enjoys strong investment credit ratings, and it is able to negotiate reduced taxation and/ or attract subsidies.

Stage theory approach/ the Network Model, the stage model of internationalization explains the process of firm internationalization as a result of learning through gradual increases in international involvement (Johanson and Vahlne, 1977, 1990) and Johanson and Weidersheim-Paul (1975). The Network model explained international involvement as a sequential learning process based on increasing experiential knowledge.

John A Mathews' (2002, 2006) Linkage, Leverage and Learning (LLL) framework is the framework of firm internationalization recognized the fact that latecomers and newcomer MNEs do not depend for their international expansion on prior possession of resources but they utilize international expansion in order to tap resources that would otherwise be unavailable. The framework explained the rapid emergence of the latecomer firms in the 1990s in terms of prior linkages developed in the global economy which firms leverage through experiential learning helping them to gain a foothold in interconnected global network.

Johanson and Mattson's (1988), Strategic Alliance Network Approach explains internationalization as learning process based on increasing experiential knowledge.

Leapfrogging Theory explains systematic and recursive behaviour used by late entrants to catch up with the competitive position of early movers while avoiding the risks of technological obsolescence and proprietary technology diffusion to rivals, as well as the extra burden of educating a changing market.

MacDougall (1958) established his model based on the assumptions of perfectly competitive market and was further elaborated by Kemp (1964). Both MacDougall and Kemp stated that when there was free movement of capital from an investing country to a host country, the marginal productivity of capital tended to be equalized between the two countries.

In the post-Second World War period, there was significant FDI growth fueled by: (a) the improvement in transport and communications, which facilitated control from a distance; and (b) the need of Europe and Japan for United States capital to finance their reconstruction. However, by 1960, host countries started to recover and FDI outflow from the United States slowdown; at the same time, other countries initiated FDI in the United States. The 1980s witnessed two important developments. First, the United States became a net recipient of FDI. Secondly, Japan emerged as a major home country for FDI flows to the United States as well as Europe. The 1990s saw the decline in the importance of Japan as a source of FDI. Moreover, merger and acquisition became an important force behind FDI. Since 2000 there has been an increasing flow of FDI from the developing countries, not only to other developing countries but also to the developed world.

By extending the work of Hymer, Kindleberger (1969) argued that advantages enjoyed by MNCs could be useful only in the case of market imperfection. The advantages described by him might be in the form of superior technology, managerial expertise, patents etc. These advantages generally encourage a firm to invest in a foreign country in order to fully exploit them instead of sharing them with potential competitors in the foreign market. The greater the chances

of earning monopoly profits, the higher will be the encouragement among firms to invest directly. Although, Kindleberger described various forms of advantages generally enjoyed by a firm over the host country firm, he failed to describe which advantage a firm should focus on. Further, a firm can exploit its monopolistic advantages abroad only if the host country's policy allows it to do so.

Internalization theory of FDI, Buckley and Casson (1976), provided another explanation of FDI by putting emphasis on intermediate inputs and technology. They shifted the focus of the international investment theory from country-specific towards industry-level and firm-level determinants of FDI (Henisz, 2003). They analysed MNCs within a broad-based framework developed by Coase (1937). They articulated their theory based on three postulates:(a) Firms maximize profits in a market that is imperfect;(b) When markets in intermediate products are imperfect, there is an incentive to bypass them by creating internal markets; and (c) Internalization of markets across the world leads to MNCs.

A firm that is engaged in research and development may develop a new technology or process, or inputs. It may be difficult to transfer technology or sell the inputs to other unrelated firms because those other firms may find the transaction costs to be too high. Faced with this situation, a firm may choose to internalize by using backward and forward integration, i.e., the output of one subsidiary can be used as an input to the production of another, or technology developed by one subsidiary may be utilized in others. When internalization involves operations in different countries then it necessarily means FDI.

Although Buckley and Casson acknowledged the risk of host government intervention, they did not consider the difference in the magnitude of this risk across various industries. For example, industries such as power generation and telecommunications may face a greater risk of government intervention because societal considerations may require the balancing of private objectives with social objectives.

Economic literature state that there two important motives for choosing a particular country as a location for setting up a new facility:(a) firms seek increased access to the host country's market; and (b) firms want to utilize the relatively abundant factors available in that country. Knickerbocker (1973) added a third motivation for choosing a location – that firms might invest in a country to match a rival's move (Head and others, 2002). In other words, firms often exhibit imitative behaviour, i.e., they follow the internationalization of competitors so that they will not lose their strategic advantage. In particular, Knickerbocker argued that in oligopolistic market conditions, firms in an industry tend to follow each other's location decision. The idea is that firms, uncertain of production costs in the country to which they are currently exporting, run the risk of being undercut by a rival switching from exporting to setting up a manufacturing subsidiary in the host country. By imitating the rival's FDI, the firm can avoid being under-priced (Altomonte and Pennings, 2003).

Knickerbocker's proposition of oligopolistic reaction holds true only when uncertainty exists about costs in the host country; i.e., a sufficiently risk averse oligopolistic firm is more likely to set up a unit in a foreign country once one or more of its rivals invest there (Head and others, 2002). However, in the case of certainty, the incentive to

go abroad decreases with rival investment. Furthermore, this theory does not explain what motivated the first firm to undertake FDI.

One of the first theories on FDI from Asian developed countries was put forward by Kojima (1973, 1975, and 1985). He argued that the inability of firms to compete domestically in Japan had compelled them to look for investment opportunities abroad. He had the opinion that, the more efficient local firms pushed the less competent firms out of the local market. As a result, the weaker firms were moving overseas, especially to other developing countries. However, Kojima's hypothesis failed to explain the expansion of business activities in international markets by the domestically competent firms.

Hirsch (1976) developed an international trade and investment theory by focusing on two aspects: (a) when a profit-maximizing firm chooses to serve a foreign market, and (b) the conditions under which foreign market servicing is carried out either through exporting or local manufacture as a result of direct investment. He asserted that FDI could be analysed within the framework of industrial organization and location theory models. However, it is not consistent with trade models that assume perfect markets, factor immobility, zero transportation costs, international identical production functions and constant returns to scale. FDI will also not take place even if it is assumed that international factor mobility is possible. For example, if it is assumed that capital is completely unhampered, capital costs between two nations will be equalized; hence, there is no incentive to undertake FDI. The relaxation of constant returns to scale also cannot explain FDI.

In the absence of transportation and marketing costs, an optimum sized plant will be less costly to operate in countries enjoying comparative advantage. Economies of scale are not associated with the size of the domestic market; they enhance rather than counteract comparative advantage. International direct investment takes place only in a world that admits revenue-producing factors that are firm-specific on the one hand, and information, communications and transaction costs, which increase with economic distance, on the other. Hirsch concluded his theory by noting that international investment facilitates specialization according to comparative advantage to a greater extent than trade, since firms that are purely exporters will incur differential export-marketing costs; in the case of MNCs, some exemptions from such costs are granted. Furthermore, multinationals have an incentive to enhance the gains from trade by expanding output or setting up new units in least-cost locations and by supplying to all markets from that location.

Kojima (1973, 1975, and 1985) also integrated trade theories with direct investment theories. He strongly recommended that FDI was required in order to make factor markets more competitive and efficient internationally as well as to improve production processes in a country that is well-endowed with the given resource. Kojima identified resource, labour and market orientation as the three major motives behind international investment by a firm. Kojima's theory mainly focused on Japanese investment.

Helpman argues that firms like to choose cost-minimizing locations to maximize their profits. The differences in the factor endowments are associated with the relative size of the country. The theory explains the simultaneous existence of inter-sectoral trade, intra-

industry trade and intra-firm trade. The theory also explains cross-country penetration by MNCs as a result of impediments to trade such as transportation cost and tariff. In another article, Helpman and others (2004) focused on a firm's choice between exports and horizontal FDI. They developed a model of international trade in which firms choose to serve the domestic market, to export or to engage in FDI to cater to markets abroad. They contended that every industry was characterized by heterogeneity; therefore, the productivity of firms will differ. The consequence of this is that firms are organized on the basis of their productivity. The least productive firms shut down as they cannot generate a positive operating profit, no matter how they are organized. Other low-productivity firms sell only in the domestic market. The remainder of the heterogeneous firms will serve both domestic and foreign markets. However, the modes of operating in foreign markets will differ from firm to firm, depending on their productivity levels. The most productive firms will decide to serve the foreign market via FDI while less productive firms will sell in the foreign market through exports. The firms that invest abroad will do so when the gains from avoiding transportation costs are greater than the costs of maintaining facilities abroad. This is called the proximity concentration trade-off. Thus, by embodying elements of the proximity-concentration trade-off in the theory of horizontal FDI, the model predicts that foreign markets are better served by exports relative to FDI when trade frictions are lower or economies of scale are higher.

During the past two decades, a number of developing economies have emerged on the map of international investors. MNCs have not only emerged from newly industrialized economies such as the Republic of Korea and Taiwan Province of China but also from countries such

as Argentina, Brazil, India, the Philippines among others (Kumar and McLeod, 1981). The so-called Third World MNCs (TWMNCs) have established themselves in every sphere of the global economy. At the outset, it must be noted that these firms have generally brought technology from the developed world. However, since such technology is more suitable for an area with a large market size, firms importing technology will export their products once local demand met. As the products become more familiar in foreign markets, and as the markets for such products gradually become established, the firms show a preference for setting up subsidiaries abroad rather than exporting.

In certain cases, a product is modified and the technology, which was originally imported, undergoes changes to suit the tastes of foreign consumers. The modification is either in the form of scaling-up (for consumers in developed countries) or scaling-down (for consumers in other developing countries). During the product modification process, technology also undergoes change. In fact, modified foreign technologies that factor in local tastes and preferences have allowed innovating TWMNCS to gain a competitive edge in other developing countries that have similar socio-economic conditions. In this way, TWMNCs have acquired the firm-specific ownership advantages highlighted by the Hymer (1976). Such firms find it more beneficial to internalize these advantages than to transfer them to other unrelated firms (Buckley and Casson, 1976).

4.3 Review of Empirical Evidence

Should a host country devote its scarce domestic resources to attracting FDI and incorporating it into its development strategy? The answer depends largely on whether an FDI project generates positive externalities (“spillovers”) for the host economy; the benefits created by the project that are not appropriated by the foreign investor undertaking the project, nor by the factors of production (workers) employed neither by the project, nor by the suppliers to the project unless possibly the suppliers are able to expand their activity beyond that directly accounted for by the project. Studies have produced highly diverse answers to the questions of whether externalities do exist and how great are their magnitudes.

Externalities due to FDI for host economy might be created in a number of ways such as movement of workers and managers who have been trained by multinational firms into other jobs, such that the benefits of the greater “human capital” of these persons are captured by agents in the host economy other than the foreign affiliate; an increase in efficiency of suppliers; leakage of technological and managerial information into the economy as a whole via channels other than suppliers or movement of workers and management; and “demonstration effects” whereby the success of one foreign investor induces other investors to come to the country.

Robert E. Lipsey and Fredrik Sjöholm begin their review of previous research by citing their own consternation at an inability to find a “universal relationship” between inward FDI and host country economic performance. Looking first at wage spillovers, they note that foreign firms consistently pay higher wages than domestic firms in both developed and developing countries. They noted that all cross-section studies and three out of four panel data studies find

statistically significant intra industry spillovers (the one that fails to find intra industry spillovers finds inter industry spillovers). Spillovers were highest in sectors with strong competition.

With regards to whether any negative effects from FDI exist, Lipsey and Sjöholm noted that studies depicting a “harmful” impact by exposing domestic firms to greater competition may miss an important analytical point, i.e., if incoming FDI raises average productivity across foreign-owned and domestically owned firms, the outcome for the host country should be considered favourable, even if the least efficient local companies became unprofitable or were forced out of the industry.

Differences in the impacts of FDIs on different countries, according to Lipsey and Sjöholm, are attributed to differences in the countries’ levels of indigenous human resources, to disparate degrees of private-sector sophistication, to differing levels of competition, and to contrasting host country policies toward trade and investment.

There are horizontal and vertical spillovers and externalities. Looking at horizontal spillovers, Beata Smarzynskajavorcik and Mariana Spatareanu point out that researchers face the challenge of disentangling the positive impact of knowledge flows from the potentially negative short-run effect that an increase in competitive pressures from foreign entry may have on some domestic firms. Since it is difficult to capture each effect separately, in a vast majority of cases, the research results reflect the combined effect of two forces.

With regard to “knowledge spillovers”, Javorcik and Spatareanu identified two principal channels—the movement of labor (managers

and workers) from foreign firms to host country companies, and the opportunity for host country companies to observe and imitate best practices and production techniques. In terms of competitive pressures, 48 percent of Czech firms interviewed and 40 percent of Latvian enterprises believed that the presence of multinationals increased the level of competition in their sector. Firms reporting rising competitive pressures as a result of foreign entry enjoyed a larger increase in employment relative to companies that were not affected by FDI inflows, and experienced faster productivity growth. Whereas almost 30 percent of firms in each country reported losing market share as a result of FDI inflow, and local firms also lost 6 to 10 percent of their employees to multinationals. The firms reporting loss of a market share, which they attributed to foreign presence in their sector, experienced a much larger decline in employment and slower total factor productivity (TFP) growth than other firms.

According to Javorcik and Spatareanu, the presence of foreign firms in downstream industries is positively correlated with higher productivity of domestic firms in the supplier industries. However, the “cherry picking” scenario would not necessarily involve externalities.

Many scholars conducted empirical studies to investigate the validity of eclectic paradigm. By and large, the results are consistent with the paradigm. The significance of ownership advantages has received broad empirical support. Firms possessing higher ownership advantages, e.g., higher technological capability and better product diversity, are more likely to engage in FDI (Grubaugh, 1987) (Pearce, 1989), and (Kogut & Chang, 1991). Although internalization advantages are regarded as difficult to quantify, its importance and

hypothesized effect on FDI are confirmed with the empirical results when suitable proxies are applied (Erramilli & Rao, 1993, Agarwal & Ramaswami, 1992 and Denekamp, 1995). Lastly, the locational advantages are also found to be crucial determinants affecting whether firms choose to produce at home or abroad (Dunning, 1998), (Hennart & Park, 1994).

Garrick Blalock and Paul J. Gertler interviewed firm managers in Indonesia to assess the processes of technology transfer to suppliers, and went in-depth for demonstrating the presence of externalities that diffuse throughout the Indonesian economy and generate welfare benefits to both firms and consumers. The authors' interviews with Indonesian managers provide a detailed description of the assistance foreign investors offer to local firms. For example, before an Indonesian firm could qualify as a supplier an American investor would inspect the local factories, suggest modifications, and then ship their subsequent products for testing in the United States. Once design standards were met, the US firm would send Indonesian firm managers to the parent headquarters to master the multinational's quality control, inventory control, and cost control systems, with future purchases dependent upon reliable performance.

Blalock and Gertler show that FDI's effect in augmenting suppliers' productivity is large and significant. Their tests find that technology transfer to suppliers' results in lower prices, increased output, higher profitability, and increased entry in the supplier market. Furthermore, lower supply prices lead to lower prices, increased output, higher profitability, and increased entry throughout the Indonesia economy. The economic returns to the host country exceed the private returns to the multinational investors and their direct suppliers.

Asim Erdilek compares the research and development (R&D) activities of foreign investors with domestic firms, and investigates whether domestic firms are more likely to engage in R&D as the presence of foreign investor in their sector grows. He finds that MNCs undertake more R&D within the host country than domestic firms, which generates new production techniques that would otherwise not exist. Perhaps more notably, he shows that national firms increase their own R&D activities as multinationals expand in their sector. Erdelik's data show that foreign establishments with the highest external ownership (81 to 100 percent foreign owned) have a lower propensity to engage in R&D internally than foreign establishments with lower external ownership. MNCs are much more likely to share their most advanced technology, quality control, and marketing procedures with their wholly owned or majority-owned foreign affiliates than with less closely controlled companies, which obviate the need for local R&D except for relatively minor customizing purposes.

Holger Görg and Eric Strobl argue that the traditional way of measuring technological externalities—productivity spillovers or an improvement in domestic establishments' productivity—is too narrow.

Quite apart from technological externalities, multinationals can affect indigenous performance through “pecuniary externalities,” which may affect entry, growth, and survival of plants in the host economy. Unlike technological externalities, pecuniary externalities do not affect the production function of the benefiting firm, but rather improve the profitability of the firm via cost reductions or increases

in revenues. When multinationals increase output, the demand for intermediate products also increases, which allows local suppliers to produce at a more efficient scale, reduces average costs, and lowers prices to all buyers, foreign and domestic.

Using plant-level data from the Republic of Ireland, Görg and Strobl find that the influx of FDI has stimulated the entry of domestic plants in the same industry. Their simulations suggest that without MNCs the actual number of plants would have been considerably less.

Ping Lin and Kamal Saggi's model captures two conflicting effects of FDI on local industry. On the one hand, they want to show that an MNC's entry decreases the market share of firms that directly compete with it in the final good market, thereby leading to a decreased demand for the required intermediate good. On the other hand, they also want to show that the MNC's entry expands the number of backward linkages as it locally sources the intermediate good. Their model demonstrates that the multinational's entry enlarges the extent of backward linkages if and only if its technological advantage over local competitors is not too large—in fact, under such circumstances, the effect of increased demand dominates the effect of increased competition.

Following Borensztein, De Gregorio, and Lee (1998), much of the research emphasizes that FDI is particularly growth enhancing after the host country acquires a minimum stock of human capital.

In marked contrast to earlier work, Carkovic and Levine conclude that FDI does not exert a robust, independent impact on economic growth when other factors are taken into account. Even if host

countries raise their average years of schooling, they find that FDI flows do not appear to boost growth. They argue that while sound host country economic policies may spur both growth and FDI, their results are inconsistent with the view that FDI accelerates growth as a general proposition.

With regard to FDI—host country growth relationship, Blonigen and Wang find that inappropriate pooling of data from developed and developing countries is responsible for estimating insignificant effects of FDI on per capita GDP growth. When mixing of the different bodies of evidence is avoided, they find that FDI does have a significant impact on per capita growth in less developed countries, in a pattern similar to the one found by Borensztein, De Gregorio, and Lee (1998), once a threshold in educational levels has been exceeded.

Can the apparently contradictory findings about the relationship between FDI and growth from authors Carkovic and Levine and Blonigen and Wang be reconciled? Marc Melitz responded yes. When Carkovic and Levine examine the impact of FDI on host country growth, with controls for initial per capita GDP, skill abundance, inflation, and government size, Melitz points out, their baseline results actually confirm the finding of Blonigen and Wang that above (historical) average levels of FDI are significantly correlated with above (historical) average growth rates. Even in the version of their analysis using the ABBB estimator, Carkovic and Levine's dismissal of the link between FDI and growth comes only after they introduce controls for trade openness and domestic financial credit. This leads Carkovic and Levine to conclude that FDI has no independent effect on host country growth.

Melitz notes, however, that the increasing presence of MNCs among developing countries is likely driven more by vertical production relationships than the horizontal FDI relationships that are more prominent among developed countries. Vertical FDI, in turn, strongly depends upon low trade barriers. Expanded channels of trade are a necessary complement to FDI in which intermediate inputs are imported by the foreign affiliate and exported as a processed product.

Why do changes in FDI that are not accompanied by changes in trade fail to contribute independently to economic growth? Melitz notes that one answer might derive from restrictive policies toward FDI on the part of some countries—forbidding majority ownership, imposing joint venture partners, dictating domestic content requirements, protecting local markets—that impose substantial performance penalties on the affiliates and prevent the integration of host country production into the MNCs’ international sourcing networks. Increases in FDI in countries with such restrictive policies are not likely to be linked with increases in trade, and could well be associated with declines in trade as affiliate production substitutes for imports. Increases in FDI in countries with more liberal investment policies, in contrast, are likely to lead to joint increases in trade and FDI as affiliates import intermediates and re-export finished products back into the parent’s supplier chain, with a positive impact on host country growth.

The potent interaction between trade and investment, as mediated within multinational corporate networks, is highlighted in the study by Susan E. Feinberg and Michael P. Keane. They ask whether MNCs that are organized to trade intra-firm in developing countries operate differently from MNCs with little or no intra firm trade. In their

research on MNCs in the United States and Canada, they discovered that MNCs that were organized to trade intra-firm were more dynamic technologically than MNCs with no intra-firm trade. In the context of US-Canada trade liberalization, as MNCs expanded their intra-firm trade they transformed the nature of the parent-affiliate relationship, by substantially increasing the production share of bilateral intra-firm shipments of intermediates.

Feinberg and Keane extend their analysis to affiliate activity in 48 other developing countries from 1983 to 1996 and discover that MNC affiliates that are organized to trade intra firm tend to be part of much larger and more active MNC networks (measured either in terms of total foreign sales or number of affiliates) than affiliates that are not. These affiliates generally grow faster and pay higher real wages than affiliates that do not trade intra firm. They also differ systematically in terms of technology and organization. These affiliates are significantly more likely to have intra firm trade with the MNC parents, in both directions.

Using detailed case studies of FDI, sector by sector, Moran demonstrates contrasts in performance first in Mexico, Brazil, Malaysia, and Thailand, and then extending across different countries, industries, and time periods. This difference in affiliates' performance takes the contention of Lipsey and Sjöholm—that perhaps the search for a single universal impact from FDI on the host economy is futile—one step further. Moran's shows that FDI in manufacturing and assembly does not have one distinct impact on host country development, but rather two clearly divergent effects—the first beneficial, the second harmful.

On the positive side, Moran shows that when parents use affiliates as part of their strategy to remain competitive in international markets they maintain those affiliates at the cutting edge of best technology, management, and quality control. They coordinate production through whole or majority ownership, with freedom to source without reference to domestic content requirements. This model of “parental supervision” meshes closely with the “deep integration” of Feinberg and Keane that provides such powerful benefits through intra-firm trade. It reinforces the earlier finding of Blomström, Kokko, and Zejan (1992) that host countries are likely to receive greater amounts of technology and more advanced production and quality control processes in their domestic economies by not imposing ownership limits or technology sharing mandates on foreign investors than by enacting regulations to force technology sharing.

While on the negative side, Moran reproduces cost-benefit analyses showing that a sizable fraction of FDI projects designed for import substitution and protected by trade restrictions actually subtract from host country welfare and—as suspected by Melitz—hinder host country growth. Mandatory joint venture requirements lead foreign investors to use older technologies. Domestic content requirements raise foreign affiliate production costs and hinder exports. The resulting performance penalties effectively preclude the emergence of protected infant industries as world-class competitors.

Moran argues that failure to differentiate between export-oriented FDI and import-substitution FDI, between foreign investors free to source from wherever they wish and foreign investors operating with domestic content requirements, or between foreign investors obliged to operate as minority shareholders and foreign investors with whole

or majority ownership, accounts for the inability of earlier studies—such as the oft-cited works of Aitkin and Harrison (1999) and Haddad and Harrison (1993)—to make sense of how FDI impacts a host economy.

New data on foreign investor behavior in the Chinese market, collected by Guoqiang Long confirm both the disadvantages of using joint venture and other performance requirements on foreign investors to try to build an advanced industrial base in the host economy, and the benefits of liberalizing investment regulations and exposing foreign as well as domestic firms to international competition. In a survey of 442 multinational firms operating in China, Long found that foreign wholly owned and majority-owned firms were much more likely to deploy technology as advanced as that used by the parent corporation than firms that had 50-50 shared ownership or firms with majority indigenous ownership. Approximately 32 percent of the foreign wholly owned firms and approximately 40 percent of the majority foreign owned firms used technology in the Chinese market as advanced as in the parent corporation, whereas only approximately 23 percent of the 50-50 shared ownership firms and approximately 6 percent of the majority indigenous Chinese-owned firms used technology as advanced as in the parent company.

In contrast to China's increasingly enthusiastic reception of FDI, African leaders and their general population have remained much more skeptical about the benefits of allowing MNCs to enter their economy. Todd J. Moss, Vijaya Ramachandran, and Manju Kedia Shah investigate whether Africa's on-going wariness about FDI is justified. They use new firm-level survey data from the World Bank's Regional

Program on Enterprise Development for Kenya, Tanzania, and Uganda to examine some of the common criticisms of FDI in Africa. They investigate the differences between domestic and foreign owned firms, including firm size, productivity, management, training, trade, investment, and health benefits. Their data suggest that FDI makes positive contributions to workers in the foreign-owned firms and to the host economy more generally. The three-country sample shows that foreign firms are more productive, bring new management skills, invest more heavily in infrastructure and in the training and health of their workers, and are more connected to global markets. Furthermore, foreign firms create value added per worker approximately twice as high as domestic firms, and their export to output ratio is more than three times as high. They are nearly twice as likely to have a formal training program for workers. Foreign firms provide on-site medical care more frequently as well as accident compensation and insurance.

Econometric tests performed by the authors show that the success of foreign firms was not driven by exercising market power or crowding out local industry. In terms of backward linkages, foreign investors rely on local suppliers for 44 percent of their inputs. Based on these results, Moss, Ramachandran, and Shah conclude that many of Africa's lingering objections to FDI are exaggerated or false.

Robert Lawrence exhibits more sympathy for the legacy of suspicion about the benefits of FDI in Africa, noting that much of the non-extractive investment in Africa has been associated with efforts at import-substituting industrialization. Applying the Moran distinction between FDI in protected versus open policy setting, he noted that

the foreign firms' superior performance may not always have enhanced host country growth and welfare.

Lawrence, African leaders have not had the experience that Long records for China, where foreign investors have increasingly become a channel to integrate the Chinese economy into world markets. Along the way, China used both sticks and carrots to affect foreign firm behavior. Applying Moran's framework to China would be to conclude that China has succeeded despite the sticks.

Based upon renewed confidence in the positive effects associated with FDI, many developing countries are increasingly looking for best-practice policies towards FDI. Whilst FDI can bring positive effects (technology, finance, market access or brand names), it can also bring negative effects. Moreover, the positive effects are not automatic for host countries and depend on many other policies and external factors.

The importance of different policies depends on the characteristics of the specific country, the objective of the country and the derived FDI strategy. However, one can identify some common elements. In each country, FDI policy should fit in with a country's development strategy. Also, FDI policy is likely to be some combination of different policies. Macroeconomic policies are often combined with specific industrial policies. Both are used to affect the locational decision of foreign investors, the upgrading of established foreign investors and affecting linkages and spillovers to domestic firms. Realising that FDI policy should comprise policies in each of these categories is a positive step towards enhancing the benefits of FDI (Rovčani n, Halilbašić, Tatić, 2008)

Girum Abebe, *et al* (2017) tried to quantify spillovers of FDI by comparing changes in total factor productivity (TFP) among domestic plants in “treated” districts that attracted a large greenfield FDI plant and “untreated” districts where greenfield FDI was licensed but has not yet operational in Ethiopia . Treated and untreated districts have similar trends in TFP prior to the opening of the large green-field FDI plant. Over the four years starting with the year of the opening, TFP in domestic plants was 8% higher in treated districts. They obtain qualitatively similar results using an alternative identification strategy that exploits the assignment of land for FDI by the Ethiopian Government. They also find evidence that the FDI plants attract new economic activity to the receiving districts. Further, using a survey module, they show that knowledge was transferred from FDI to domestic plants through: (i) labor flows from FDI to domestic plants; (ii) learning by observation and; (iii) customer and supplier relationships.

A study by Zhang (2001) on 11 developing countries of Latin America found that a significant benefit of FDI to host countries is due to technology transfer and spill over efficiency. They scrutinize the 11 Latin America countries using co-integration and Granger causality test. In their analysis, they found that FDI has a positive impact only in five of the eleven countries. The author indicated that the benefits does not happen automatically instead depends on host country absorptive capacities, liberal trade policy, human capital, and export-oriented FDI policy.

Likewise, Bengoa and Sanchez-Robes (2003) found that FDI has a significant positive effect on economic growth of developing

countries. In order for a positive effect to be achieved from FDI, the host country must have an adequate level of human capital, economic stability and liberalized capital market.

De Mello (1999) and Borensztein *et.al.* (1998) found that there is a relationship between FDI and economic growth, though this tends to be so because of the host country characteristics such as human capital. Thus, the impact of FDI is dependent on the conditions and characteristics of a host country's enabling environment. Investment recipient countries with better endowment of human capital and strong institutional capacity are supposed to benefit more from FDI induced technology transfer and productivity gain herewith.

De Mello (1999), focused on 32 individual countries both from OECD and non-OECD countries over the period (1970-90). He concluded that the long run growth in host countries is determined by the spillovers from knowledge and technology from foreign investment. However, in the non-OECD samples he found negative short run impact of FDI to GDP and no causation from FDI to growth. This perhaps relate to the claim, by some scholars, that the growth promoting effect of FDI is related to the income level of host countries. Likewise, studies by Blomstrom, Libsey and Zejan (1994) found that foreign direct investment promotes growth only in higher income developing countries. As a cross country analysis of 78 developing countries and they found no positive effect for lower income developing countries.

Jacques (2010), examine the long run relationship and causality of FDI and growth for ten Sub Saharan African (SSA) countries by applying a co-integration and non-causality test approach in the periods from

1970-2007. They find a long run relationship between FDI and economic growth in Angola, Cote d'Ivoire, Kenya, Liberia, Senegal and South Africa. However, FDI was statistically significant and positive only in Angola and Cote d'Ivoire and insignificant in Kenya. In Senegal and South Africa the direction of causality runs from GDP to FDI, GDP affects FDI significantly and positively. An empirical work of Magnus and Fosu (2008) for Ghana economy found that there is a one way causal relationship between FDI and GDP growth in Ghana and the direction of causality is from FDI to growth.

Balasubramanyam *et al.* (1996) investigated how FDI impacted economic growth in developing countries and found that FDI has a positive impact on economic growth only in countries that have export promoting strategy. This supports the "Bhagwati hypothesis" that the growth impact of FDI is positive for export promoting countries than import substituting countries, focusing on the role of trade regime on FDI impact.

Kokko *et al.* (2001) investigated the possibility of spillovers to local firms using a cross sectional data of 1,243 manufacturing firms in Uruguay in 1998. The study distinguishes the difference in spillovers effect in different trading regimes. This was defined in terms of the number of years in which the country was under import substitution and export promoting trade policies. They found that exporting tendency of locally owned firms appeared to be positively related to the presence of outward-oriented MNCs; however, the case was not the same for MNCs established during the import substituting regimes.

Likewise, Greenway *et al.* (2004) provide evidence on export spillovers from MNCs to local firms in an industrialized economy. The

study showed that export-enhancing effect of FDI was not only limited to the export performance of MNCs but also related with higher export orientation of domestic firms. Similarly, a study conducted by IMF(2011) on Eastern Central and South Eastern Europe countries indicate that the impact of FDI on trade depends on whether the sectors are tradable and non-tradable. According to the study a high positive correlation between export performance of host countries and stock of FDI going to the tradable sectors, in contrast, FDI stock in the non-tradable sectors is positively associated with import.

Alfaro (2003) considered the sector specific impact of FDI on economic growth and he found that the growth impact of FDI varies across sectors. According to which no causal relationship in the primary sector, temporary growth effects of FDI in the services sector, and FDI stock and growth were mutually reinforcing in the manufacturing sector.

A few scholars have also emphasized on the way in which the growth effects of FDI depends on the financial market conditions of the recipient country. Alfaro *et al.* (2004) and Durham (2004), emphasize that growth effect of FDI depends much on existence of sound financial markets of the host country. Alfaro *et al.* (2004) used cross-country data for the period of 1975-1995 and found that FDI alone plays a vague role in promoting economic growth, however, when several financial development measures are included positive effects come out. Durham (2004) used data for 80 countries from 1979-1998 and found that it is also necessary for a country to have a strong institutional capacity and investor friendly legal framework for FDI to have a positive effect on growth. Similarly, Olofsdotter (1998) argues

that the beneficial effect of FDI is stronger in those countries with higher level of institutional capacity. Likewise, Chang (2009) applied panel co integration and panel error correction model for 37 countries using annual data from 1970-2002, found positive relationship between FDI and growth when financial development measurement are included. When a country has a solid financial system as its foundation, it follows that it is in a better position to more effectively reap the benefits from FDI inflows.

The theory of institutional FDI fitness has been empirically tested mainly in the African context. Muthoga (2003) (as cited in Popovici & Calin, 2014), investigated FDI determinants in Kenya for the period 1967-1999. The author found that economic openness, GDP growth rate, level of domestic investment, internal rate of return and availability of enhance a country's attractiveness to foreign investors. Along the same ideologies, Musonera, Nyamulinda and Karuranga (2010) evaluated the institutional FDI fitness model in the East African Community bloc, using Kenya, Tanzania and Uganda as their sample, and data drawn from 1995 - 2007. They found that for Tanzania and Uganda, FDI inflows were predetermined by more than a single country risk factor, such as population size, size of economy, financial market development, trade openness, infrastructure and other economic, financial and political risks. Their research also further refuted the perception that FDI inflows to Africa are attracted by natural resources. This was evidenced by that Tanzania and Uganda, both resource-poor countries, were also able to attract FDI on condition that their Governments fulfil two conditions: establish macroeconomic and political stability, and introduce an efficient regulatory framework, as well as eliminate corruption.

Chapter V

Investment laws, Institutional Framework and Incentives

5.1 Introduction

This section gives an overview of the laws and regulations governing FDI, and institutions their duties and responsibilities in relation to FDI and the incentive structure meant to attract FDI into the country. FDI is considered as the investment made by a company outside its home country. It is the flow of long-term capital based on long-term profit consideration involved in international production (Caves, 2007).

5.2 Investment Laws of Ethiopia

The Growth and Transformation Plan (GTP), the policy framework of the country, envisions Ethiopia to become a light manufacturing hub in Africa, reaffirming the critical role of the manufacturing industry in realizing the goals of the medium term development strategy (GTP II). In this regard, the plan gives emphasis to the significance of FDI in broadening the manufacturing industrial base.

The Constitution is the supreme law of the land and under it are proclamations that are passed by the Parliament, followed by regulations that are enacted by the Council of Ministers, and implementing directives passed by ministries or agencies. The legal

and regulatory framework governing FDI in the country is based on a series of Investment Proclamations issued since 1996. There are many other general business-related policies and regulations that can affect FDI. The most relevant legislation governing FDI are briefly discussed in the following paragraph.

The Constitution protects private property. The Investment Proclamation also provides investment guarantee against measures of expropriation and nationalization that may only occur for public interest and in compliance with the requirement of the law. Where such expropriations are made, the government provides adequate compensation corresponding to the prevailing market value of property and such payment is effected in advance. Ethiopia is a member of the World Bank affiliated Multilateral Investment Guarantee Agency which issues guarantees against non-commercial risks to enterprises that invest in signatory countries. The country has also concluded bilateral investment promotion and protection agreements with a number of developed and developing countries (EIC, 2012).

Ethiopia does not have a separate policy for FDI the existing institutional and policy arrangements for investment are designed to facilitate the flow of investment from abroad. The country's investment law gives equal treatment for both foreign and domestic investors with some limited exceptions.

The investment code of the country has been repeatedly revised since 1996 to present day so as to remove emerging bottlenecks and incorporate new and innovative facilities that will help promote private sector investment, more importantly FDI. The current

investment law of the country allows that a foreign investor can engage in any sector listed under the Investment Proclamation No. 769/2012 Amendment Proclamation No. 849/2014 and Regulation No. 270/2012 amendment Regulation No. 312/2014), except the few sectors reserved for domestic investors, Ethiopian nationals or the government in the same laws.

According to the law, there is a minimum investment capital requirement based on the type of the investors. This minimum capital requirement is not applicable for FDI that exports $\geq 75\%$ of its output and/or reinvests its profit. It should be noted that there are areas where foreign investment is not permitted and therefore are reserved for domestic investors.

Besides, the overall investment laws, the country has also issued a proclamation on industrial parks and investors operating in the park. These laws are the Industrial Parks Proclamation No. 886/2015 and the Industrial Parks Regulation, 2017.

There are various laws and codes governing commercial matters in the country. These include the Commercial Registration and Business Licensing Proclamation No. 980/2016; the Trade Practices and Consumer Protection Proclamation No. 813/2013; the Commercial Code of Ethiopia, Proclamation No. 166/1960, which provides the legal framework for undertaking business activities in Ethiopia; and the Civil Code of Ethiopia, Proclamation No. 165/1960.

Ethiopia has been providing a wide range of incentives to attract the FDI inflows among which tax incentives is the major one. Among the tax laws the following are deemed important, Income Tax

Proclamation No. 979/2016; Tax Administration Proclamation No. 983/2016; Value Added tax Proclamation No. 285/2002, Amendment Proclamation No.609/2008; VAT Regulation No. 79/2002 and Excise Tax Proclamation No. 307/2002, Amendment Proclamation No.610/2008.

The relevant customs laws to FDI include the Customs Proclamation No. 859/2014, Export Trade Duty Incentive Schemes Proclamation No. 768/2012 and Ethiopian Customs Guide, Ethiopian Revenues and Customs Authority, March 2017.

Another important law is labour law. The Labour Proclamation No. 377/2003, Amendment Proclamation No.494/2006 is issued to ensure worker-employer relations. Underpinned by the basic principles of rights and obligations with a view to enabling workers and employers to maintain industrial peace and work in the spirit of harmony and cooperation towards the all-round development of the country; and to guarantee the right of workers and employers to form their respective associations and to engage, through their lawful elected representatives, in collective bargaining, as well as to lay down the procedure for the expeditious settlement of Labour disputes, which arise between workers and employers.

Intellectual property is very crucial in guaranteeing the flow of FDI into the country. In this connection, there are various laws governing the protection of property right in the country. These include, Copyright and Neighbouring Rights Protection Proclamation No. 410/2004, Amendment Proclamation 872/2014; Trademark Registration and Protection Proclamation No. 501/2006; Trademark Registration and Protection Regulation No. 273/2012; Inventions,

Minor Inventions and Industrial Designs Proclamation No.123/1995 and Inventions, Minor Inventions and Industrial Designs Regulation No. 12/1997.

Environmental laws governing investment. The Environmental Impact Assessment (EIA Proclamation, 299/2002) regulates offences and penalties and it states that ‘any person who violates the provision of this proclamation commits an offence and shall be liable accordingly’. Furthermore any person who, without obtaining authorization from the Authority, implements any project subject to environmental impact, or makes false presentations in an environmental impact assessment study report commits an offence and shall be liable.

The Environmental Pollution Control Proclamation No. 300/2002 regulates issues of pollution. According to the proclamation, the relevant environmental agency may take an administrative or legal measure against a person who, in violation of the law, releases any pollutant to the environment. Any person engaged in any field of activity which is likely to cause pollution or any other environmental hazard shall, when the agency so decides, install a sound technology that avoids or reduces, to the required minimum, the generation of waste and, when feasible, apply methods for the recycling of waste. Any person who causes any pollution shall be required to clean up or pay the cost of cleaning up the polluted environment in such a manner and within such a period as shall be determined by the Authority or by the relevant regional environmental agency.

5.3 Institutional Framework for FDI Promotion

The principal government agency which is responsible for most aspects of FDI in Ethiopia is the Ethiopian Investment Commission (EIC) which has the duty for promoting, coordinating, managing and monitoring all types of inward investment including joint-ventures.

5.3.1 Ethiopian Investment Commission

The Ethiopian Investment Commission (EIC) is a government organization established in 1992 to promote private investment, primarily Foreign Direct Investment (FDI). The overall activities of the Commission are supervised and followed up by an Investment Board, which is chaired by the Prime Minister and its members are composed of relevant Ministers. The board makes high-level decision on investment policy and supervises investment promotion and facilitation activities.

The major duties and responsibilities of the EIC include Providing information to investors; receiving investment applications; approving and issuing investment permits; providing registration services to newly incorporated business organizations, including notarization of memorandum and articles of association; providing work permits to foreign employees; Issuing trade and operating licenses to approved foreign investments; facilitating the acquisition of land by foreign investors; Providing all other pre and post- approval services to investors and promoting and facilitating foreign direct Investment.

It also approves investment incentives, promotes, facilitates and regulates industrial parks, initiates policy and implementation measures necessary for a conducive and competitive investment climate in collaboration with relevant stakeholders.

Besides EIC, a number of other Government organization involve in contributing to Ethiopia's investment promotion efforts. The organizations and their roles are discussed in the following section.

5.3.2 Other Government Agencies and Roles in Promotion FDI

Industrial Parks Development Corporation: The government established the Ethiopian Industrial Parks Development Corporation (EIPDC) in 2014 with the mandate to establish Industrial Parks so as to facilitate access to land, infrastructure, utilities, and logistic and customs processes. The corporation develops public industrial parks, rents or sells pre-built factory sheds to industrial park enterprises; sub-leases developed land and operates, manages and maintains parks.

The Industrial Parks proclamation 886/2015 provides that industrial parks can be developed by any profit-making public, public-private or private enterprise. Three mechanisms are in place for the establishment of IPs/SEZs: (a) fully developed by the federal or regional government; (b) developed by PPPs with the IPDC; and (c) by private developers only. Industrial parks in Ethiopia can also be categorized based on their focus sector including textile and garment; leather and shoes; agro-processing, pharmaceutical and IT parks.

Ministry of Trade: the ministry provides commercial registration and licensing services (delegated to EIC as regards foreign direct investment); registers brownfield investments (purchase of existing enterprise or shares) by foreign investors; registers and certifies commercial representatives and issues import/export release permit.

Ministry of Industry: The ministry ensures the growth of industrial productivity through facilitation of technology transfer, skills development and extension services; establishes sector-specific industry development institutes which provide support in areas such as market facilitation, labour screening and recruitment, knowledge and skills development etc.

Ethiopian Revenue and Customs Authority: among others it collects revenue from customs duties and other taxes; administers tax incentives given to investors and provides customs clearance and facilitation service for import and export items; provides on-site customs clearance in industrial parks.

Ministry of Labour and Social Affairs: The ministry provides information on labour rules and regulations for investors; initiates and leads a tripartite engagement with employer and employee associations within and outside of industrial parks and assigns labour inspectors to follow up and supervise on implementation of labour laws by investors.

National Bank of Ethiopia: The country's central bank manages the country's foreign exchange reserve; ensures effective use of such reserve through monetary and financial regulations; issues approval

of transactions involving foreign hard currency (investment capital inflow, repatriation of funds, suppliers' credit, export/import bank permit etc.).

Development Bank of Ethiopia: A specialized financial institution established to promote the national development agenda through development finance and technical; support to viable investment projects in priority sectors such as agriculture, agro-processing and manufacturing and Provides medium and long-term loans for export-oriented investment projects in priority sectors. DBE is charged with the task of supporting national economic policy by extending higher-risk medium and long-term loans to large- and medium-sized enterprises. Priority is being given to growing companies in the resource, export and import-substitution sectors through provision of loans. The principal ways in which DBE managers envisage the Bank supporting investment promotion is through providing co-financing of FDIs and joint ventures and to local businesses that are major FDI suppliers.

Legally established foreign companies in Ethiopia have access to domestic bank loans on the same terms as domestic investors. Exporters also have access to external loans and suppliers' or foreign partners' credit in keeping with the directives of the National Bank of Ethiopia (NBE). However, foreign investors must have their investment capital, external loans, and suppliers' or foreign partners' credits registered with the NBE.

Regional Investment Bureaus (RIB): The final group of public sector organizations which could play an important role in national FDI strategy and policy are the RIBs. RIBs have been given the responsibility to identify, develop and promote specific investment

projects in their regions. Most RIOs works within the framework of the national investment code although some have their own incentive schemes. Their priority functions are to license domestic investors; research, identify and prepare local investment opportunities; help domestic and foreign investors acquire land or property required for their businesses; and host visits by potential investors.

5.3.3 The Private Sector Organizations

In addition to government agencies, private sector organizations plays important role in promoting FDI. The most important include the chambers of commerce and sectoral associations and existing foreign companies operating in the country.

The Chambers of Commerce and sectoral associations are active participants in the FDI promotion and will become a more important part of the FDI delivery framework in Ethiopia. The Chamber undertakes functions covering business and market information; trade affairs and overseas trade missions; business advisory services, especially to start-up businesses; business skills training; publication of business directories and advisory leaflets; and the operation of a small library, Internet service and web site. It also undertakes specific studies on the obstacles to doing business in Ethiopia and proposes new policies and/or adjustments to existing policies; promotes entrepreneurship, sectoral trade associations and the culture of democracy and free market system; and serves as a bridge between the Government and the business community.

Senior management of FDI companies play a lead role in building the external image and corporate perception of the commercial

profitability and attractiveness of a host country, within their parent corporations (perhaps determining follow-on investment) and in their contacts with their international suppliers of goods and services.

5.4 Investment Incentives

5.4.1 The Objective of FDI Incentive

Countries have different FDI objectives and strategies, which are meant to serve their overarching development objectives. The objective of providing incentive can enhance a country's revenue by making investment condition favourable. According to UNCTAD, incentives are used to channel investment into four major categories, including regional Investment, Sectoral Investment, Performance enhancement, and Transfer of technology.

Regional Investment: Countries often employ a mix of incentives to channel investment for development of a particular area or region. Regional development objectives include support for rural development, building industrial zone away from major cities and reducing environmental hazards, over-urbanization and concentration of population. In this case the government focus is only to specific region that needed attention/affirmative action

Sectoral Investment: Countries employ tax incentives in order to promote sectors of industry or activities considered crucial for development. The majority of tax incentives granted by developing countries relate to investment in manufacture, exploration and extraction of mineral reserves, promotion of export and, increasingly, the tourism and leisure sectors. The above mentioned sectors are

selected because of their behaviour like great start-up capital need of educated human force and the like.

Performance enhancement: Incentives can be targeted at many types of activities, such as export promotion, employment/skills training etc. Free trade zones (FTZs) typically cover incentives for export-oriented manufacturing. To be competitive in the world market it's a must to be able to provide quality goods & services so the need to improve the way of production is essential. In the meantime it will force to improve performance.

Transfer of technology: Another important objective of incentives is to transfer technology. Due to Foreign Direct investment new technologies will enter in the country. The skills of the host country employees will improve and new technology will be familiarized.

Today, technology has become the most important source of economic growth. It is well understood that economic growth results either from accumulation of factors of production or from improvements in technology or both. New technologies spread throughout the world through a multitude of channels like FDI, licensing, import of capital good, turnkey plants, cross-border movement of personnel, etc. Technology transfer through FDI has become the predominant channel of technology transfer.

FDI can have important technological spillovers in host economies, especially if it takes a joint-venture form subject to local control. Technology transfer has been a subject of considerable interest to many groups, such as government policymakers, international funding agencies, and business executives, because of the close relationship

between technology transfer and economic growth. The experiences of countries which have built their technological capability in a relatively short period of time show that technology copying is an important vehicle for technological capability building.

Ethiopian tech transfer policy: Technological learning and change in Ethiopia shall take place primarily by improving foreign technologies that are required by the economy. Currently, however, there is lack of systematic transfer of foreign technologies based on the demands of the various social and economic sectors. There is also weak technological capability for the effective absorption of foreign technology. The country shall, therefore, devote resources to assimilation, adaptation and improvement of foreign technologies with prior attention given to development of domestic technological capabilities. The strategy among others promote Expanding the flow of technology through foreign direct investment, Promote the development of domestic technological capabilities for the effective absorption of foreign technologies and accelerate inter-firm dissemination of technological information and know-how.

5.4.2 Classification of Investment Incentives

Hereunder Investment incentives are broadly classified into non-fiscal and fiscal ones.

a) Non-Fiscal Incentive

Non-tax incentives refer to all nontax aspects that encourage investment, such as effective regulation, good access to land, and a healthy business environment. In addition, the processes that encourage investors to invest can also be included under this category.

Loss carry forward

Business enterprises that suffer losses during the income tax exemption period can carry forward such losses, following the expiration of the income tax exemption period, for half of the tax exemption period. Any loss incurred during income tax exemption period is not allowed to carry forward for more than five income tax periods.

Non-fiscal export incentives

In relation to exporting investors, the key Y incentives include:

One, exporters are allowed to retain and deposit in a bank account up to 20 percent of their foreign exchange earnings for future use in the operation of their enterprises and no export price control is imposed by the National Bank of Ethiopia;

Two, Franco Valuta import of raw materials are allowed for enterprises engaged in export processing;

Three, Exporters can benefit from the export credit guarantee scheme, which is presently in place in order to ensure an exporter

receives payment for goods shipped overseas in the event the customer defaults, reducing the risk of exporters' business and allowing it to keep its price competitive;

Repatriation right

Any foreign investor shall have the right, in respect of his approved investment, to make the following remittances out of Ethiopia in convertible foreign currency at the prevailing rate of exchange on the date of remittance. These include, Profits and dividends accruing from the investment; Principal and interest payments on external loans; Payment related to technology transfer agreement; Payment related to a collaboration agreement related to export oriented non-equity based foreign enterprise collaboration agreement; Proceeds from the transfer of shares of parties ownership of the enterprise to domestic investor; Proceeds from the sale or liquidation of the enterprise; and Compensation payment.

b) Fiscal Incentives

A good tax system ensures predictable revenue for government, presents a reasonable tax burden to investors, is stable, and minimizes distortions in investment decisions. In the past tax issues were not determining factors for businesses to decide whether to invest in one country over another. Some studies showed that “the statistical determinants of the location of investment are market size, labor cost, infrastructure quality, growth of industrialization, level of foreign investment, growing domestic markets, and stable international relations. However, according to more recent studies, tax issues are becoming a more important factor in the decision-making process; “globalization has dramatically reduced the

importance of these factors, and elevated the role of tax incentives” (Margalioth, 2003).

Tax incentives can be defined as any incentives that reduce the tax burden of enterprises in order to induce them to invest in particular projects or sectors. They are exceptions to the general tax regime. According to (Clark, Cebriero & Bohmer, 2007) tax incentives are chosen by governments to attract investment in developing countries are mainly because they are: much easier to provide than to correct deficiencies in, for example, infrastructure or skilled labor, implementing economic reforms; do not require an actual expenditure of funds or cash subsidies to investors; and, politically easier to provide than funds.

Of the fiscal incentives, Customs duty and Income Tax Exemption incentives are discussed in the following paragraphs.

i) **Customs Duty**

Foreign investors engaged in eligible new enterprises or expansion projects benefits from the following incentives:

- 100% exemption from the payment of customs duties and other taxes levied on imports is granted to all capital goods, such as plant, machinery and equipment and construction materials;
- Spare parts worth up to 15% of the total value of the imported investment capital goods, provided that the goods are also exempt from the payment of customs duties;

- An investor granted with a customs duty exemption will be allowed to import capital goods duty free indefinitely if his investment is in manufacturing and agriculture, and for five years if his investment is in other eligible areas;
- An investor entitled to a duty-free privilege who buys capital goods or construction materials from local manufacturing industries shall be refunded the customs duty paid for raw materials or components used as inputs for the production of such goods;
- Investment capital goods imported without the payment of custom duties and other taxes levied on imports may be transferred to another investor enjoying similar privileges.

Income Tax Exemption

- Investors engaged in manufacturing, agribusiness, generation, transmission and supply of electrical energy; and ICT are entitled to income tax exemptions for a period ranging between 1 and 9 years, depending on the specific activity and the location of the investor;
- In addition, any investor who establishes a new enterprise in Gambella; Benishangul-Gumuz; Afar (except in areas within 15 kilometers right and left of the Awash River); Somali; Guji and Borena Zones (in Oromia); or South Omo Zone, Segen (Derashe, Amaro, Konso and Burji) Area Peoples Zone, Bench-Maji Zone, Sheka Zone, Dawro Zone, Keffa Zone, Konta and Basketo Special Woredas (in Southern Nations, Nationalities and Peoples Region) is entitled to an income tax deduction of 30%

for three consecutive years after the expiry of the income tax exemption period specified above;

- An investor who expands or upgrades his existing enterprise and increases at least by 50 percent its production or service capacity, or introduces a new production or service line at least by 100 percent of an existing enterprise is entitled to the income tax exemption period specified in the first bullet above;
- Investors who export at least 60 percent of their products or services, or supply these to an exporter, will be exempted from the payment of income tax for an additional 2 years;

Industrialization Policy and FDI

Attracting FDI is at the core of Ethiopia's industrialization strategy, which is supported at the highest level and in particular by the Prime Minister (Ohno, 2013). To that end, Ethiopia's investment policy has been reformed at least four times over the past 20 years, making the country increasingly open to FDI.

Focusing on the manufacturing sector, Ethiopia is prioritizing FDI in specific sectors: textile and apparel, leather and leather products, agro-processing, and pharmaceuticals and chemicals. The imperative is to build on the country's agricultural foundations by moving toward new tradable activities in manufacturing that absorb large numbers of young and semi-skilled workers. Ethiopia's potential in the light manufacturing sector is significant, but faces binding constraints related to access to land, infrastructure, trade logistics, customs regulations and a skills gap (World Bank, 2012). FDI is seen as a way

of lifting all these constraints, with an important role to be played by industrial parks.

INDUSTRIAL PARK

With this scheme, Ethiopia is seeking to replicate the experience of East Asian countries such as Taiwan, Malaysia, or China, which have made an extensive use of industrial parks or SEZs to attract foreign investment and push her industrialization.

The GTP identifies industrial parks (or SEZs) as one of the means for industrialization and includes provisions on the establishment of industrial parks for the following manufacturing industries: textiles and garments, leather and leather products, sugar, cement, metals and engineering, chemicals, pharmaceuticals and agro-processing products. The selection of these specific sectors is to maximize Ethiopia's comparative advantages.

IPDC is mandated to develop and operate the parks, availing developed land and pre-built sheds equipped with all-encompassing utilities and infrastructural facilities. The industrial zones offer land for factories at US\$1 per square meter per month, tax holidays for up to seven years and customs & other services on site for those investing in the country.

The Industrial Parks proclamation 886/2015 provides that industrial parks can be developed by any profit-making public, public-private or private enterprise. Three mechanisms are in place for the establishment of IPs/SEZs: (a) fully developed by the federal or regional government; (b) developed by PPPs with the IPDC; and (c)

by private developers only. Industrial parks in Ethiopia can also be categorized based on their focus sector including textile and garment; leather and shoes; agro-processing, pharmaceutical and IT parks. In the following section, we will discuss each paths of industrial parks development with practical examples.

Chapter VI

An Overview of the Structure, Performance and Determinants of Foreign Direct Investment in Ethiopia

6.1 Introduction

According to the 2018 UNCTAD report, foreign direct investment (FDI) has been an important source of financing globally. It covers 39 percent of the financial requirement of developing economies. It is also believed to have significant effects on economic growth by serving as a medium of technological transfer, increasing global competitiveness, and creating employment.

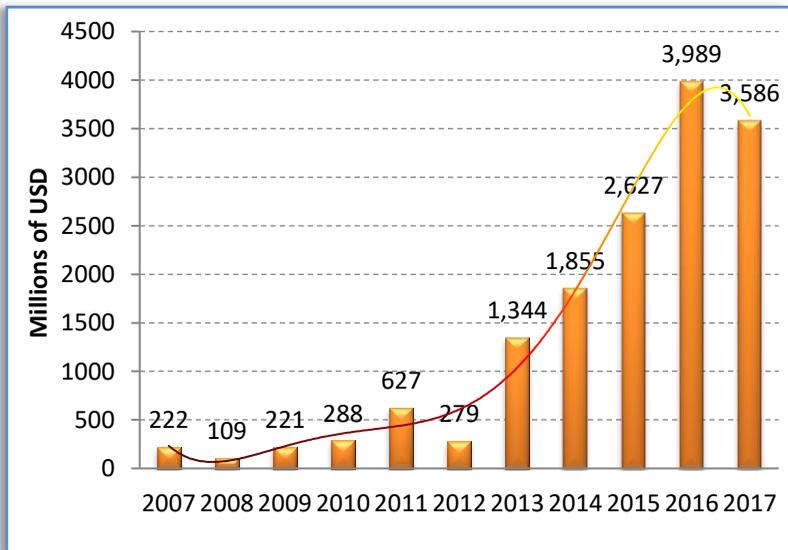
The worldwide volume of FDI stood at 1.43 trillion USD in 2017. Developing economies attracted 47 percent of the global FDI and was estimated at 671 billion USD. Flow of FDI to Asia accounted for 33.3 percent of the global volume and 71 percent of the total flow of FDI to developing countries. Africa's share in the global FDI stood at 2.9 percent with a volume of 42 billion USD in 2017 (UNCTAD, 2018).

FDI flow to Ethiopia in 2016, and 2017 was estimated to be 4 billion USD, and 3.6 billion USD, respectively (UNCTAD, 2018). This is equivalent to 0.25 percent of the global FDI, 8.6 percent of volume of FDI in Africa, and 47 percent of FDI flow to Eastern Africa. According to UNCTAD's report, the stock of FDI in Ethiopia stood

at 18.5 billion USD. This accounts for 22.5 percent, and 2.5 percent of stock of FDI in East Africa, and Africa, respectively.

FDI is a recent phenomenon in Ethiopia. It began to surge in 2003/04 in terms of number of projects but a noticeable increase in the value of capital of FDI projects was observed beginning in 2012/13, a period that marks the second year of the implementation of the growth and transformation plan (GTP) of the country. This appears to follow the overall high growth episode the country has witnessed. Inflow of FDI in Ethiopia increased 18 fold in eight years' time between 2009 and 2016.

Figure 6.1: Trends in FDI inflow to Ethiopia (millions of USD)



Sources: EEA staff compilation using data from UNCTAD, various issues. The level of FDI Ethiopia has attracted in recent years is high by African and even other developing countries standards. In 2015, FDI

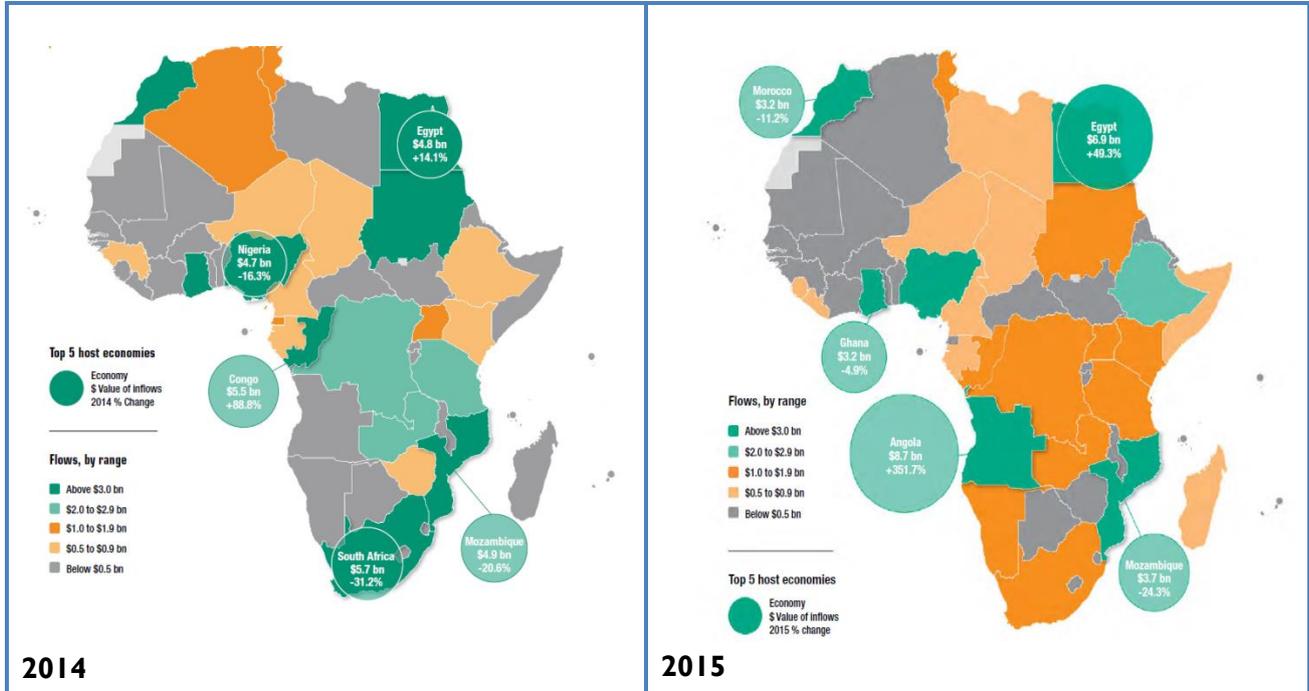
inflow to Ethiopia was the sixth largest after Angola, Egypt, Mozambique, Ghana, and Morocco. With the exception of Egypt, all the other four countries that had FDI larger than Ethiopia have natural resources in particular oil. In 2016, Ethiopia was the fourth top destination of FDI in Africa after Angola, Egypt, and Nigeria. In the year 2017, the country significantly improved its rank in terms of size of FDI inflow (3.6 billion USD) to second place in Africa after Egypt which attracted 7.4 billion USD.

Ethiopia for the years 2014, 2015, and 2017 are revised to USD 1.9 billion, 2.6 billion, and 4.0 billion, respectively, in the 2018 report.

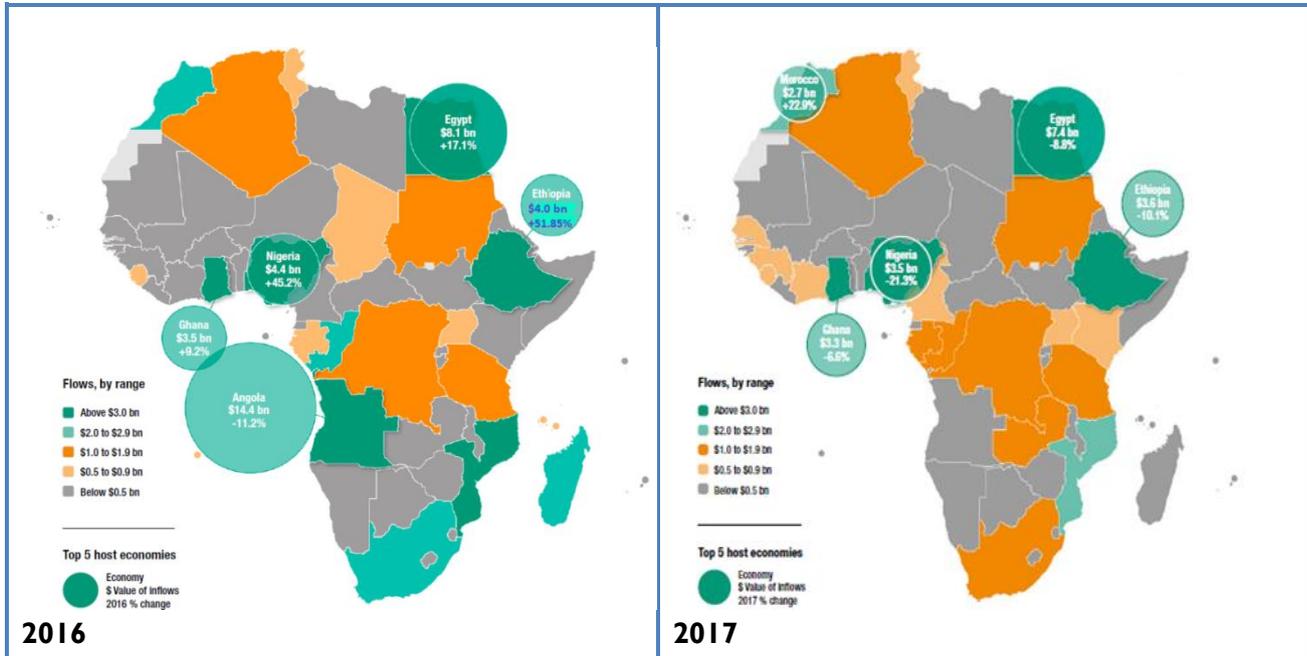
FDI has had an important role in financing Ethiopia's development endeavor. In 2017, FDI was higher than foreign exchange earnings from merchandise export by the tune of 43 per cent. It was equivalent to 67 per cent of the foreign exchange earnings from the export of goods and non-factor services, and 44 per cent of foreign exchange earnings secured through private and official transfers (NBE, 2018).

The centralized economic system by the Derg Regime (1974-1991) discouraged market economy and private property. Consequently, FDI was not encouraged during that period. After change in government in 1991 and more particularly following the 1992 investment reform, the inflow of FDI started to show a gradual increase. Accordingly, FDI rose from 2 percent of total investment in Ethiopia in 1995/96 to 59 percent in 1997/98. Even though this share fell during the Ethio-Eritrea war, FDI accounted for 20 percent of total investment capital for projects commencing in 1992–2001 (ECA, 2002).

Figure 6.2: Ethiopia fast becoming top destination of FDI in Africa



REPORT ON THE ETHIOPIAN ECONOMY



Sources: UNCTAD, various issues. Note that Ethiopia's FDI figures for the year 2016 are revised in the latest UNCTAD report.

Consistent with the global trends, there is a 10 percent decline in FDI flow to Ethiopia in the year 2017 over the preceding year (UNCTAD, 2018). The global performance of FDI was in general healthy and robust in 2015. However, it has been declining by about 2 percent in 2016 and even further by 23 percent in 2017. Primarily, return on investment had been an important driver of FDI flow globally. Return on FDI declined from 8.1 percent in 2012 to 6.7 percent in 2017. FDI in Africa is in particular vulnerable to volatility of commodity prices in the global market and political instability. Return on FDI in Africa fell from as high as 12 percent in 2012 to 5 percent in 2017. As if to follow the pattern, FDI in Africa fell by 21 percent while FDI to Asian economies rose. FDI to developing countries in general declined by 37 percent (UNCTAD, 2018).

Flows of FDI to economies are not automatic. It requires favorable initial conditions in the form of high growth, market, cheap and skilled labor, enabling policies, good infrastructure, efficient logistical support, political stability and good political capital. In Ethiopia, there are still a number of constraints to both domestic and foreign investment, namely, poor condition of infrastructure, difficulties related to land acquisition, strict foreign exchange controls, high transaction costs, and weakness of institutions. For instance, according to the World Bank's 2017 doing business report, Ethiopia ranks 159th out of 190 economies in 2016 (World Bank, 2017).

This chapter of the report reviews the structure and performance of FDI in Ethiopia at a macroeconomic level and identifies possible determinants of FDI inflow by using a panel data comprising ten selected countries including Ethiopia.

The main findings in this chapter are that:

FDI in Ethiopia has mainly been directed to the manufacturing sector (accounting for 71 percent of the total FDI) followed by agriculture, construction, and real estate.

FDI in Ethiopia has more capital capabilities and thus are larger than domestic firms by a factor of 8 fold and employees more labor than the domestic ones by a factor of 2 to 3 folds.

Foreign investment projects in the county has had better rate of completion compared to the domestic projects which are known to be unbearably delayed or even fail. Between 1992 and 2018, only 9.8 per cent of licensed investment projects owned by Ethiopian nationals were completed and began production. This sharply contrasts with the fact that 54 per cent of foreign owned investment projects that were licensed during the same period went operational.

China takes the lead in FDI in Ethiopia followed by India, the Sudan, USA, UK, Saudi Arabia, Turkey, and Netherlands.

Initial endowment in the form of per capita income, large size of population, infrastructure, and low cost of labor are found to be important drivers of FDI.

Domestic investment and FDI have shown complementarity either because FDI flows towards economies with better momentum signified among others by domestic investment or because FDI triggers domestic investment to flourish or due to both effects.

Foreign direct investment was associated with an improving current account balance in the case of East Asian countries unlike in the case

of African countries including Ethiopia. FDI was found to be accompanied by a deteriorating current account balance. One possible explanation is that FDI projects in those countries could be net users of foreign exchange earnings in the form of profit expatriation and imports of raw materials in excess of their own foreign exchange earnings.

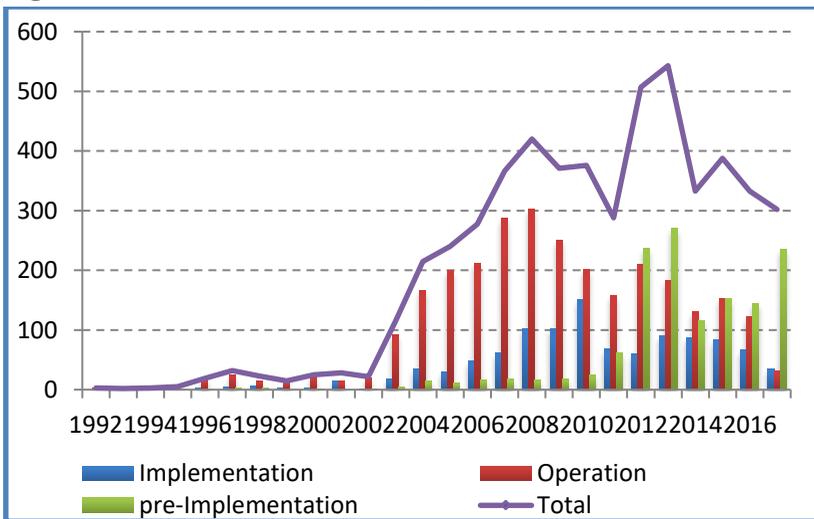
6.2 Structure and Performance of FDI in Ethiopia

FDI in Ethiopia is a recent phenomenon

Despite the country's commitment to promote investment in Ethiopia as early as 1992 after the incumbent government took power in 1991, FDI began to increase significantly in 2003. Between 1992, the number of FDI projects was only 3. Even after a decade, the number could not exceed 22. In the 2003, the number of projects that went operational surged up to 92 and reached 302 by the year 2008. As the growth and transformation plan intensifies into its second year of implementation in 2013, the total number of FDI projects reached 543. Unlike the investment projects owned by Ethiopian nationals (domestic investment), about 50 per cent of the total number of projects in 2013 either went operational or were in the implementation stage. There has been a deceleration in the number of FDI since then in the number of FDI projects that began operation to reach a modest 31 in 2017. The total number of FDI projects in 2017 stood at 302. This patten tends to follow the overall economic performance under the period of both phases of GTP where the causation between FDI and economic growth may operate in either way. As much as a slowdown in the economic growth caused by factors such as instability tends to slow FDI, slower FDI inflows in

turn operate against rapid economic growth. Overall, between 1992 and 2017, the Ethiopian Investment Commission has approved about 5,255 FDI projects. The annual average growth of FDI inflow in the last twenty-seven years periods was 40.3. Of the total number of FDI projects approved by the Commission, 67.5 percent were under operation stages.

Figure 6.3: Trend of FDI inflow, status



Source: EIC (August 22, 1992 - January 08, 2018 GC)

FDI is fast becoming an important source of financing development in Ethiopia

FDI in Ethiopia has been playing a pivotal role in financing Ethiopia’s development. In 2016/17, FDI accounted for 61.1 per cent of the net capital inflow into the country. In the same fiscal year, it exceeded the receipts from merchandize export by a margin of 43 per cent. It

is also equivalent to 60.3 per cent of private and official transfers (Table 6.1).

Table 6.1: Role of FDI as source of financing in Ethiopia

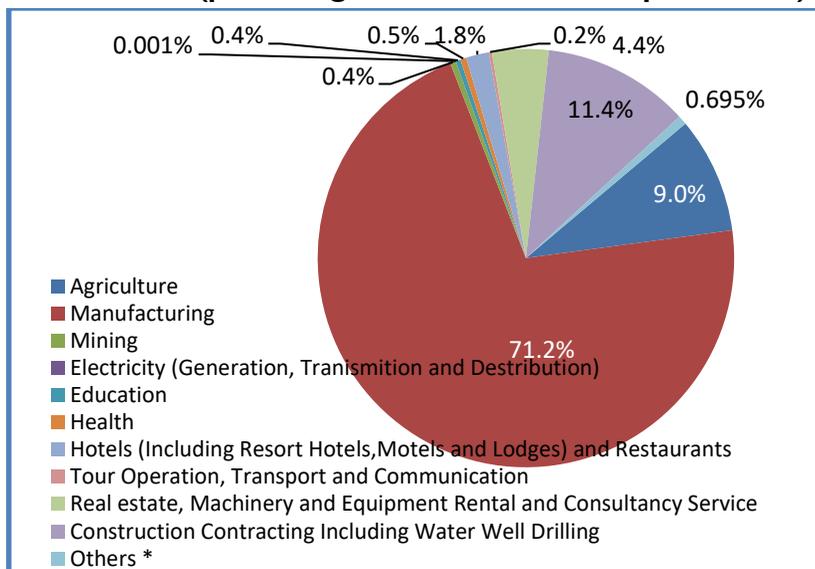
Particulars	2012/13	2013/14	2014/15	2015/16	2016/17
Exports, f.o.b.	3,081.2	3,254.8	3,019.3	2,867.7	2,907.5
Imports	11,467.3	13,721.9	16,458.6	16,725.2	15,802.6
Trade Balance	-8,386.1	-10,467.2	-13,439.3	-13,857.5	-12,895.1
Current account balance (exc. official transfers)	-4,349.4	-5,865.2	-8,899.1	-8,557.2	-7,956.8
Private transfers	3,577.5	4,042.5	4,881.6	6,013.0	5,485.3
Official transfers, net	1,529.9	1,161.6	886.5	1,493.0	1,428.3
Capital account	3,226.4	3,901.6	7,030.6	6,245.4	6,831.5
Foreign Direct Investment(net)	1,231.6	1,467.0	2,202.2	3,028.2	4,170.8
FDI to export ratio (%)	40.0	45.1	72.9	105.6	143.4
FDI to transfers (official plus private) ratio (%)	24.1	28.2	38.2	40.3	60.3
Share of FDI to capital Account (%)	38.2	37.6	31.3	48.5	61.1

Source: National Bank of Ethiopia

FDI projects in Ethiopia are concentrated more on the manufacturing sector

FDI projects in Ethiopia are distributed across different sectors (see Figure 6.4). However, the largest number of FDI projects is found in the manufacturing sector followed by the services sector. The primary sector (for example agriculture and mining sub-sectors) has the lowest number of number of FDI projects in the country over the 1992 to beginning of 2018 period. Four important features of FDI projects stand out in Ethiopia. About 71 per cent of the total capital of FDI that is 73 billion birr was the share of the manufacturing sector. This was distantly followed by construction, and agriculture sectors with respective shares of 11.4 per cent, and 9 per cent of the total capital inflow in the form of FDI.

Figure 6.4: Sectoral distribution of FDI in Ethiopia (percentage share in the total capital of FDI)

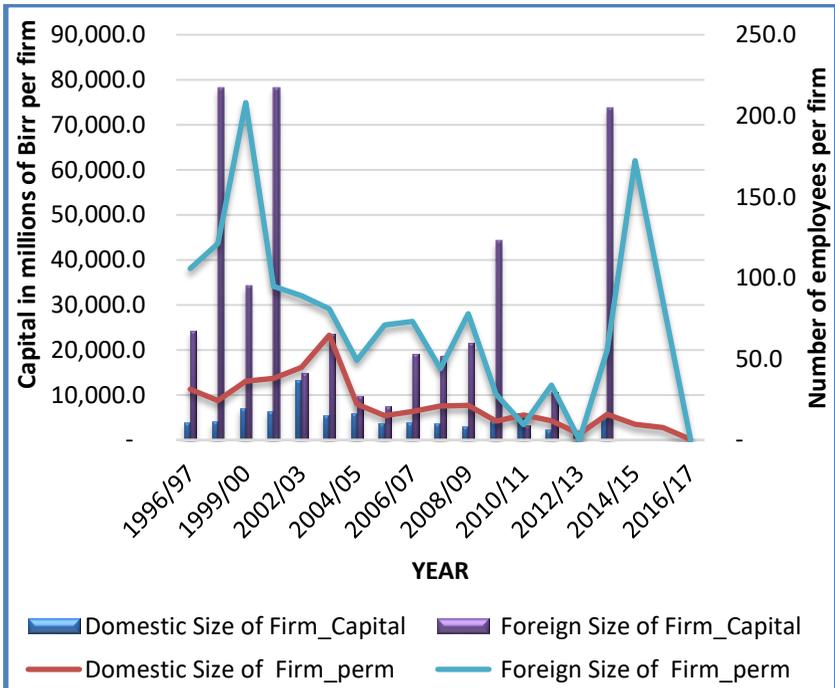


Source: EIC (August 22, 1992 - January 08, 2018 GC)

FDI projects in Ethiopia have larger firm sizes than domestically owned firms

One of the important attributes of FDI in Ethiopia is that foreign-owned firms are larger than domestic firms by the measure of both capital and labor. In general, foreign owned firms have an average size of capital eight times higher and employ two to three times more labor than firms owned by Ethiopian nationals (Figure 6.5).

Figure 6.5: Comparative size of FDI and domestic firms by size of capital and labor

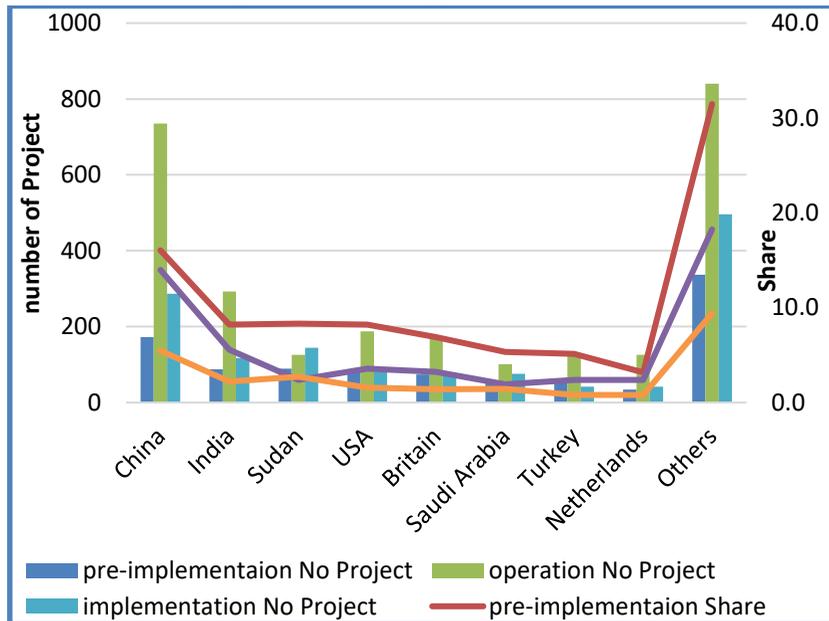


Source: EEA staff computations using data from EIC.

Chinese investment projects dominate the FDI in Ethiopia

Chinese investment dominates the FDI in Ethiopia accounting for 22.8 per cent of the total number of registered FDI projects and 14 per cent of investment projects that went operational until 2018. India follows with a share of 9.5 per cent in the total number of licensed investment projects and 5.5 per cent of FDI projects that began production. Chinese firms are known to participate in the construction, and manufacturing sectors. China is also an important source of financing Ethiopia’s infrastructure sector mainly in the form of loan.

Figure 6.6: FDI by source of origin



Source: EIC (August 22, 1992 - January 08, 2018 GC)

FDI in Ethiopia has better rate of completion than domestic investment projects

Total number of FDI projects licensed during August 22, 1992 to January 17, 2018 is about 5,255. According to their stage of development, these projects are classified into different status namely, approved/licensed, under-construction/implementation, and operational. Out of 5,255 FDI projects, 2,835 projects (54%) have become operational during the time period under consideration with a capital of Birr 103 billion while another 1,349 projects are in the stage of implementation or construction. The rest 1,071 projects are approved FDI projects awaiting implementation. The likelihood of FDI projects to mature to operational stage is generally low. For instance, of the total number of FDI projects in primary sector, manufacturing sector, and services sector only 42%, 54% and 59%, respectively have become operational. A close look into the available data show that the share of total licensed FDI projects that has become operational is declining over time.

Nevertheless, the performance of the investment projects owned by Ethiopian nationals in term of rate of completion is even worse. In contrast to the 54 per cent of rate of completion of FDI projects, 9.8 per cent of total investment projects licensed to domestic investors began commencing production and only 4 per cent of the projects were in the implementation phase during the period 1992 to 2018. Thus, the seemingly high rate of surge in investment projects in particular owned by Ethiopian nationals can at best indicate the level of optimism during a particular episode than the prospect of generating employments at the promised level.

Table 6.2: Domestic and foreign investment projects in Ethiopia by status of completion (1992 -2018)

Status as of January 2018	Foreign Direct Investment		Domestic Investment	
	Number of projects	Percent	Number of projects	Percent
Operational	2,835	53.95	8,970	9.83
Under construction	1,349	25.67	3,771	4.13
Approved	1,071	20.38	78,539	86.04
Total	5,255	100.00	91,280	100.00

Sources: EEA staff computation using data from EIC.

6.3 Determinants of Foreign Direct Investment

6.3.1 Introduction

Numerous theoretical and empirical studies have been conducted on the determinants of FDI using time series and panel data on developing countries. Nevertheless, the findings are still inconclusive on the factors that determine the inflow of FDI. While the prime objective of this study was to empirically identify the determinants of FDI inflow into Ethiopia, limited variation in FDI in the country over a fairly longer period of time dictated to use a panel data that involves other countries along with Ethiopia. In this setting, the purpose of the study is to draw a lesson for Ethiopia by identifying key drivers of FDI in East Asian countries vis-à-vis other African countries.

The study particular focuses on investigating how economic, institutional, and political factors affect FDI inflows to countries using standard econometric techniques in particular pooled OLS, random effects, and fully modified OLS in the framework of panel co-

integration by considering data over the period of 1990-2017. Specifically, the study examines the impact of market size, domestic investment, current account balance, political stability, infrastructure development, and labor cost on FDI in selected East African and Asian countries.

6.3.2 The Literature

Theoretical Literature

Bhatt, P. (2014) stated that there is an emerging consensus that FDI inflows depend on the motives of foreign investors. Motives of foreign investors can be broadly classified as (i) market seeking (ii) resource or asset seeking and (iii) efficiency seeking. Market seeking FDI is to serve local and regional markets. Tariff-jumping or export-substituting FDI is a variant type of this FDI. Market size and market growth of the host country are the main drivers of FDI. In the case of resources or asset seeking FDI, investors are looking for resources such as natural resources, raw materials or low-cost labour. This vertical-export oriented FDI involves relocating parts of the production chain to the host country. Resources like oil and natural gas, iron ore, cheap labour attracted FDI in these sectors. Efficiency seeking FDI occurs when the firm can gain from the common governance of geographically dispersed activities in the presence of scale and scope. One important variable explaining the geographical distribution of FDI is agglomeration economics. Investors simply copy investment decision taken by others. The common sources of these positive externalities are knowledge spillovers, specialized labour and intermediate inputs.

The neoclassical international trade and capital market theories assume perfectly competitive markets, as a result of which

international specialization leads to gains from international trade. According to this approach, the scarcity and relatively high cost of labor in developed countries make them transfer production facilities to less developed, labor-intensive countries (Caves, 1996; Cantwell, 2000). As a result, there is only one direction of capital flows: from advanced countries to capital-scarce countries. However, in the context of transition, it was highly criticized due to absence of perfect competitive market and basic market institutions and tools. On the other hand, the assumption of capital movement from economically developed countries to the capital-scarce countries was very important for understanding incentives of FDI in transition economies (McDougall, 1960; Kemp, 1964).

The second theory is monopolistic advantage theory. Coase (1937) initiated the discussion of the efficient allocation of assets to dispersed locations, and explained international activities of companies as their attempt to reduce transaction costs.

He also introduced the concept of transaction costs to explain the nature and limits of the organization of the firm, Consistent with Coase, Hymer (1960) offered an alternative, a microeconomic analysis of MNCs based on industrial organization theory, which relates MNCs' motives for FDI as to extend their activity abroad and transfer intermediate products such as knowledge and technology over the world. Actually, he was the first to identify the MNC as a business entity for international production rather than international trade in an imperfect market. Also, his theory highlights such important factors for transition economies as product differentiation, managerial expertise, new technology or patents, government

intervention, information asymmetry, culture differences and business ethics (Caves, 1971).

Based on the hypothesis of comparative advantage of factor endowments, which suggests that differences in endowments and initial conditions between countries explain the geographical pattern of inward FDI, Vernon (1966) introduced the theory of international product life cycle. However, his model simplifies FDI as a substitute for trade, and cannot explain the investment activities of transition countries in advanced economies.

Aggregate variables as determinants of FDI theory is based on empirical findings, rather than on any existing theory of FDI. While testing MNCs' incentives to invest abroad, Scaperlanda and Mauer (1969) found evidence of an impact of GNP size on FDI in Europe. Other researches also disclosed the significant role of market size, market growth, distance between the investor and host countries, cultural and language similarities, and diverse trade barriers as main determinants of FDI (Goldberg, 1972; Davidson, 1980; Lunn, 1980). Many investigations of FDI in transition economies are based on this approach. In the context of CEE countries, Altomonte (1998) showed that the bigger the size of the market and its potential demand, the higher the probability of attracting foreign investment; the distance between the home and the host country also influences MNCs' FDI decisions. Using an empirical model of bilateral FDI flows between the EU and CEE countries, Brenton, Di Mauro and Liicke (1998) found that income growth and business-friendly government policies were the key determinants of FDI to the region. The results of Lyrroudi, Papanastasiou and Vamvakidis (2003) for transition countries for 1995-98 indicate that FDI does not exhibit any significant

relationship with economic growth, which can be explained by the fact that all the transition countries had a similar crisis situation characterized by low economic growth then. Cukrowski and Kavelashvili (2001), and Mogilevsky (2001) claim that the poor transition economies attract fewer investors.

The other theory is substitute theory of FDI. Mundell (1968) argued that relations between commodity and factor movements are substituted when high trade barriers discourage commodity movements. This implies that FDI growth will diminish exports from the home country to the host country, and capital movements driven by FDI become the perfect substitute for exports. Goldberg and Kelin (1999) also argued that FDI can serve as a complement or substitute for trade on the effects identified by the Rybczynski curve. Their results indicated that the relations between FDI and trade present a mixed pattern of linkages, while some FDI flows tend to expand manufacturing trade, the other FDI reduce trade volumes. In the context of transition economies, Johnson (2005, 2006) proved that investment in a host country leads to an increase in the trade of intermediate goods used in production, which also implies that MNCs invest in the transition host country in order to export the output to third countries (neighboring markets).

An alternative to Substitute theory, complement theory, developed by Kojima (1979), called Complement Theory of FDI states that FDI originates from the comparatively disadvantaged industries of the home country, which are potentially comparatively advantaged industries for the host country, depending on the different stages of economic development in home and host countries. In other words, export-oriented FDI occurs when the source country invests in those

industries in which the host country has a comparative advantage; and thus, it is welfare improving and trade creating since it can promote both host countries' and source countries' exports. Such evidence found by him for Japanese business may also be extended to other transition countries.

According to the theory of internalization of FDI (OLI paradigm) suggested by Dunning (1988), transactions are made within an institution if the transaction costs on the free market are higher than the internal costs. Later, this theory was developed into the eclectic OLI paradigm, which argues that production of a firm in a foreign country depends on these three conditions: firm should have tangible and intangible assets and skills so that they can compete with the domestic firms of the host country who have national knowledge and experience (production technique, entrepreneurial skills, returns to scale, trademark - Ownership); for a firm, through an advantage taken from the host country, it should be more profitable to produce in the host country than to produce in the home country and export it (such as existence of raw materials, low wages, special taxes or tariffs - location), and realizing FDI project should be more profitable than selling, leasing or licensing the skills (advantages by producing through a partnership arrangement such as licensing or a joint venture - Internalization). In the context of transition countries, Dunning was the first to consider structure of resources, market size and government policies as the determinants of the location of FDI. He also argues that the patterns of FDI are not constant, but differ according to these determinants.

Three approaches were proposed within The Theory of Traditional Multinational Activity. The first is the vertical FDI model, that FDI geographically fragments the production process into stages, and

thus, possibly reverses trade in terms of asymmetries of factor endowments between host country and home country, and the asymmetries between countries also make it possible for trade and FDI to coexist (Markusen, 1984); the horizontal FDI model, that FDI produces the same goods and services in different locations, the interacting countries are assumed to be identical in technologies, preferences, and factor endowments, and hence MNC can be motivated by international trade (or by high productivity, lower labor costs, resource endowments, and favorable business environments) (Helpman, 1984), and the knowledge-capital model, which integrates vertical and horizontal approaches (Markusen et al., 1996). Both horizontal and vertical models highlight variables such as research and development across plants, plant-level scale economies, market size, factor endowments and transport costs, including geographical and cultural distance costs as well as the other kinds of barriers involved in the trade between home country and host country. Brenton, Di Mauro and Lüicke (1998) demonstrated that FDI has a direct impact on the economy of the source country in terms of being a substitute for trade, supporting the hypothesis of complementary relationship between FDI and trade. Lankes and Venables (1996) note that the mode of MNCs' entry into transition economies forms are different and reflects changes in both internal and external conditions. Bevan and Estrin (2000) and Hunya (2000) in case of CEE countries, Kumar and Zajc (2003) in the context of Slovenia, and Sova, Albu, Stancu and Sova (2009) for the new EU countries have studied many aspects of this issue. Their general finding is that MNCs prefer to construct horizontal FDI in transitional economies patterns due to the high uncertainty of host markets.

According to the resource-based theory of FDI, MNCs aim to possess resources that are rare, unique, and limited in order to beat their competitors in various performance indicators (Wernerfelt, 1984; Barney, 1991; Grant, 1991; Davidow, 1986). Tondel (2001) supports a hypothesis of market-seeking and resource-seeking investments prevailing in CEE and former Soviet republics. In line with Kudina and Jakubiak (2008), market-seeking orientation has the most positive effect on investment performance, followed by skilled labor and cheap input orientations in smaller transition countries. Based on statistically significant positive relation between FDI and market size, wage differential, the stage of the transition process and the degree of openness of the economy, Resmini (2000) also argues the same. However, in transition economies where the government is main stakeholder, the natural-resource-seeking activity of foreign investors is limited, which is particular characteristic of rent-seeking countries, such as Russia (Filippov, 2008). Consequently, foreign investors should seek labor and efficiency and form horizontal FDI patterns.

According to Krugman (1999), if trade is largely shaped by economies of scale, then those economic regions with most production will be more profitable and therefore will attract even more production and FDI, and production will tend to concentrate in a few regions (or big cities) with high levels of business infrastructure and large market size. This theory is known as The Theory of New Economic Geography. Analyzing FDI distribution in Russian regions, Ledyeva and Mishura (2006) conclude that only a factor of aggregate profit is robustly related to regional distribution of investment in Russia, which can be explained by the fact that only high profits can compensate for the risks and attract investors, due to unfavorable investment climate in Russia.

While the transaction-cost approach and the knowledge-capital model can explain horizontal and vertical patterns of FDI, they cannot explain diversified FDI (both in product and in location), as it occurs because of MNCs' desire to spread investment risk (Faeth, 2009) and explained by Diversified FDI and Risk Diversification Model. And there is strong evidence of this phenomenon among MNCs emerging in transition countries according to recent studies. Apart from advantage-seeking, a crucial motive for capital outflow is to avoid or diminish the unfavorable environment impact for domestic business. The attitude towards risk in the home country is strongly related to the size of FDI outflows that can be observed in transition countries (Kimino, Saal, and Driffield, 2007; Kayam, 2009).

The host government's promotion of an attractive business environment for foreign investors can influence MNCs' FDI decisions. In the context of transition, the role of government is strengthened even more by a high level of uncertainty, and thus, the risk. Tests of different proxies of transition uncertainty (such as the level of privatization and risk of expropriation, corruption, use of mass media by competitors, imperfect, non-transparent, and frequently revised legislative systems, political and economic instability, and the dual role of government in declaring policies to attract investment while in fact promoting domestic MNCs in which it is a stake-holder) produce evidence of such an impact. These factors also might cause capital flight from transition countries, and then capital return again via offshore jurisdictions (such as Cyprus, one of few countries with which many CIS countries have agreement to avoid the double taxation).

Empirical Literature Review

Empirical literature on the determinants of FDI often found the size of the market and the market potentiality, typically proxied by the level of GDP and GDP growth rate, significantly affect FDI inflow (see Nunnenkamp and Spatz, 2002; Bandera and White, 1968; Schmitz and Bieri, 1972; Root and Ahmed, 1979; Torrasi, 1985; Schneider and Frey, 1985; Petrochilas, 1989; Wheeler and Mody, 1992; Jun and Singh, 1996).

In most empirical literatures, It is extensively recognized that foreign direct investment (FDI) produces economic benefits to the recipient countries by providing capital, foreign exchange, technology, competition and by enhancing access to foreign markets (for example Brooks and Sumulong, 2003; World Bank, 1999; Caves, 1974; Crespo and Fontura, 2007; Romer, 1993; UNCTAD, 1991). It is argued that FDI can also enhance domestic investment and innovation (Brooks and Sumulong, 2003).

Singh and Jun (1995) find export orientation to be the strongest variable for explaining why a country attracts FDI. Yet, it is somewhat heroic to conclude that their findings are "in line with the secular trend toward increasing complementarity between trade and FDI" (ibid: inside cover). Surprisingly, the study also supports the tariff jumping hypothesis, which is in conflict with the authors' conclusion. Gastanaga, Nugent and Pashamova (1998) address the tariff jumping hypothesis in the context of a panel analysis on the effects of host country reforms on FDI. While cross-section results suggest that FDI flows were motivated more strongly by tariff jumping than by potential exports, the effects of import tariffs on FDI tend to be

negative in a time-series context.¹³ These authors conclude that "over time in individual countries trade liberalization has become the more important motive for FDI" (ibid: 1312).

According to the sensitivity analysis of Chakrabarti (2001), openness to trade (proxied by exports plus imports to GDP) has the highest likelihood of being correlated (positively) with FDI among all explanatory variables classified as fragile. Asiedu (2002), using the same proxy for openness, comes to a similar conclusion when separating Sub-Saharan host countries from host countries in other regions. Africa differs significantly from non-African sample countries with regard to other FDI determinants, whereas the promotional effect of openness to trade on FDI is found to be only slightly weaker in Africa.

Taylor (2000) resembles most other studies in that he does not assess changes over time in the importance of openness as an FDI determinant. His results do suggest, however, that a globalization-induced increase in the relevance of openness cannot be taken for granted. The positive correlation between openness and FDI is restricted to the manufacturing sector, whereas the correlation is insignificant for FDI by MNEs from the United States in the services sector. Considering that the recent boom of FDI in developing countries is largely because of FDI in non-traded services the relevance of openness even may have declined.

Peter Nunnen Kamp (2002) argued that Traditional market-related determinants are still dominant factors. Among non-traditional FDI determinants, only the availability of local skills has clearly gained importance. As concerns the interface between trade policy and FDI,

we find that the tariff jumping motive for FDI had lost much of its relevance well before globalization became a hotly debated issue.

Sobir Shukurov (2016) obtained the results of empirical analysis using panel data models, conducted with the purpose of identifying the factors that determine the motivation and decision of multinational companies (MNC) to invest in CIS economies, show that regardless of the presence of high investment risk in transition economies, the choice of FDI location always depends on a preliminary analysis of countries' advantages (FDI stock, market size, abundance in natural resources) and disadvantages at macro level (fiscal imbalance and inflation). These pre-existing conditions can always roughly predict the type of FDI (resource-seeking, market-seeking, efficiency-seeking).

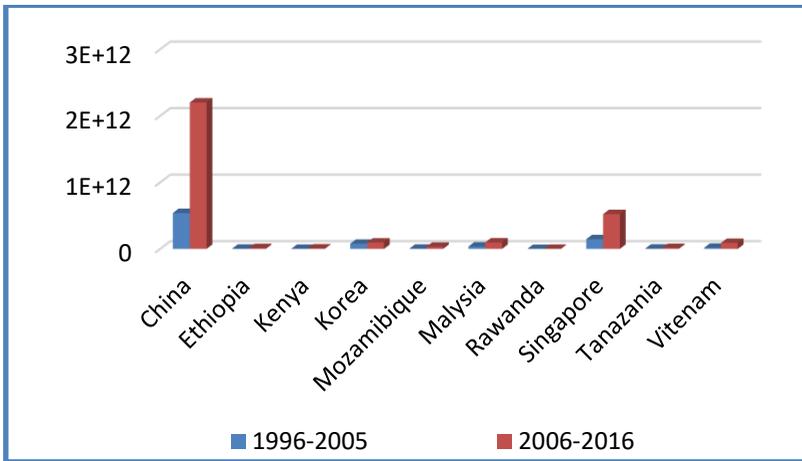
Overview of FDI in the Sample Countries: East Africa and Asia

Foreign direct investment is considered as a major factor towards development progress in East Asia and Africa countries (China, Singapore, Vietnam, South Korea, Malaysia, Ethiopia, Kenya, Tanzania, Mozambique, and Rwanda) via capital inflows, technological knowhow, human capital development and managerial expertise. In 2016, the FDI inflow to the top FDI receiver East Africa and Asia countries reached 296 billion dollar.

As per the data of World Bank database, foreign direct investment inflow in the top FDI receiver East Asia and Africa countries have been increased in the last 20 years. As for the share of FDI inflow, between 1996 and 2016, East Asia countries saw a high increase in

their share of FDI inflow compared to those of East Africa. Between 1996 and 2016, the average growth of East Asia countries share in the world FDI inflow has increased by 2.2%, whereas the East Africa countries has been slightly increased by 0.02%. Although FDI inflow has generally been growing, it is apparent that the growth rates remain quite different across the selected countries. For instance, China and Singapore accounted for 7.7 % and 3.05 % of world FDI inflow in 2016 respectively. In general, the top FDI receiver countries of East Asia account for about 11% of global FDI inflow, while the top FDI receiver countries of East Africa accounts only about 0.25% in 2016.

Figure 6.7: FDI inflow in the top FDI receiver East Africa and Asia countries

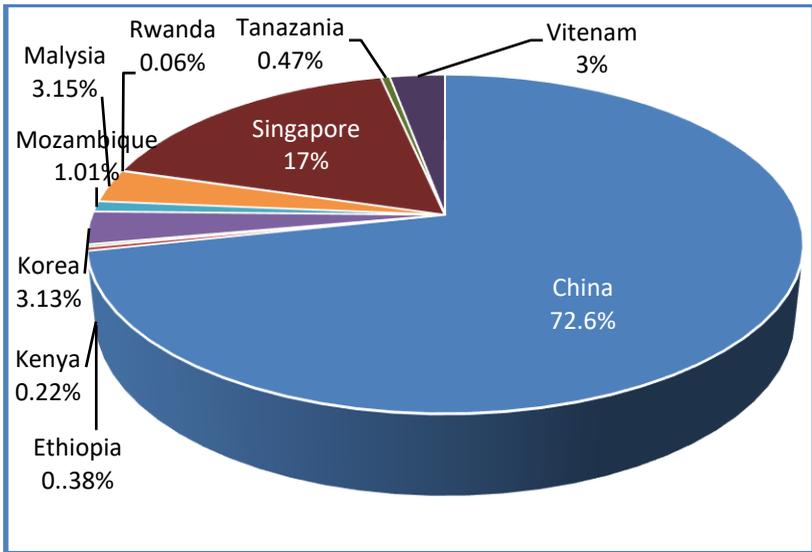


Source: World Bank data base

The Above figure showed that the achievements East Africa countries in attracting FDI are still low compared to the East Asia. Among the East Africa, Kenya achieved the highest Average growth in FDI inflow at 453 %, followed by Ethiopia (130%) between 1996 and 2016.

Mozambique has achieved the lowest growth rate in attracting FDI. Compared with other east-Asia countries, the increase in FDI inflows is more noticeable in case of China and Singapore in the 20 years.

Figure 6.8: Average share in the world FDI inflow between 2006 and 2016



Source: World Bank data base

Within selected two regions in the paper, foreign direct investment inflows are concentrated in East Asia countries. For instance, more than 72 percent of the foreign direct investment inflows were concentrated to the china. As depicted in Figure, amongst the countries, china and Singapore were the main contributors, with shares of 72.6% and 17.01% between 2006 and 2016, respectively. As for the East African countries, Mozambique accounted for the largest

share 1.1 % in 2013 (compared to 15.4% in 1990). This is followed by Tanzania (0.47%) and Ethiopia (0.38%).

6.3.3 Theoretical Framework

To identify the determinants of FDI several models have been used. One of the first models was the Heckscher model that explains the FDI theory based on the possibility of high profitability in growing market, low interest rate to finance the investment and low trade barrier in the host country. Some scholars show that the transaction cost and ownership advantage as one of the determinants of FDI (Buckley and Casson, 1981). OLI (Ownership, Location, Internalization) paradigm developed by the John Dunning shows that foreign firms hold advantage over domestic firm as result of the ownership, location and internalization advantages. The efficient infrastructure will encourages the foreign investors since it reduce the means high costs for transaction and facilitate Dunning (1993) states that FDI inflow is seeking of the low wage rate in the host country. Market size that mostly indicated by GDP per capita considered as a key determinates of FDI inflow that allow for the foreign companies to benefit from scale and scope economies (Mossa, 2002). The political instability has an adverse influence on the decision of the foreign companies (Fatehi-Sedah and Safizedah, 1989). Thus, based on the different model above, there are different factors that determined the FDI. The study used some of the factors that mentioned in the above.

Model Specification

Following the theoretical and empirical framework in the above, the variables used in this study are net inflow of FDI, GDP per capita, current account, labor cost, infrastructure, political stability and population. FDI is treated as dependent variable while others as independent variables. The model can be specified as:

$$FDI = f(PCI, N, infra, DI, CA, w, s)$$

Where FDI = foreign direct investment, PCI = per capita GDP, N = population size, infra = infrastructure, DI = domestic investment, CA = current account balance, w = cost of labor, and s = political stability.

Annual data was collected on key variables from ten countries for the period 1996-2016 providing 210 observations. The data is obtained from the World Bank database. The countries covered in the study are China, South Korea, Singapore, Malaysia, Vietnam, Rwanda, Ethiopia, Kenya, Tanzania, and Mozambique. The selection is based on variations in FDI.

Pooled OLS, random effects, and fully modified OLS (panel co-integration analysis) were employed to identify the determinants of FDI in the panel of the selected countries. The later method is applied irrespective of the relatively shorter time series dimension of the panel data (T = 21) to avoid possible spurious regression.

6.3.4 Empirical Result

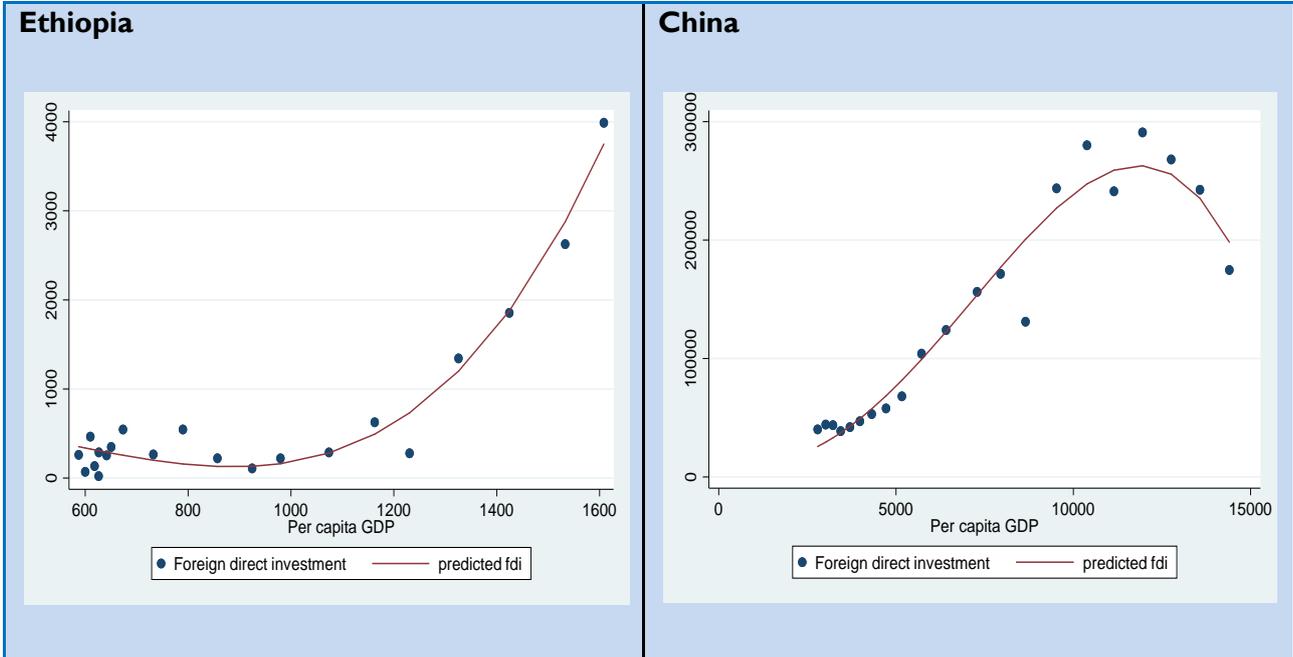
Preliminaries

Scatter plots of FDI with its potential determinants gave interesting clues on the possible direction of the impact of the drivers of FDI. Among the potential drivers of FDI, per capita income, infrastructure, cost of labour, and current account balance are discussed in the preliminary investigation of determinants of FDI in the panel of ten African and Asian countries.

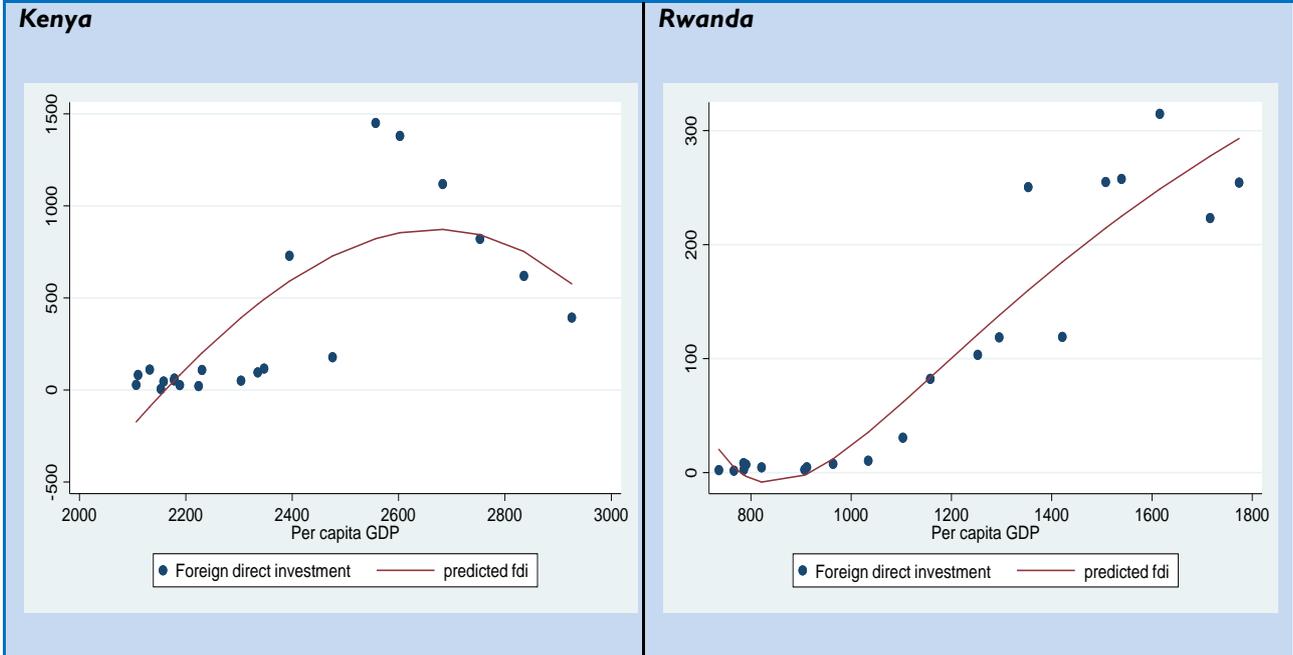
Per capita income is found to be systematically associated with FDI

In all ten countries considered by this study, there is a strong association between per capita income and FDI. Theoretically, FDI tends to flow towards countries with a promising economy. As it can be seen in Figure 6.9, there is less systematic relationship between per capita income and FDI at lower levels of and less vibrant per capita income. As per capita income tends to grow faster with a certain level of threshold, FDI tends to interact systematically and positively. The expected causation is that FDI first flows following promising domestic efforts in the form of high growth and begins to fuel and invigorate growth as FDI intensifies. High cost of labor and competition from domestic firms eventually reduces FDI flow as it is demonstrated in the case of China (and the same pattern is observed in the case of South Korea). Ethiopia and Rwanda are in the stage of attracting FDI and seem to be poised to exploit the return from it. The pattern is less systematic in the case of Kenya. One explanation for this might be the fact that even though Kenya has a relatively higher level of income than Ethiopia, it has not experienced a momentum of fast growth over the last decade.

Figure 6.9: Co-movements in per capita income and FDI in selected countries



AN OVERVIEW OF THE STRUCTURE, PERFORMANCE AND...

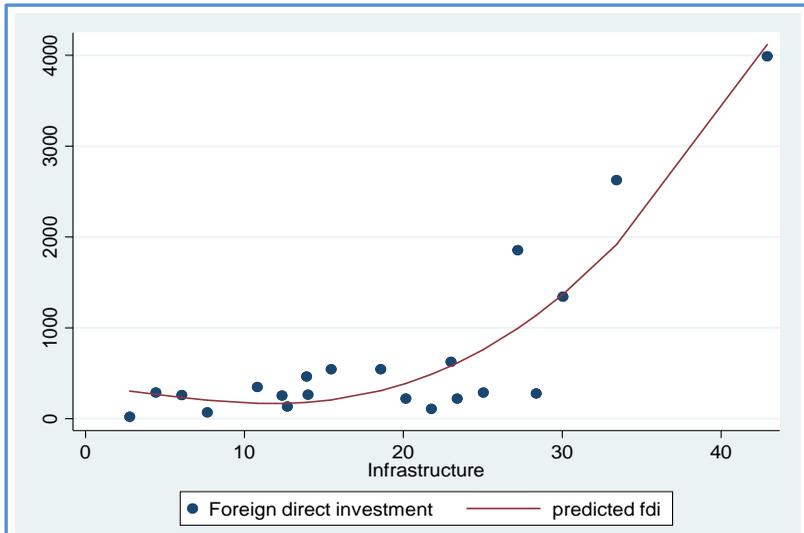


Source: EEA staff computations using data from the WB

Infrastructure exhibits a systematic association with FDI

In all countries considered FDI has less systematic association with infrastructure (measured by expenditure in the sector) at the early stages of infrastructural development. FDI exhibits a more systematic relationship with infrastructure as the latter expands significantly. Figure 6.10 shows the pattern of association between FDI and infrastructure in Ethiopia.

Figure 6.10: Co-movements in FDI and infrastructure in Ethiopia



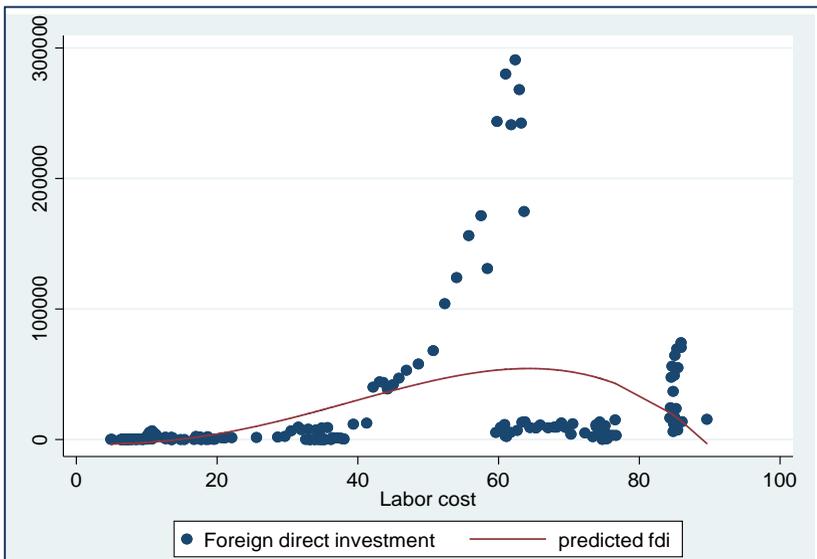
Source: EEA staff computations using data from WB

Cost of labor exhibited a complex pattern in relation to FDI

As it can be seen from Figure 6.11, cost of labor has less clear association with FDI. One possible interpretation of the pattern is that countries initially have less cost of labor and at the same time

less inflow of FDI as both are jointly determined by low level of per capita income. As FDI tends to flow mainly due to rising income, low cost of labor tends to encourage FDI inflow. More competition and increase in demand in a growing economy leads to a rise in cost of labor (wage in this stage becomes endogenous). As the economy develops (for example in countries such as South Korea and China), higher wages and thus high cost of labor tends to operate against FDI inflow.

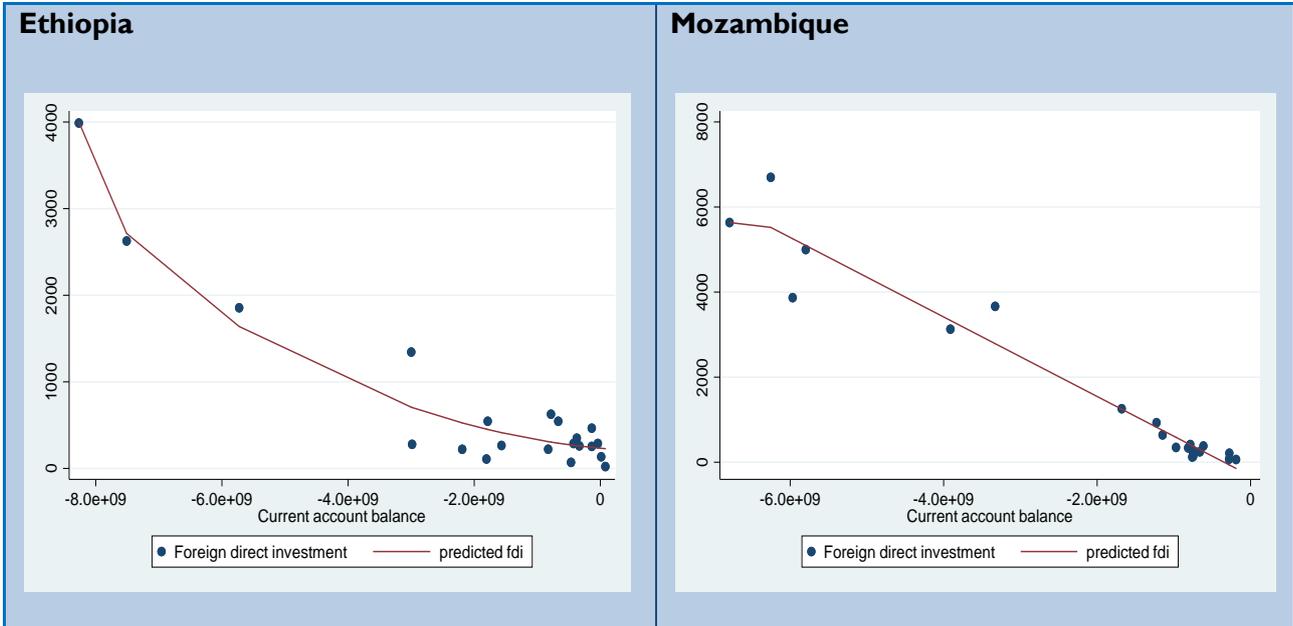
Figure 6.11: Patterns of cost of labor and FDI in selected countries



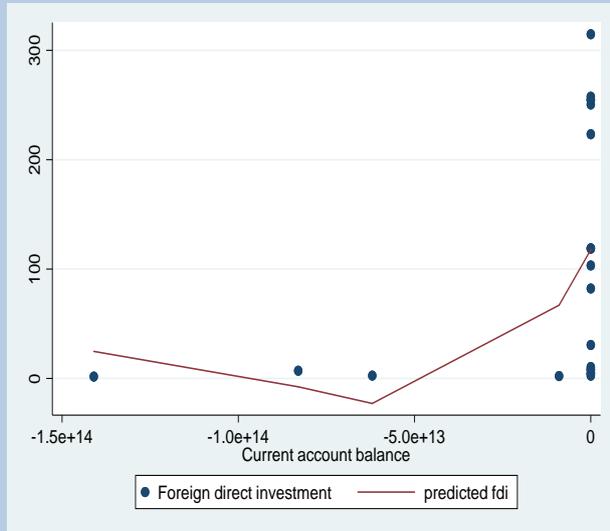
FDI is associated with current account balance differently in Asian and African countries

An important observation from the scatter plot of current account and FDI is that FDI in the sample countries from Asia is associated with improving current account balance while in the sample countries from Africa; FDI was associated with a deteriorating current account balance. An exception is Rwanda where FDI was initially neutral to but was later associated with an improving current account balance. One possible explanation is that FDI in Asian countries were engaged in export oriented strategy and at the same time encouraged to reinvest profit instead of repatriating it. In African countries, FDI might be net user of foreign exchange earnings. Whatever the case may be, FDI that is not associated with an improving current account balance may not be sustainable due to high debt burden and difficulties to recoup profits in the form of hard currencies.

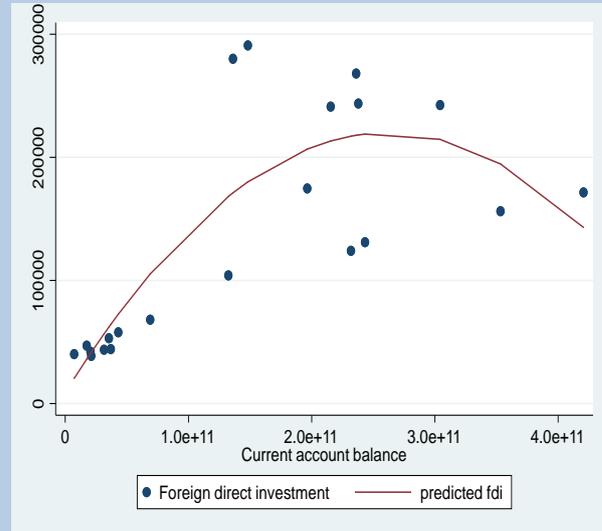
Figure 6.12: Current account balance and FDI in selected countries



Rwanda



China



Econometric Results

The Fisher-ADF unit root test shows that all variables involved in the study are non-stationary in levels but their first differences are stationary implying that each variable is integrated of order one (See Annex Table 6.4). The implication is that outright application of OLS cannot be justified. As a result other advanced methods in particular co-integration analysis should be sought. Even though the time series dimension of the panel is short to dictate the need for co-integration analysis, using the later method can still be complementary to other methods.

Results of the panel co-integration analysis

The Kao, Pedroni, and Westerlund tests are among residual based tests for panel co-integration. In this particular study, the Pedroni test for panel co-integration was applied to identify a possible long-run relationship among FDI inflow and its determinants using data for a sample of 10 countries over the period 1996-2016. Primarily, all the test statistics reject the null hypothesis of no co-integration in favor of the alternative hypothesis that there exists panel co-integration among foreign direct investment, per capita GDP, infrastructure, current account balance, domestic investment, labor cost, and population size. Following the result for co-integration tests, three methods are used to estimate the model: pooled OLS, random effects, and fully modified ordinary least square (FMOLS). While FMOLS is procedurally implied by the fact that there is co-integration among the variables involved, results of pooled OLS and random effects method are presented also conducted and were found to yield results consistent with that of FMOLS. Results are shown in Table 6.3.

Table 6.3: Regression results of determinants of FDI

Dependent variable: Foreign direct investment

	Pooled OLS		Panel Regression (RE)		Fully modified OLS	
	Coefficient	t-statistics	coefficient	t-statistics	Coefficient	t-statistics
Per capita income	1.307	7.257**	1.264	8.268**	1.228	4.190**
Domestic investment	6.57×10^{-13}	3.598**	2.90×10^{-13}	2.274*	4.99×10^{-13}	2.367*
Current account balance	2.22×10^{-14}	3.196**	1.74×10^{-14}	3.846**	3.27×10^{-14}	2.871**
Infrastructure	1.215	6.187**	1.0513	7.112**	1.128	4.341**
Size of population	0.479	4.260**	0.639	7.055**	0.688	8.920**
Average cost of labor	-1.519	-5.996**	-1.089	-5.002**	-1.647	-3.595**
Dummy for instability	-0.104	-0.619	-0.056	-0.486	0.138	0.4395
Constant	2.508	1.026	-0.713	-0.359		
N		10		10		10
T		21		21		21
R^2		0.82		0.75		0.81
\bar{R}^2		0.81		0.74		0.80

** Significant at 1% level; * significant at 5% level.

Note that covariates domestic investment and current account balance are in levels while the dependent variable (FDI) and all other explanatory variables except the dummy for instability are in logarithm scales.

In terms of significance, the results are similar under the three methods - pooled OLS, random effects, and fully modified OLS models. Per capita GDP, domestic investment, infrastructure, improved current account balance, and size of population are found to have positive impact on FDI. In particular, the positive sign and significance of per capita GDP and domestic investment may imply that in order to attract FDI, a country needs to have a certain minimum effort. The per capita income along with population size represents size of market in a country and domestic investment tends to signal the dynamics of the economy for foreign investors who contemplate investing in a particular country. The result also support the argument that infrastructure is critical to attract FDI.

The result also shows that high cost of labor is negatively associated with flow of FDI. Countries with a relatively lower cost of labor tend to have more advantage to attract FDI. However, the quality of labor in terms of productivity was not considered in this study.

In particular, one may cautiously interpret that a 1 per cent increase in per capita income induces an inflow of FDI by about 1.3 per cent. This result is consistent with the argument of Demirhan and Musca (2008), and Asiedu (2002) which claim that high per capita GDP implies a better business prospect in the host country and represents the market size of the country. Political instability should in principle include government stability, corruption, law and order, democratic accountability, and quality of bureaucracy. However, data were missing on this index for a key country and hence the study had to rely on dummy for only political instability. The dummy variable was not however statistically significant. Paucity of data has also limited the model from including index of ease of doing business in each country.

The positive impact of availability of good infrastructure on FDI inflows is also supported by several empirical studies. For countries such as Ethiopia which have had poor state of basic infrastructure, an improvement in key infrastructure would be expected to encourage more FDI.

There might be competing theories on the role of domestic investment on FDI inflows. One argument is that domestic investment is a signal for foreign investors on the positive prospect of the economy of the country. The other possibility is that once FDI begins to emerge in a county, it motivates and transfer knowledge and technology to domestic investors. Still a third possibility is that FDI may flow to countries with less stiff competition. In this particular study, FDI has been found to be complementary to domestic investment.

Current account balance is found to be positively associated with FDI. Investors may look at the prospect of recouping their profit in hard currency and considers the countries position in terms of current account balance. Nevertheless, the causation from FDI to current account balance may also dominate if foreign firms are net users of foreign exchange earnings for importing raw materials and expatriating profits.

In conclusion, FDI inflow depends on a country's initial own effort in the form of domestic investment, and most importantly fast growing income. FDI need also be targeted in terms of its sustainability in strengthening the country's trade balance, technological choice and employment capacity.

Chapter VII

Sectoral Issues on Foreign Direct Investment in Ethiopia

7.1 FDI in the Agriculture Sector

7.1.1 Background

The agricultural sector across the developing world has experienced under-investment over the past decades. As a result, many governments in developing countries seek to attract increased foreign direct investment (FDI) in their agriculture sector¹⁸. Flows of FDI comprise capital provided (either directly or through other related enterprises) by a foreign direct investor to an enterprise, or capital received from an investing enterprise by a foreign direct investor. FDI has three components: equity capital, reinvested earnings and intra-company loans¹⁹.

¹⁸ Foreign direct investment (FDI) is defined as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate) (UNCTAD, 2007). https://unctad.org/en/Docs/wir2007p4_en.pdf

¹⁹ Equity capital is the foreign direct investor's purchase of shares of an enterprise in a country other than its own. • Reinvested earnings comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates, or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested. Intra-company loans or intra-company debt transactions refer to short- or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises (UNCTAD, 2007).

FDI is seen by host governments as a potentially important contributor to filling the investment gap and providing developmental benefits, for example, through technology transfer, employment creation and infrastructure development. Investing economies view FDI in agriculture as a potential way to increase their food security, particularly considering the volatile global food markets the world experienced in mid 2000s.

In recent years, FDI in agricultural land of the size of approximately 49 million hectares has been reported globally²⁰. Most of the deals have taken place in developing countries with agricultural water resources, such as in South East Asia, Latin America and Sub-Sahara Africa, but FDI is also occurring in developed countries such as North America, Australia and New Zealand. From the invested economy's perspective, a greater promotion of FDI in agriculture is a form of export-led agricultural industrialization making use of its comparative and competitive advantages. In agriculture, comparative and competitive advantages for a target economy could mean the wide and cheap availability of land, water and labor.

The benefits of FDI could theoretically involve provision of additional income, creation of additional job opportunities, improvement of the livelihoods of local populations, supply of capital and technical know-how, positive impact on supply and cost of food, increased tax income for host countries and improvement of infrastructure and technology for realization of unutilized agricultural potential and market access for farmers in rural areas (Tanja P., 2011).

²⁰ Land Matrix: <http://landportal.info/landmatrix>

However, FDI in agriculture is pursued in some cases only for speculative purposes without making use of the leased land resources. Implementation of agricultural FDI projects involves a number of risks, such as endangerment of local food security and water supply in invested countries, aggravation of land conflicts, creation of risks in local jobs, resettlement without compensation and forced evictions, insufficient contractual provisions to protect interest of local people and ecological and environmental risks, such as over-allocation of water resources, soil degradation and forest destructions.

7.1.2 Status and Performance of FDI Agricultural Projects in Ethiopia

FDI in the Ethiopian agriculture is largely a recent phenomenon. FAO data, for instance, indicates that agriculture's share in the total FDI coming into the country was less than 1% between 1994 and 1998. This, however, grew significantly since 1999 when agriculture's share in FDI projects increased to 6% and then to 11% in 2000 (FAO database)²¹. A study by Lucie (2009) indicates that agriculture's share has increased further since then and by 2007/8, FDI inflows into the agricultural sector account for 32% of the total FDI inflows into the country. Since then agriculture's share in total FDI has declined. As indicated below in Table 7.2 the average share of agriculture in total FDI projects licensed between 1992 to 2018 was 14.4%.

Data on large commercial agricultural projects is hard to find; and when available the quality in terms of the level of aggregation/disaggregation and the elements on which data was

²¹ FAO database: <http://www.fao.org/faostat/en/#data/FDI> (accessed: 11/06/2018). Unlike the total FDI inflows, FAO data on FDI to Ethiopian agriculture is available only for 7 years between 1994 to 2000.

collected is usually not sufficient. There are also some differences between the different data sources. This study uses data generated from two sources, namely a comprehensive study commissioned by the Ethiopian government and conducted by UNDP in 2013²², and recent data obtained from the Ethiopian Investment Authority on FDI projects in Ethiopia²³. There is, however, some inconsistency between the two sources.

Table 7.1: Agricultural investment projects registered between 1999 and 2011

• Total number of Agricultural Investment Projects registered b/n 1992 and 2011 (FDI and domestic)	10,224
• Land transferred to these projects	10.1 million ha
• Number of Licensed Foreign Owned Agricultural Projects(FDI Agricultural Investment Projects)	1,743
• Share of FDI Agricultural Projects (in total agricultural investment projects)	17.1%
• Number of operational FDI projects	386
• Share of operational FDI Projects (in total FDI agricultural investment projects)	22.1%
• Land Transferred to operational foreign owned agricultural projects (agricultural FDI Projects)	1.52 million ha

Source: UNDP (2013).

²² This study get access only to the summary of the commissioned study, as the full report is not available at least online to the public.

²³ The other potential source for such data is CSA's sample survey report on large and medium commercial report. But this was not considered in this report as CSA report didn't provide agricultural activities related to FDI projects but for all commercial farms that include domestic private and state farms.

Based on data from the Ethiopian Investment Agency (EIA), the UNDP (2013) study indicates that 10,224 agricultural investment projects were registered between 1992 and 2011 and allocated 10.1 million hectares. Of which, 17.1% or 1,743 projects are owned by foreign investors and hence classified as FDI agricultural projects.

In terms of operations, only 386 of the 1,743 foreign owned agricultural firms have started some operation on their leased farmlands, indicating a 22% of efficiency in making use of the leased land resources²⁴. In terms of land allocation, the 386 FDI operational agricultural projects occupy approximately 1.52 million ha (UNDP, 2013), implying an average of 3,938 ha per FDI agricultural project (Table 7.2).

The data from the UNDP study, however, significantly inflate the number of agricultural FDI projects²⁵. The Federal Investment Commission's statistics on FDI indicates that only 759 FDI agricultural projects were licensed during the 1992 and 2018 period (Table 7.2), which is significantly lower than the 1,743 reported by the UNDP

²⁴ The corresponding figures for domestic agricultural investment projects is even lower as only 1,540 of the 8,481 domestic agricultural investment projects were operational during the same period. These operational domestic investors received 1.08 million hectares (UNDP, 2013).

²⁵ The UNDP study classified commercial agricultural projects into two: domestic investment agricultural projects and foreign owned foreign agricultural firms. According to the study, 10,224 agricultural investment projects were licensed between 1999 and 2011, of which domestic investment projects accounted 83%, and the remaining 17.7% by foreign owned foreign firms. This study considered these foreign owned licensed agricultural projects as licensed agricultural FDI projects.

study²⁶. Similarly, a recent study by the Ministry of Finance and Economic Development put the number of licensed FDI agricultural projects only to 762 (MFED, 2017), which accounted 14.7% of the total number of FDI licensed projects in the country.

Table 7.2: Key statistics on foreign direct investment projects in the Ethiopian agricultural sector (1992 – 2018)

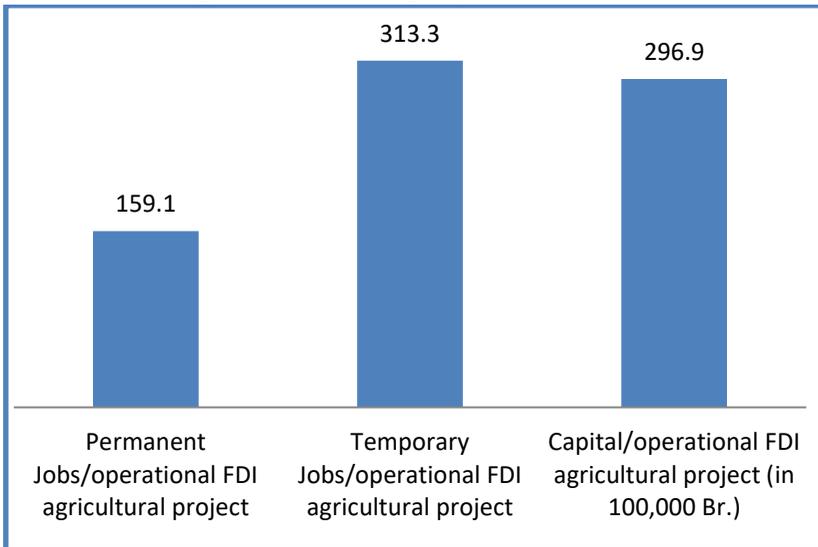
	Number	Share in All FDI Projects Registered in Ethiopia
• Total number of Licensed FDI agricultural projects	759	14.4%
• Projects at Pre-implementation stage	257	19.1%
• Projects at Implementation Stage	191	17.8%
• Operational No. Projects	311	11.0%
Capital in Birr ('000 Birr)	9,232,080	9.0%
Permanent employee	49,470	21.5%
Temporary employee	97,434	44.6%

Source: Ethiopian Investment Commission’s FDI Statistics, (Various Reports).

²⁶ As this data is more recent and obtained from official sources, readers could depend much on this data. However, the study by UNDP is equally valid as the study was commissioned by the UNDP on behalf of the Ethiopian government to assess the performance of commercial farmers in Ethiopia and to generate evidence based policy actions aimed at enhancing the performance and development of the country’s commercial agricultural sector.

As shown in Table 7.2, about 759 projects were licensed as FDI related agricultural projects between 1992 and 2018. Only 41% of them are operational, indicating the remaining 51% are either abandon or found at their implementation or pre-implementation stages²⁷.

Figure 7.1: Capital and labor intensities of operational agricultural FDI projects



Source: Computed based on Ethiopian Investment Commission’s FDI Statistics, (Various Reports).

The contribution of FDI projects to employment is very low (Table 7.2). FDI projects which started operations generated only 230,314

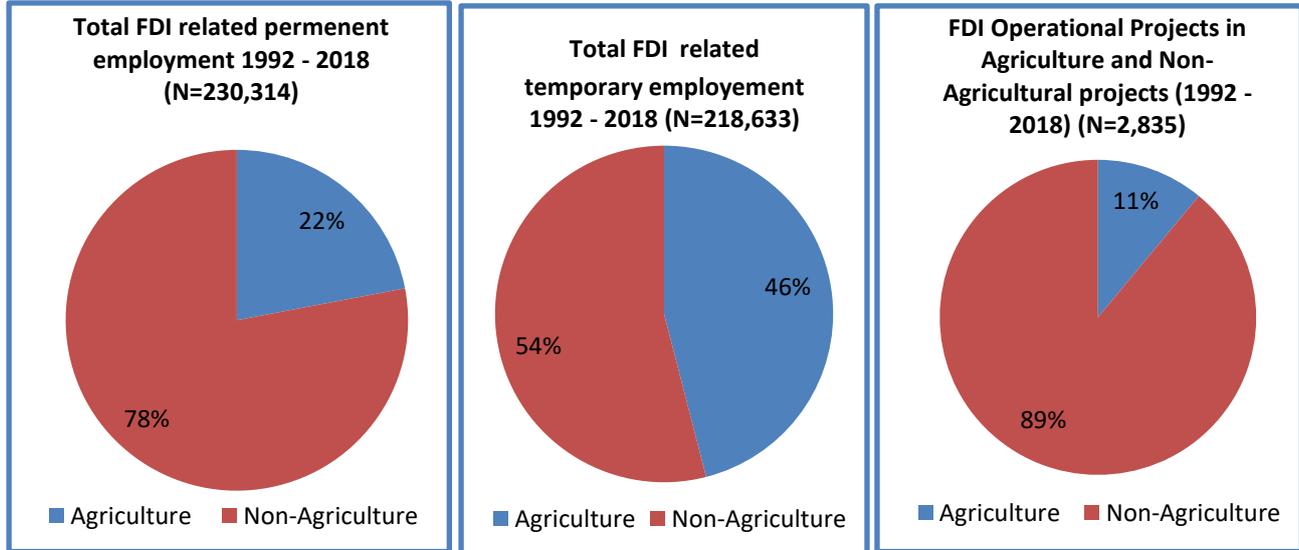
²⁷ Please note that the word operational doesn’t denote the scale or level of operations of the projects. It just indicates the start of the project at any scale or level of operation.

and 218,633 permanent and temporary jobs over the past 26 years (from 1992 to 2018). Of these total FDI jobs, agriculture contributed 22% to permanent jobs and 46% to temporary FDI projects. Agricultural FDI projects are largely capital intensive. On average, operational FDI agricultural investment projects have registered 29.7 million Birr, but created only 159 and 313 permanent and temporary jobs (per project).

7.1.3 FDI Projects and Agricultural Land

As indicated earlier disaggregated data that could warrant a systematic analysis of FDI in the Ethiopian agriculture is hard to find. The study, however, found detail but scanty data on non-Floriculture agricultural FDI projects licensed during the 2001 and 2012 period (see Table 7.3 and Annex Table 6.9.) which helped to generate some insights on FDI in Ethiopian agriculture. The data obtained from the Investment Directorate of the ex-MoARD indicates that at least about 38 commercial agricultural investment projects got license during this period when the Ethiopian government formulate a new strategy to promote large scale commercial agriculture in general and agricultural FDI projects in particular. Out of the 38 projects, 15, 12 and 4 projects were registered in 2002, 2003 and 2004, respectively.

Figure 7.2: Employment and agricultural FDI projects

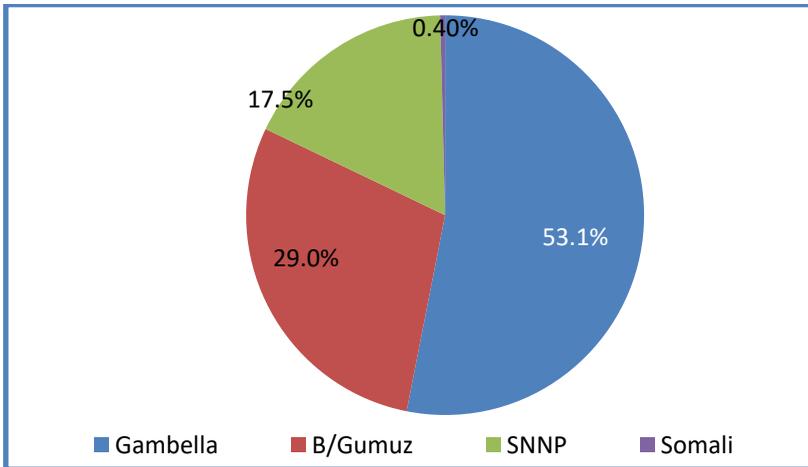


Source: Computed based on data from the Ethiopian Investment Commission.

Overall, the government transferred about 453,803 hectares of lands to the 38 commercial agricultural projects. Out of which 21% of the land transferred to domestic investors, and the remaining 80% of the land transferred 26 foreign investors coming from India (12), Turkey (2), China, Israel, Turkey and Pakistani (1 from each), and 8 diaspora Ethiopians/Ethiopians with foreign Passport.

In terms of regional distribution, the bulk of farmlands transferred to FDI agricultural projects are found in Gambella (53%), and Benishangul-Gumuz(29%), which is followed by SNNP (mainly in the lower OMO valley of the region) with 18% and Somali region with 0.4%.

Figure 7.3: Regional distribution of agricultural land transferred to FDI investors (N=453,803 ha)



Source: Computed from Government Statistics (Annex Table 6.9)

Note: Data exclude lands allocated to FDI investors in the Floriculture sector.

In terms of annual land rental fee, FDI investors in the agricultural sector were lucky to access farmlands literally at no cost. The average annual land rental fee was 169 Birr per hectare farmlands. The disparity in the land rental fee among different FDI projects is also high. An Indian company (Karaturi), for instance, was able to rent a hectare of farm land for 20 Birr per year, while another investor in the same region (Gambella) was paid 162 Birr for the same hectare of land. The highest amount of land rental fee was for single FDI agricultural investment for the production of Match Stick Tree Plantation in the SNNP region where the investor signed an agreement to pay 19,439 Br./ha/year (see Table 7.3 and Annex Table 6.9)²⁸.

- **Land utilization**

Data on the land utilization of agricultural FDI projects is hard to find. A study by UNDP in 2013, however, indicates the large scale inefficiency in land utilization both in domestic and foreign agricultural investment projects. Based on data from the Ethiopian Investment Agency for 1992 to 2012, the study shows that only 18% domestic and 25% of foreign agricultural investors converted from registration as license holders to an enterprise establishment during this period (UNDP, 2013).

²⁸ While the land rental fee for most of land transferred to the investors were comparable, the disparity in the land rental fee for the three FDI investments which were asked to pay 20 Birr, 19,439 and 658 per ha/annum was significantly different from the other investments. The author could not able to get the causes behind such differences but disparities in expected economic return of the respective investments, social or environmental costs associated with land and forest resources could explain such differences. Preferential treatment of some investors or corruption could also play a role.

Analysis of field and secondary data further shows that land utilization rates are still very low with only 42% of land leased converted into production over the last 20 years. However, the rate of land utilization varies significantly across regions and by size of land holding. The larger the size of leasehold, the greater the percentage of unutilized land; with those mostly foreigners, with land holding of greater than 10,000 ha currently utilizing only 1 percent of the land against the average of 42% for 112 commercial farmers captured in the survey conducted by UNDP (2013). Given such huge underutilization and mis-utilization, as well as the average land use, the study recommends that the size of land allocation should be capped at about 2,000 ha per investor.

Large-scale land allocations to investors have been made on the basis of administrative boundaries without due consideration of the benefits of strict application of watershed approaches to land allocation for commercial agricultural development. This has negative impacts on environment and productivity of the farms (UNDP, 2013).

In terms of crops, industrial crops like cotton and oil crops were the primary crops for agricultural FDI projects. Cotton production accounted for more than 26% of agricultural land transferred to FDI agricultural projects. Oil crops for Edible and bio-fuel production comes next with close 20% share.

Table 7.3: Key features of selected FDI agricultural projects²⁹

	Land Transferred to investors (Ha.)	Annual Land Rental Fee Agreed		Number of Investors/ Companies
		Total (Birr/Year)	Per Ha (Br./Ha/Year)	
Cotton	118,220	18,106,336	153.2	15
Cotton and Grains	9,140	1,444,214	158.0	3
Cotton, Sesame and Soybean	42,000	6,806,000	162.0	5
Cotton, Fruits, Oil Crops and Pulses	3,000	448,219	149.4	1
Soybean	25,000	2,775,000	111.0	1
Bio-fuel Crops (Pongamia, Castor etc)	62,000	10,499,500	169.3	2
Edible Oil Crops	30,000	4,010,400	133.7	2
Rice	20,000	1,880,000	94.0	2
Sesame and Bean	5,000	3,288,750	657.8	1
Tea	3,012	334,322	111.0	1
Match Stick Tree Plantation	1,000	19,489,500	19,489.5	1
Palm, Cereals, Rice and Sugar Cane	100,000	2,000,000	20.0	1
Sugar cane	25,000	3,950,000	158.0	1
Ground nut	20,000	3,160,000	158.0	1
Horticultural Crops	431	307,135	712.6	1
Total	463,803	78,499,376	169.3	38

Source: Investment Directorate, MoARD

²⁹ This data doesn't include FDI floriculture projects.

7.1.4 Financing FDI Projects

The Development Bank of Ethiopia (DBE) is a key player in financing commercial projects in the Ethiopian agricultural sector. The Bank has been very generous to lend up to 70% of the total investment for foreign investors in the Ethiopian agriculture. This proportion (30 to 70) has been reduced to 50% recently, indicating a foreign agricultural investor still access half of his/her investment cost from the domestic source³⁰.

This cheap, easy massive domestic finance impacted the size of inflow dollar associated with FDIs that are normally expected from normal FDI projects. What is worse is the inability of most of the FDI agricultural projects to use their finance properly. This harms the development programs of the country dearly. Most of such projects failed to produce the commodities which could generate revenue from export of products or save the country's foreign currency by substituting the import of industrial crops like cotton. As indicated in Table 7.4 below, about 63% of DBE-financed commercial agricultural projects were not operating as intended in the finance agreement they signed with the Bank. Of the total 471 FDI and other commercial agricultural projects owned by Ethiopians, 40% misallocated the loan they got to other purposes, while the other 60% allocated only part of the loan the Bank disbursed to them for the intended purpose.

³⁰ A corresponding change has been made for domestic investors in Ethiopian agriculture. Until recently they enjoyed up to 75% of their investment from credit made available by the Bank, and recently this has even increased to 85%.

Commercial agricultural projects that include some FDI agricultural projects are the contributors for disappointing performance of the development bank of Ethiopia which now suffer with close to 40% of non-performing loan. This level of bad loan is simply a reckless event that demands an independent professional investigation to generate lessons for the future and hold individuals and officials accountable for their misdeeds and the loss they accrue to the nation.

Table 7.4: DBE financed agricultural projects

Total Number of (Rain-fed) Agricultural projects finance by DBE		471
Agricultural Projects capacity to use credit made available by the DBE	Projects that allocate part of their credit for the intended purpose	60%
	Projects that completely failed to allocate their credit for the intended purpose	40%
Total number of DBE-financed agricultural projects with problems		298 (63% of the total financed by the DBE)
Sectoral Share of DBE available loan	Commercial Agriculture and Agro-Processing ³¹	70%
	Manufacturing and Mining Industries	30%
DBE loan size/disbursement/ to agricultural sector	2015/16	2.1 billion Br (33% of all loan)
	2014/15	1.7 billion Br. (25% of all of loan)

Source: Ethiopian Reporter (2018) and Addis Fortune (2018) (for info related to the sectoral share of DBE loan), and DBE (2016) for info on the last two rows).

³¹ The DBE 2016 Annual Report, however, indicates that agriculture’s share in the DBE’s loan portfolio was 19.5%. The outstanding loan was 31.6 billion Br until June 30/2016. This could be partly explained by the consideration of credit to agro-industries to the agricultural sector in computing the sectoral share.

7.1.5 FDI Policy and Strategy in the Ethiopian Agriculture

Ethiopia is highly endowed with natural-, especially land and water, resources. Over the past decades investing inland has particularly become interesting for foreign investors as was for the domestic investors. As discussed above massive land acquisition was taking place in different parts of Ethiopia; most significantly in Gambella region.

Realizing the bottleneck of foreign investment in the agricultural sector, the Federal Government of Ethiopia introduced FDI policy framework in 1992 which was amended since then in 1996, 1999, 2002, 2003, 2008, and in 2014. The investment code has been repeatedly revised so as to remove emerging bottlenecks and incorporate new and innovative facilities that will promote private sector investment more importantly high quality FDI. The laws currently in force and regulating investments are: Investment Proclamation No. 280/2002; Investment (Amendment) Proclamation No. 84/2003; and Investment (Amendment) Proclamation No. 146/2008 (Teshome, 2012, MFED, 2017). The latest investment proclamation is Investment (Amendment) No. 849/2014.

The investment proclamation which has been amended over the past few years provides various incentives for foreign investor in the agricultural sector. Such incentive includes free repatriation of capitals; duty free importation of goods and vehicles related to the investment; tax holidays up to seven years; opening and operating foreign currency accounts; owning immovable property for the

purpose of the investment; loss carry forward; no expropriation or nationalization of investments except for public purpose in which case due compensation would be effected; and enjoyment of domestic investor status if a foreign national prefers to be treated as such (UNCTAD, 2008; Teshome, 2012). All these are in addition to the non-fiscal incentives like easy access to large tract of lands at very generous nominal lease fee. The privilege of credit access up to 75% of investment cost (which has been reduced to 50% over the past two years) from the Development Bank of Ethiopia is also an important strategy for Ethiopian policy makers to attract FDI into the agricultural sector.

Foreign companies should obtain an approval from Ethiopian Investment Authority or regional investment authorities to invest in Ethiopia. In relation to this, Ethiopia has signed international law that gives investment guarantees for foreign investors. Many institutions were established at the federal and regional level to facilitate the foreign investment in the agricultural sector. In an effort to streamline the investment process the Ethiopian Investment Commission has established and implemented a “one-stop shop” service for investors (MFED, 2017) which is implemented by coordinating and streamlining its activities with other federal and regional institutions.

The government is also committed to avail considerable amount of domestic credit to promote FDI. Public banks such as the Development Bank of Ethiopia are established to support the country’s economic transformation. Thus investors who are investing in areas of agriculture are eligible to obtain loan (up to 50% of their investment cost) from Development Bank of Ethiopia.

Investors who produce export products are also allowed to import machinery and equipment necessary for their investment projects through suppliers' credit. With regards to investment guarantees, the investment code provides guarantee for repatriation of capital, interest payments on foreign loans, profit, dividends, asset sell proceeds and technology transfer payments (UNCTAD, 2008; Teshome, 2012).

7.1.6 Challenges and Constraints in FDI in Ethiopian Agriculture

Although the benefits of FDI are well known, the magnitude of the potential effects is determined by the economic characteristics of a given country and a host of other factors. FDI can have a direct impact on economic growth, income generation and job creation. Higher levels of FDI can also trigger increasing levels of total trade of goods and services and a variety of other linkages with the domestic economy, such as technology transfer, human capital formation, creation of new industries and greater integration into the world economy.

Yet, agricultural FDI may also entail risks, such as displacement of local industries, environmental degradation or loss of sovereignty, and displacement of communities. In the case of countries with lower levels of development, key binding constraints to fully benefit from FDI are associated with low levels of skilled labour, non-functioning or nonexistent infrastructure, poor access to basic services, limited technology and lack of or underdeveloped financial markets (UNCTAD, 2008).

FDI investment in the Ethiopian agriculture (aside from FDI in floriculture sector), however, characterized by a range of problems including engagement for speculative purposes without making use of the leased land resources.

A number of studies have been conducted on FDI in the Ethiopian agriculture and identified major problems that caused huge misallocation of resources and left very little opportunity for actual commercial farming in Ethiopia. Critics on FDI in Ethiopian agriculture ranges from environmental concern and ‘land grab’ to motives of FDI investors as well as technical inefficiencies both in terms of short-term and long-term growth impact. A study by UNDP (2013) indicates that over 50% of agricultural investors in Ethiopia adopt ‘low-cost’ low-output’ farming systems designed to maximize short-term profit with minimal fixed investment expenditure. There is, however, other category of investors with, apparently, other agendas beyond agricultural production such as exploring medicinal plant collection from thousands of hectares of leased lands/forests (UNDP, 2013).

High level corruption and information asymmetry and power imbalance between investors, governments and the affected local population (normally the weaker group) are also big problems in agricultural FDI projects in Ethiopia (Adenäuer, L. 2011). Another study by Dave (2013)³² indicates that unqualified management teams

³² The Author has traveled to Ethiopia over the last 18 months—looking back from August 2012. He has spent a total of 3 months in the country. He has seen large-scale agriculture operations first hand. Foreign investors have made a lot of expensive mistakes. He knows 4 companies who have spent combined at least \$200 million dollars collectively, WITHOUT producing a commercial crop in more than 2.5 years. One of these companies has exited the country.

and poor decisions made with respect to machinery and equipment selection as two main problems that caused huge misallocation of resources and left very little opportunity for actual commercial farming in Ethiopia³³.

The risks of non-floriculture FDI in agriculture currently outweigh the opportunities. The current phenomenon of transnational land acquisition is criticized for limited local interaction and spill-over effect on domestic/smallholder farmers (Out-growers), and value to the economy in terms of job creation, foreign currency earning, infrastructure and economic linkages.

In view of these and many other challenges, Ethiopian policy makers should need to have strong evidence to justify government support (e. g., tax incentives) to the growth of commercial agriculture in Ethiopia including FDI agricultural projects. The costs of support, including both the cost of delivering services (including the opportunity cost of large DBE loan, land, forests and livelihood of

³³ Machinery should ALWAYS be given lower budget priority than personnel. Foreign investors in Ethiopia have prioritized investment in machinery over having qualified labor. So, after 2 to 3 years they have commercialized ZERO kg of grain, after spending at least a combined \$100million (this is just for 3 investors). This is absurd from the point of view of successful commercial farmers. These projects have become a “black-hole” for capital. They are more examples of how Africa is “a grave yard” for expensive, inappropriate foreign machinery. These companies put tractor operators that were paid \$400/month in charge of \$150,000 tractors and sprayers. Similarly, the three agricultural FDI companies are staffed by mostly “farming constables” –who do the bare minimum, take no initiative and block/impede anything outside their limited knowledge domain. These personnel have replicated the dysfunction of a government office on a farm. Some of these farming companies are “boiling the ocean” to make a “cup of tea” Dave (2013).

displaced communities) and the loss of revenue arising from any tax incentives offered to investors in commercial farms needs to be empirically assessed periodically. This, then, needs to feed modality, type and intensity of engagements and re-engagements with commercial agricultural investors. It is essential to develop and apply appropriate track indicators of agricultural FDI projects. This in turn demands to develop a system that generates accurate and reliable FDI data on existing projects too³⁴, as data quality and data availability are the major limitations of analyzing FDI inflows into the sector, and their efficiency and contribution to the sector and the national economy.

Unlike the current practices of presenting data as general figures or sporadic disaggregated data, the monitoring and evaluation capacity of relevant institutions should be developed to deliver quality data on key indicators (on their performance, challenges etc.) of FDI agricultural projects. Beyond the incentives the country created to attract agricultural FDI projects, this is very important to enhance the development of sustainable FDI agricultural projects in the country.

The country should also develop its capacity to analyse agricultural FDI trends and impacts, and assess the policy and regulatory investment framework as well as institutional set-ups in view of new challenges, opportunities, risks/threats and progress by investors in the sector.

³⁴ It is important to note that lack of information/data was the major challenge for this study.

7.1.7 Summary

Ethiopia has huge investment opportunities in its agricultural sector. About forty-five percent of its estimated 1.14 million sq.km land is estimated to be suitable for agriculture. The country has abundant arable and irrigable land especially in the low land parts of the country where production for a range of farm products (cotton, oil crops and rubber tree plantation, livestock production, other tree and root crops like coffee, sugar cane and for a range of horticultural crops, floricultural crops).

Because of these natural factors as well as many other including Ethiopia's geographic location and the generous fiscal incentives and other promotions by the government, FDI in Ethiopian agriculture has been growing especially since 2000s. Other factors like globalization and the 2007/8 global financial crisis and escalated food prices have also contributed for the transnational land acquisitions Ethiopia has experienced during this period.

Although the benefits of FDI are well known, the magnitude of the potential effects is determined by the economic characteristics and a host of other factors like security, degree of support and control to FDI projects. With a lenient investment regulation, the government offers significant investment incentives and support to agricultural FDI, apart from the floriculture sector and to some degree to livestock sector, Ethiopia's experience of agricultural FDI is, however, not encouraging. This is equally true for domestic agricultural investment projects witnessed in parts of the country like Gambella, Benishangul-Gumuz and lower Omo valley of the SNNP region. Most of these agricultural FDI projects and large transnational land acquisition in these areas were criticized for limited local interaction

and value to the economy in terms of job creation, foreign currency earning and economic linkages (production and consumption linkages/forward or backward linkages along the value-chain of the commodity), and environmental sustainability. This is in addition to the massive financial loss these ‘investors’ and their agents in the public sectors brought to the country.

Agriculture will continue as promising sector for FDI in Ethiopia. But the country should get sufficient lesson from the experience of the recent past where many speculative FDI as well as domestic ‘investors’ were looking for cheap land and state credit. Having comparative advantage is a necessary but not sufficient condition to promote sustainable investment in Ethiopian agricultural sector. In this regard, it is important to learn the background as well as technical and farm managerial capacity of potential investors who are expected to manage large commercial farms. Otherwise, the country will continue to make very expensive mistakes.

As sustainable development contains three constituent parts: the economy, the environment and the social segments in terms of the welfare and the right of people in the FDI areas, (Lucie, 2009), any FDI investment in the agricultural sector should also try to maintain the optimal balance of these three integrated elements of sustainable development.

7.2 FDI in the Manufacturing Industries

Ethiopia envisions becoming a middle-income country by 2025. To this end, the manufacturing industry sector is expected to grow, on average, by 25% per annum for the period 2015-25. By 2025, the manufacturing industry sector would contribute 20 percent of the GDP and 50 percent of the export volume.

In principle, a vibrant national business sector and domestic private investment are the basis of growth in any economy. In practice, however, many developing countries and countries with economies in transition face shortages in domestic resources and therefore seek to mobilize external funds for economic growth. Foreign portfolio investments have been the largest source of external development finance at the global level, but foreign direct investment (FDI) accounts for the majority in developing countries and countries with economies in transition. Learning from the success stories of East Asian countries, developing countries have been exerting efforts to attract FDI into their countries, and Ethiopia is no exception.

FDI is believed to offer stable capital inflows, create job opportunities, technology transfer, know-how of management, access to foreign markets, have positive spill-over effects on local firms through increased productivity, skills formation, and value chain integration. Despite the increasing DI Flows into Ethiopia during the last two decades, no comprehensive study has been undertaken covering wider sectors of the economy. This study is can therefore be considered as an attempt to bridge this research gap.

In speeding up the transformation of the Ethiopian agriculture based economy, manufacturing industry plays critical role. The growth of

the manufacturing sector, in turn, requires huge investment, mainly from FDI. During the last two decades, FDI has been flowing into different sectors of the economy. The key questions that this section of the study tries to answer include, what proportion of FDI has been flowing into manufacturing industry, whether priority manufacturing industry sub-sectors have been attracting FDI, whether FDIs are engaged in export oriented or import substituting, generating employment, transferring technology, generating capital and foreign exchange.

7.2.1 Licensed FDI Projects by Sector and Status

Of the total investment projects licensed during the period (1992-2018), the share of manufacturing industry was about 46.4 percent. Like the number of licensed projects, the number of operation manufacturing sector has remained at 46.1 percent thereby indicating that the sector went proportional to the number of licensed. This in turn indicates that the problem of going operational is not unique to a specific sector. Of the total FDI capital invested, manufacturing sector took over 2/3rd of the finance; this is because the sector is highly capital intensive and then require higher finance than most of the other sectors. The data shows that FDI creates proportionately higher size of permanent employment, which is the nature of the sector, but creates proportionately lower employment for temporary workers, which is in line with the nature of manufacturing industries employees' nature (Table 7.5).

Table 7.5: Licensed FDI projects by sector and status, August 1992 - January 2018

SECTORAL ISSUES ON FOREIGN DIRECT INVESTMENT...

Sector	Implementation		Operation	pre-Implementation		Total	
	No of Projects	No of Project	Capital in'000' Birr	Permanent Employ' t	Temporary Employ' t	No of Projects	No of Projects
Manufacturing	498	1,307	73,189,193	135,916	56,219	635	2,440
Total Projects	1,071	2,835	102,778,231	230,314	218,633	1,349	5,255
Share in total, in %							
Manufacturing	46.5	46.1	71.2	59.0	25.7	47.1	46.4

Source: Ethiopian Investment Commission (EIC)

7.2.1.1 Manufacturing FDI

During the years preceding the beginning of GTP I implementation period (2010/11), FDI inflows into Ethiopia had showed very limited increase. However, due to setting of ambitious growth goals under GTP I and II and regarding of FDI was as essential tool to finance the plans, a significant increase in FDI has started to be witnessed.

The total FDI which was USD 814.6 million in 2007/08 has been increasing on average by 21.4 percent per annum and reached 4190.8 million in 2016/17. Similarly the manufacturing FDI which was USD 570.2 million in 2007/08 has increased on average by 24.8 percent and reached USD 3,712 million in 2016/17. Of the total FDI, the share of manufacturing has been consistently increasing over time from 70 percent in 2007/08 to 89 percent in 2016/17. The manufacturing FDI has been flowing into the country, on average, by 24.8 percent which has been more than the average growth registered by the total FDI inflow (21.4 percent) over the same period. By implication, this indicates that agriculture and service sectors have been taking

insignificant share of the total FDI flowing into the country over the period (2007/08-2016/17) (Table 7.6).

Table 7.6: Trends in the total and manufacturing FDI inflows into Ethiopia

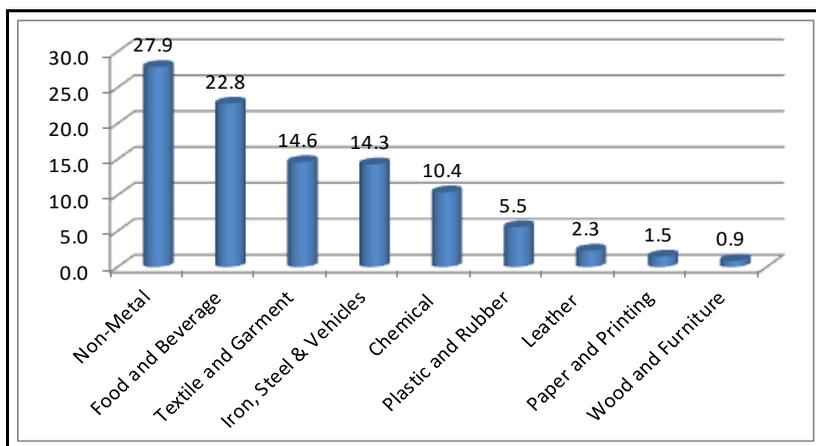
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Value, in million USD										
Total FDI	814.6	893.7	960.3	1,242.5	1,072.1	1,231.6	1,467.0	2,202.2	3,268.7	4,170.8
Manufacturing FDI	570.2	661.3	768.2	1,018.9	836.2	985.3	1,261.6	1,893.8	2,843.7	3,712.0
Share in %										
Manufacturing FDI	70.00	74.0	80.0	82.0	78.0	80.0	86.0	86.0	87.0	89.0
Growth in %										
Total FDI		9.7	7.5	29.4	-13.7	14.9	19.1	50.1	48.4	27.6
Manufacturing FDI		16.0	16.2	32.6	-17.9	17.8	28.0	50.1	50.2	30.5

Source: EIC

FDI in the Manufacturing Industry by sub-sectors

Hereunder attempt is made to categorize the FDI flowing into the manufacturing industries by sub-sectors. According to the data, about 27.9 percent, 22.8 percent, 14.6 percent, 14.3 percent, 10.4 percent of the total manufacturing industry FDI has been flowing into non-metal, food and beverage, textile and garment, iron & steel and chemical and chemical products, respectively over the period 1992-2018. Despite the fact that leather and leather products sub-sector is priority export sector and is believed to be a sub-sector in which the country is believed to have comparative advantage little investment has been finding their ways into the subsector. Of the total investment, only about 2.3 has been into the sub-sector over the same rod. This indicates that the majority of FDI has been into the sub-sectors producing to substitute import (Figure 7.4).

Figure 7.4: FDI by manufacturing industries sub-sector, share in %



Source: Ethiopian Investment Commission (EIC)

Analysis of the comparative advantage of Ethiopia using Revealed Comparative Advantage (RCA) shows that there exist comparative

advantage in leather and textile manufacturing industries sub-sectors. This is, mainly, because of the sub-sector's large dependence on local sources for the bulk of its raw materials sources. However, relatively lower share of investment has been going into these sub-sectors, especially leather.

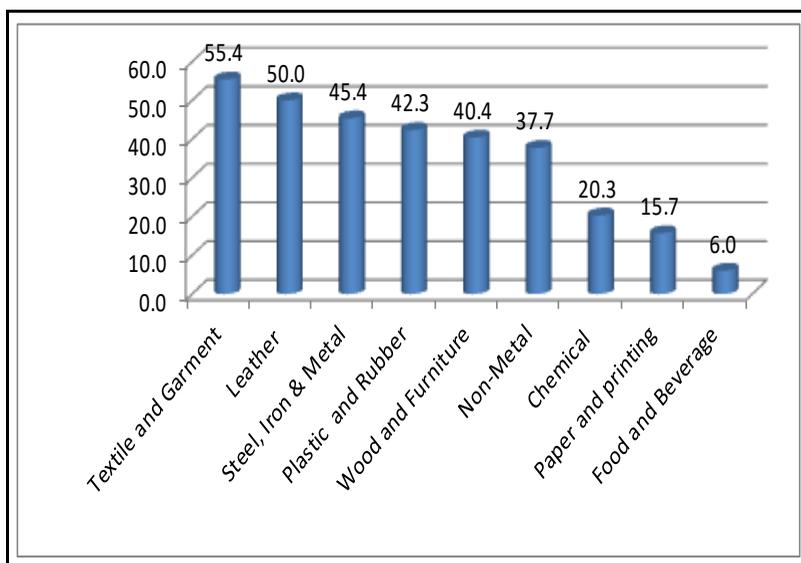
In sum, the majority of FDIs flowing into the country has been horizontal FDI (foreign firms producing for local markets— market-seeking), but not vertical FDI (firms producing for export—efficiency-seeking). Given the low per capita income of the population, the domestic market is not that attractive for investors and hence the FDI strategy has to push FDIs into producing for exports into the regional and global market places. Or the country's FDI strategy has to limit entry of import substituting FDIs to only those which do not request any hard currency from local sources except for the repatriation of dividend, profit and upon liquidation.

Chinese FDI by Manufacturing Industry sub-sector

The data from the EIC shows that China, India and Turkey are the top three countries investing in the manufacturing industries of Ethiopia. Of the three major countries, attempt is made here to identify concentration of Chinese investors among the different manufacturing industry sub-sectors. According to the data, Chinese companies have been investing mainly in import substituting manufacturing industries, which produce to satisfy local market. Chinese investment in the Textile, leather, steel and iron, plastic & rubber, and wood & furniture the major manufacturing industry sub-sectors constitute for about 55.4 percent, 50 percent, 45.4 percent,

42.3 percent and 40.4 percent of the total investment in each sub-sector, respectively. Of the various sub-sectors, Chinese investment in the food and beverage sub-sector has been the least accounting for only 6 percent leaving the balance to be financed by investors from other countries.

Figure 7.5: Chinese FDI engagements in Ethiopia by sub-sector in %



Source: Ethiopian Investment Commission (EIC)

Employment Generation and Technology Transfer

Employment Generation

Although the expected effects of FDI would largely be based on the FDI strategy of a particular country, FDI companies would create jobs proportional to the size of the capital invested for in hosting countries. The question, however, is whether FDI is creating jobs job saving /or job creating. Ethiopia is labour abundant country and needs labour intensive companies to flow into Ethiopia. However, given the current global competition, and the technology choice available for investors to pick from the shelf, companies coming into Ethiopia are labour saving. And the degree of automation of the machine used for production, i.e., the intensity of the plant.

Surveys show that most workers have been use manufacturing sector work as a transition to other better paying jobs in urban service sectors. As the result, there has been high turnover in manufacturing sector jobs. First they stay for short period before getting rich experience and secondly those who leave manufacturing sector have been witnessed moving into the service sector where there is little relevance to apply experience cumulated in manufacturing industries.

According to EIC, FDIs have created a lot of jobs for Ethiopian citizen; for instance, it has created permanent jobs for about 135,916 persons and temporary jobs for 56,219 workers over the last two decades. The kinds of jobs created have been largely low-skilled and this kind of jobs has little potential to help transfer technology into the economy. Since this segment of workers do not have the required capability to embody and transfer technology. This may be due to

shortage of skilled labour forces which can operate the machine that FDI companies use in the production processes.

FDI also process work permit for expatriates to get workers for the skill which it cannot get in Ethiopia thereby creating jobs for other countries citizens. The problem is proofing absence of such skill from the local labour market since we do not have the database. As the result, the country forgoes wage income.

Technology Transfer

FDI can bring both benefits and costs to host countries suggesting the need to carefully design FDI strategy so that the net effects of the FDI on the host turn positive. Another argument for promoting FDI is technology transfer spill-overs to local firms. In this connection, one of the requirements for issuance of FDI permit is registration for technology transfer agreement, for those companies to which the requirement applies at the Ethiopian Investment Commission (EIC).

Whether the FDI inflows have brought about technology transfer into local firms/economy?. In this connection, Girum Abebe, *et al* (2017)³⁵ tried to quantify Foreign direct investment (FDI) spill-overs by comparing changes in total factor productivity (TFP) among domestic plants in “treated” districts that attracted a large greenfield FDI plant and “untreated” districts where greenfield FDI was licensed but not yet operational. Treated and untreated districts have similar trends in TFP prior to the opening of the large green-field FDI plant. Over

³⁵ Foreign Direct Investment and Knowledge Diffusion in Poor Locations: Evidence from Ethiopia Girum Abebe, Margaret McMillan, Michel Serafinelli 5 December 2017.

the four years starting with the year of the opening, TFP in domestic plants is 8% higher in treated districts. They obtain qualitatively similar results using an alternative identification strategy that exploits the assignment of land for FDI by the Ethiopian Government. They also find evidence that the FDI plants attract new economic activity to the receiving districts. Further, using a survey module, they show that knowledge was transferred from FDI to domestic plants through: (i) labour flows from FDI to domestic plants; (ii) learning by observation and; (iii) customer and supplier relationships.

FDI Capital by Sources

Although the major sources of investment capital for FDI are believed to be from foreign country of origin, FDIs have access to financial resources from host countries. According to Ethiopian investment code, FDI companies have the right to borrow from foreign banks and domestic banks. This entails that FDI have been benefiting from both local and external loans.

Foreign

Ethiopia is a capital constrained country, especially foreign exchange required to import capital goods and technology. Therefore; attracting FDI has been believed by the government to address this constraint and finance investment and bridge the domestic investors–saving gap. The issue is whether the FDI which has been flowing into the country have been generated the capital required to augment the domestic investment endeavour and whether the FDI are competing over the scarce domestic resource accessing loans from the local banks thereby crowding out domestic investors.

Obviously, FDI companies have been flowing into Ethiopia with varying percentage of resources required to cover project cost. Significant numbers of FDIs have been witnessed accessing credit from the Development Bank of Ethiopia (DBE). Thus, based on the current credit policy of the country (50 percent equity requirement), one fairly estimate that 50 percent of the total FDI capital have been FDI own fund.

Domestic bank loans to Manufacturing Industries

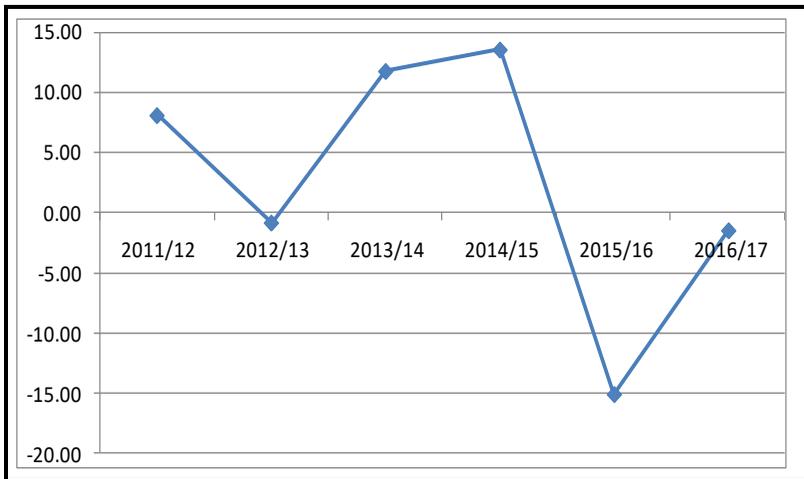
According to the investment code, the government is committed to avail considerable amount of domestic credit to promote FDI from local banks. To this end, the Development Bank of Ethiopia (DBE) was established to support investment activities and has been instrumental in the full or partial financing of most of the major investment projects in the country. DBE reports shows that it has been extending loans to foreign investors engaged in various investment activities, including Elsie Addis, AYKA Addis Investment Group, Derba Cement Enterprise, and many other FDI companies.

The credit policy preceding the revision policy was which require the borrower to present only 30 percent of the project cost and hence accessing the bank loan for the balance 70 percent. According to DBE's revised credit policy, however, all prospective foreign investors or borrowers for new projects (including those projects operating in industrial parks) are required to raise as equity capital at least 50 percent of the total project cost. And the Bank will finance the remaining balance up to a maximum of 50 percent of the total project cost after the borrower deposit in block account its equity contribution at the Bank.

Loan Disbursement to Manufacturing Industries by DBE

DBE has been extending, on average, about 3.5 billion loans to manufacturing industries per annum, owned by both foreign and domestic investors. Although there is no separate database on credit disbursement by foreign and domestic investors, evidences shows that foreign investors have been accessing significantly loans from DBE. Figure 7.6 below shows that there have been fluctuations into the growth of loans flowing into manufacturing industries from year to year. The loan annual rate has been growing, on average, by 2.7 percent per annum over the period (Figure 7.6).

Figure 7.6: DBE credits to the manufacturing industries (2015/16), growth in %



Source: DBE Annual Report (Various Issues)

Credit Quality and its Repayment

Loan repayment depends largely on credit quality. Given the complexity of FDI projects, one may raise questions whether the

lending local bank, DBE, has the required capacity to appraise the various feasibility studies submitted for financing by FDI companies, strong follow-up and monitoring team for supervising project execution, etc.

As can be seen from Figure 7.6 above, DBE has been extending significant size of loan to both local and FDI companies. However, some companies were unable to pay back their debts in accordance with the loan repayment schedule and gone bankrupt thereby making DBE to suffer from bad loans during the last several years. Consequently, the bank has foreclosed a number of FDI companies. The problem is although the bank floats bids to sell the bankrupt companies, for instance, Elisie Addis, DBE could not get buyers who could offer the amount required to recover its the credit that the company owes to the bank. This tells that the size the loans of extended to companies were greater than the net worth of the companies, which , in turn, could be due to variety of reasons, including poor credit appraisals capacity, corruption, poor follow-up and monitoring, etc.

Recommendations

In a foreign exchange constrained economy and in a country where FDIs concentrate on import substitution, what happens if all import substituting FDI in the economy request the government to repatriate profit and repay their foreign bank loans simultaneously? This would definitely lead to BOP crisis and hence economic crisis. Therefore, the FDI strategy of the country has to limit entry of new

FDIs to exporting, joint venture and highly critical import substituting ones.

7.3 Ethiopia's FDI in the Services Sector: Openness, Structure, and Performance

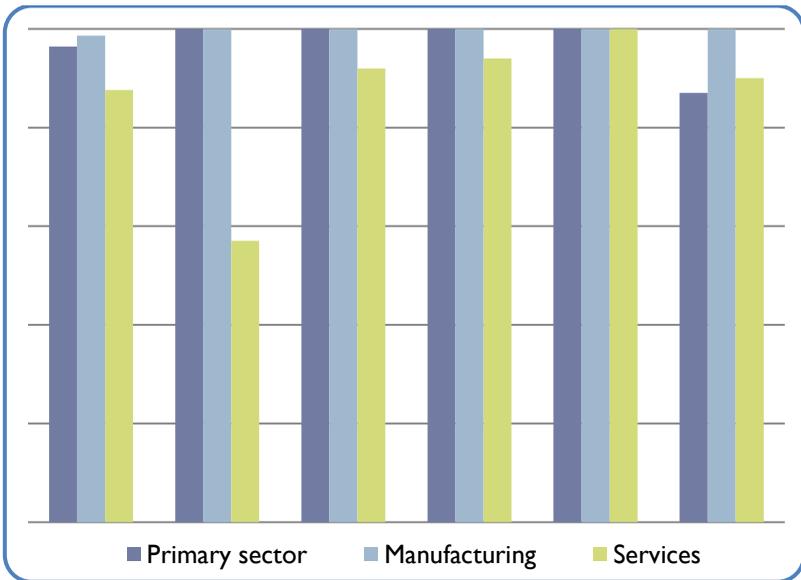
7.3.1 Introduction

The services sector in Ethiopia continues to make a growing economic contribution. For instance, in 2015/16 the services sector has the largest share (47%) of the country's GDP. Nonetheless, the sector's performance in terms of attracting FDI remains limited. The services sector comprises of social services, trade, hotels and restaurants, finance, real-estate, construction etc. Increasing the engagement of the private sector in the services sector including through FDI is one means of improving the performance of the services sector. Apart from its own direct effect on the economy, improved performance of the services sector can raise the efficiency and productivity of other sectors in the economy (World Bank, 2018). For instance, previous empirical studies in Latin America, Asia, and Eastern Europe demonstrate that a strong and vibrant service sector is an important contributor for growth of the manufacturing sector (see e.g. Arnold *et.al*, 2010; Fernandes and Paunov, 2012; World Bank, 2018). In the present report, we review trends and patterns of FDI in the services sector of Ethiopia. Our analysis relies on secondary data drawn from Ethiopia's Investment Commission and other relevant sources.

7.3.2 Ethiopia's Service Sector Openness for FDI

Figure 7.7 portrays a comparative analysis Ethiopia’s service sector FDI. As can be seen in the figure, Ethiopia’s services sector is more restricted than other sectors of the country’s economy. Compared to the average of Sub-Saharan African countries in general and those of neighboring countries, Ethiopia’s services sector is more restricted for foreign investment and many of the county’s services sub-sectors are characterized as state monopolies (e.g. telecom). In contrast, Rwanda, for instance, has the most open services sector for FDI among the countries considered.

Figure 7.7: Service sector openness for FDI



Source: FDI Regulations Database 2012 (World Bank).

Note: 100%=Full FDI ownership allowed.

7.3.3 Ethiopia’s Openness for FDI in Services Sub-sectors

Openness to FDI varies across the different sub-sectors of the services sector. For instance, of the 32 sectors covered in World Bank's the Foreign Direct Investment Regulations indicators (World Bank, 2012), healthcare, education, and tourism are fully open to foreign equity ownership in Tanzania, Rwanda, Kenya, Ethiopia, and South Africa (see Table 7.7). However, unlike all these countries, sub-sectors such as media, telecom, banking and insurance have not been allowed for FDI. Whereas Kenya and Tanzania are partially open for FDI into media and insurance sub-sectors, the banking sub-sector is fully open in both countries. In Ethiopia, these sub-sectors are prohibited for FDI. An interesting show case for open service sector is Rwanda's where its various sub-sectors are fully open for FDI.

Table 7.7: Comparative openness of some of Ethiopia's services sectors for FDI

Service sub-sectors	SSA	Ethiopia	Kenya	Tanzania	Rwanda	South Africa
Healthcare	100%	100%	100%	100%	100%	100%
Education	100%	100%	100%	100%	100%	100%
Tourism	100%	100%	100%	100%	100%	100%
Electricity	90.50%	60%	100%	100%	100%	100%
Transport	86.60%	50%	97%	100%	100%	87%
Media	69.90%	0%	75%	70%	100%	60%
Telecom	84.10%	0%	80%	100%	100%	70%
Banking	84.70%	0%	100%	100%	100%	100%
Insurance	87%	0%	66.70%	66%	100%	100%

Note: 100%=Full FDI ownership allowed.

Source: FDI Regulations Database 2012 (World Bank).

7.4 Structure and Performance of FDI in Services Sector

7.4.1 Foreign Direct Investment Projects by their Implementation Status

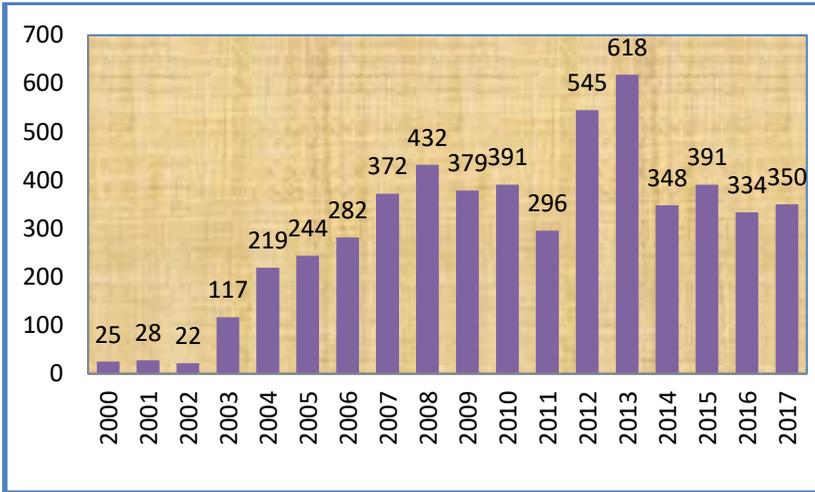
Table 7.8 summarizes total number of FDI projects licensed during August 22, 1992 to January 17, 2018 is about 5,255. According to their stage of development, these projects are classified into different status namely, approved/licensed, under-construction/ implementation, and operational. Out of 5,255 FDI projects, 2,835 projects (54%) have become operational during the time period under consideration with Ethiopian Birr 102,778,231 while another 1,349 projects are still under-implementation or construction. The rest 1,071 projects are approved FDI projects awaiting implementation of which 312 or 29% are in the services sector.

Table 7.8: Foreign Direct Investment Projects Status in Ethiopia (1992 to 2018)

Status as of January 2018	Number of projects	Percent
Operational	2,835	53.95
Under construction	1,349	25.67
Approved	1,071	20.38
Total	5,255	100.00

Sources: EEA Staff computation and EIC.

Figure 7.8: Number of licensed FDI projects (2000-2017)



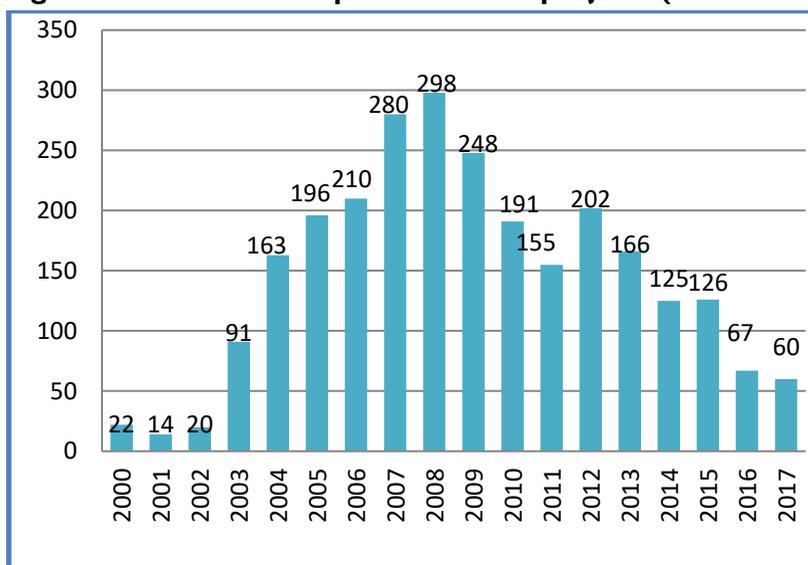
Source: Own computation based on EIC data.

In 2000, proportion of FDI projects which entered into operation was about 88% against licensed projects in the same year. During the same year, both numbers of operational and licensed projects were small, however. In recent years, however, number of operational projects is evaluated against high number of licensed projects over the same period.

In recent years, the GoE has established industrial parks (IPs) in different regions to attract foreign direct investors to the country. One of the main promises of establishing IPs is to facilitate project entry as well as to overcome the different institutional and physical constraints facing investors during the course of project implementation and operation. Although number of FDI projects could provide us some clues about overall direction of foreign

interest to invest in the country, it is not permit us to gauge the volume of invested capital and technologies by various FDI projects. Indeed, recent FDI projects are big, with high investment capital per project, despite low number of operational projects. In 2000, for instance, investment capital per FDI project was about Ethiopian Birr 39 million, while this has increased to Birr 191 million in 2016 in nominal terms (see Figure 7.9). This trend is consistent with the Ethiopian Investment Commission’s objective of attracting large international corporations (EIC, 2015).

Figure 7.9: Number of operational FDI projects (2000-2017)

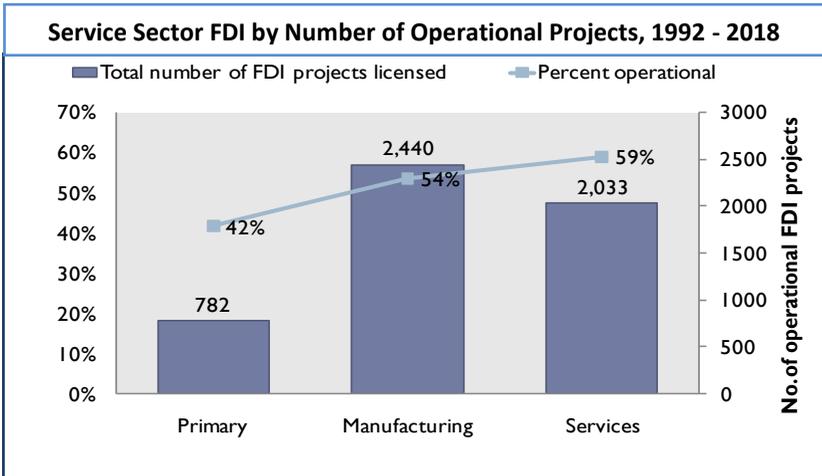


Source: Own computation based on EIC data.

7.4.2 Distribution of Operational FDI Projects by Sector, 1992-2018

FDI projects in Ethiopia are distributed across different sectors (see Figure 7.10). However, the largest number of FDI projects is found in the manufacturing sector followed by the services sector. The primary sector (e.g. Agriculture and mining sub-sectors) has the lowest number of number of FDI projects in the country over the 1992 to beginning of 2018 period. The likelihood of FDI projects into operation is generally low. For instance, of the total number of FDI projects in primary sector, manufacturing sector, and services sector only 42%, 54% and 59%, respectively have become operational. A close look into the available data show that the share of total licensed FDI projects that has become operational is declining over time. Unfortunately, however, we are not able to investigate the reasons for this because of lack of data availability

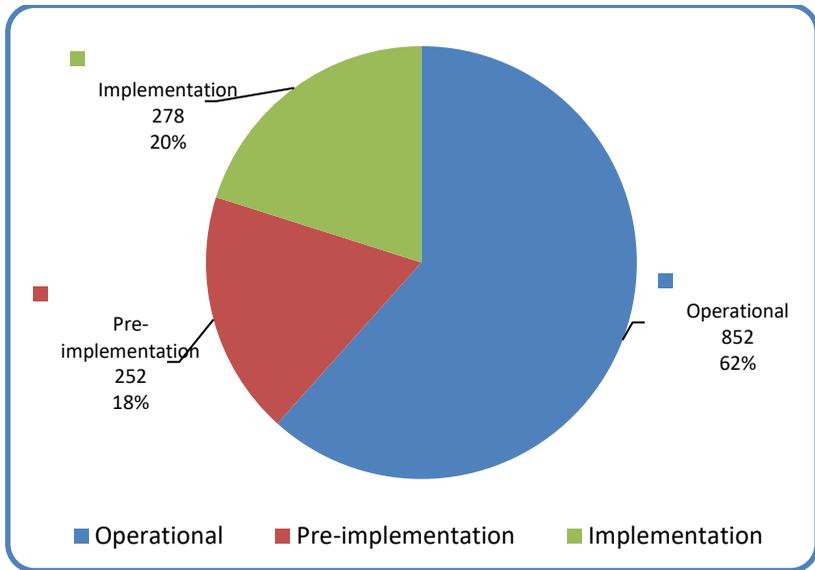
Figure 7.10: Number of operational projects in service sector



7.4.3 Composition of Service Sector FDI Projects by their Implementation Status (1992-2018)

According to data obtained from EIC over 1992 – 2018 about 62%, 20% and 18% FDI projects were in operation, under-implementation and in pre-implementation phase, respectively. Until or in beginning of 2018, the proportion of total number of FDI projects which entered into operation was about 62%. In the same year both number of operational and licensed projects were small. In recent years, however, operational projects are evaluated against high number of licensed projects in the same year.

Figure 7.11: FDI projects in service sector by their implementation phase

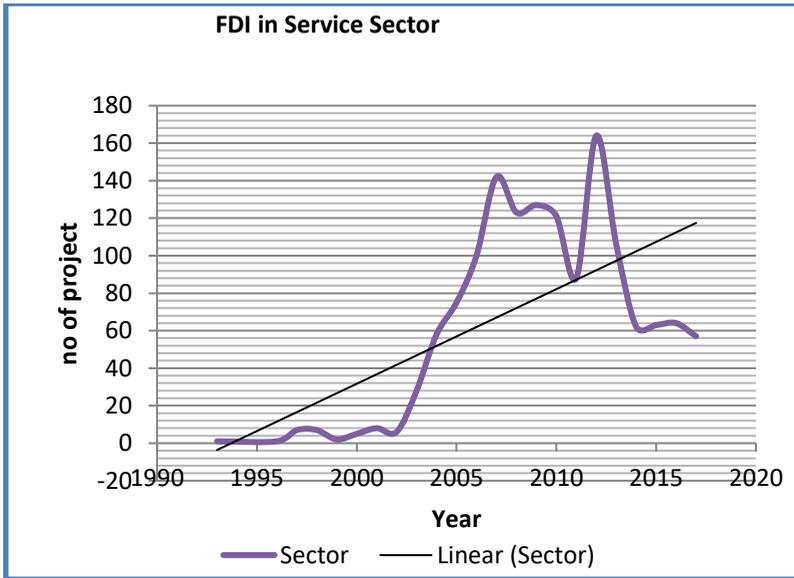


Sources: EEA Staff computation and EIC

7.4.4 Trend of Service Sector FDI Project (1992 to 2018)

It is undeniable fact that Ethiopia has made a considerable progress in economic and social development since 1992 because of the implementation of favorable policies and strategies that are instrumental in improving the national economy and as a result investment inflow started. Foreign investors are flooding due to these and other external factors. There has been increased FDI inflows in terms of total number of projects and capital invested (EIC, 2015). As indicated in Figure 7.12, FDI in the service sector has shown a cyclical pattern over time that span from 1992 to 2018. The number of all service sector FDI projects (i.e in pre-implementation, under-implementation, operation phases) in the country was the highest in 2014 and lowest in 2002. Recently, number of service sector FDI projects show a declining pattern from 2014 onwards and this might be due to incidences of social unrest which occurred in the country over the past three years since 2015.

Figure 7.12: Trend of number of FDI projects in service sector



Sources: EEA Staff computation and EIC

As shown in Table 7.9, number of FDI projects in pre-implementation status has been increasing over the past decades. In 2017, there were about 312 FDI projects in pre-implementation phase. Moreover, 50 projects are licensed before 2010 but still have not become operational.

Available data also demonstrate that the number of licensed FDI projects has decreased over time. Recent operational FDI projects are mostly projects licensed in earlier years which are relatively small in number compared with high number of recent licensed projects.

Table 7.9: Number of service sector FDI projects in pre-implementation phase by year licensed.

Year licensed	No of FDI projects in pre-implementation phase as of January, 2018 (out of total number of FDI projects licensed in a given year)
1997	1
2002	1
2004	3
2005	4
2006	7
2007	12
2008	10
2009	5
2010	7
2011	10
2012	71
2013	53
2014	20
2015	31
2016	33
2017	44
Total	312

Sources: EEA Staff computation and EIC

By end of 2017, there were 251 FDI projects in the implementation phase since 1996. Moreover, 7 projects which were reported to have received their licenses in 1990's are still under-implementation. Looking at temporal distribution of number of FDI projects, one can notice that 22, 27 and 51 projects which received license in 2008, 2009 and 2010, respectively, had not become operational even by end

of 2017. Although some time lag between approval and operation is an avoidable fact in any project set-up, the speed at which a given project enters into operation might be influenced by various factors emanating both from the investors' internal readiness and external factors beyond their control. Most investments require working places including manufacturing and storage buildings, service providing premises, and other facilities. Availability of infrastructure, appropriate labor, and input are also other elements vital to start operation. Further legal requirements by government in establishing business can also speed up or make sluggish the process of being operational. Furthermore, there may be a failure in project follow-up and weak enforcement for immediate implementation. However, appropriate data are lacking to investigate which of these factors actually have determined the observed time lag in the transition of FDI projects from approval to realization in Ethiopia.

Table 7.10: Number of service sector FDI projects under-implementation phase by year licensed

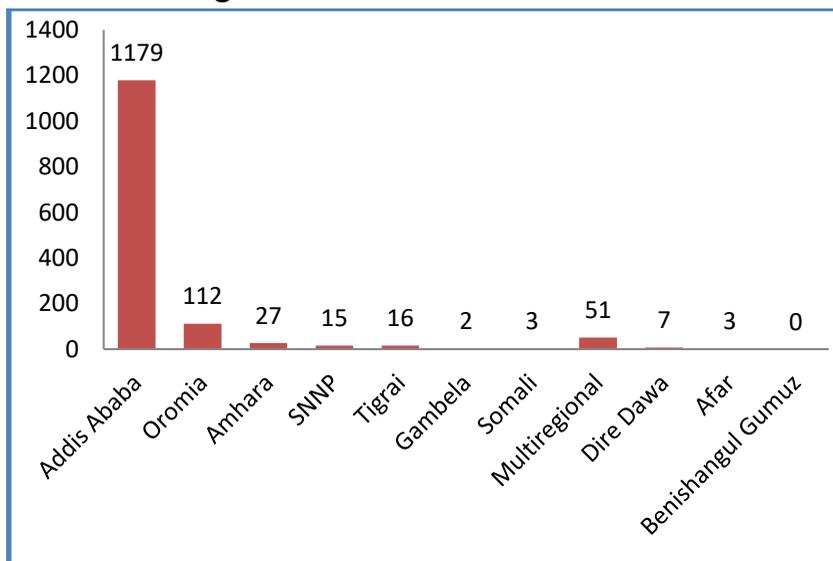
Year licensed	No. of FDI projects under-implementation as of January 2018
1996	1
1997	2
1998	4
2000	1
2001	6
2002	1
2003	5
2004	9
2005	5
2006	12
2007	18
2008	22
2009	27
2010	51
2011	21
2012	14
2013	20
2014	13
2015	8
2016	7
2017	4
Total	251

Sources: EEA Staff computation and EIC

7.4.5 Distribution of Service Sector FDI Projects across Regions (1992-2018)

Figure 7.13 displays regional distribution of FDI projects in Ethiopia. As indicated in the figure, Addis Ababa city administration has the largest number of FDI projects followed by Oromia and Amhara, respectively. Number of FDI projects found in Benishangul Gumuz, Gambella, Afar and Somali are very small in spite of the fact that the GoE provides extra incentives to encourage FDI in these regions. Although government provided incentives might influence placement of FDI project, actual location decision might also be determined by a combination of several factors such as proximity to the capital city (Addis Ababa), access to input and output market, availability of labor, and access to infrastructure. According to Dunning and Lundan (2008), a foreign investor's choice of a particular location or site for investment could depend on its motives to engage in foreign value adding activity. The authors categorize foreign investment can be categorized as resource-seeking, market-seeking, efficiency-seeking and strategic asset-seeking investments. Data are lacking, however, to investigate the relative importance of these different motives for engaging in FDI in services in Ethiopia. As such, further research is required to understand the key driving motives of FDI in Ethiopia's service sector.

Figure 7.13: Number of service sector FDI projects across regions



Sources: EEA Staff computation and EIC

7.4.6 Composition of Service Sector FDI Projects (1992-2018)

FDI projects within the service sector are unevenly distributed. As shown Table 7.11, the largest number of FDI projects within the service sector is found in Real-Estate, Machinery and Equipment Rental and Consultancy Service sub-sector followed by Construction Contracting Including Water Well Drilling. In terms of their project implementation status, there is huge intra-sector variation within the service sector. For instance, over-half of the total 1,202 FDI operational projects in the service sector are found in the Real-Estate, Machinery and Equipment Rental and Consultancy Service sub-sector.

The second largest number of operational projects is found in Hotels and Restaurants sub-sector. Real-Estate, Machinery and Equipment Rental and Consultancy Service sub-sector and Hotels and Restaurants sub-sector also account the first and second largest proportion of FDI projects in the implementation status, respectively. In contrast, in the Electricity (Generation, Transmission and Distribution) sub-sector, there is a lowest chance that FDI projects get implemented or become operational (see Table 7.11). In spite of the lack of FDI in telecommunications sub-sector, the bulk of FDI into the infrastructure services such as real-estate, construction, and hotels and restaurants sub-sectors complies with experiences in other fast growing developing countries (Dunning and Lundan, 2008).

Table 7.11: Composition of number of service sector FDI projects, 1992-2018

Sub-sectors	Percent of total number of FDI projects			
	Pre-implementation	Implementation	Operation	Total
Education	5%	8%	5%	6%
Health	4%	9%	5%	5%
Hotels and Restaurants	8%	9%	12%	10%
Tour Operation, Transport and Communication	7%	7%	6%	6%
Real-Estate, Machinery and Equipment Rental and Consultancy Service	49%	34%	52%	48%
Construction Contracting Including Water Well Drilling	25%	28%	16%	20%
Electricity (Generation, Transmission and Distribution)	1%	0%	0%	0%
Others *	3%	5%	5%	4%
Total number of projects	454	377	1,202	2,033
	100%	100%	100%	100%

Sources: EEA Staff computation and EIC.

7.4.7 Composition of Invested Capital of Service Sector Operational FDI Projects, 1992-2018

Table 7.12 summarizes the share of capital invested (in nominal terms) on different FDI projects within the service sector. As with number of FDI projects, we see that the largest share of total capital invested in FDI projects within service is found in the Construction Contracting Including Water Well Drilling sub-sector (59%) followed by Real-estate, Machinery and Equipment Rental and Consultancy Service sub-sector (23%). Despite their openness, education and health sub-sectors each only have two percent of invested capital in their operational FDI projects. Unfortunately, however, available data are not disaggregated by source of capital to permit us explore the share of invested operational capital originating from domestic and international sources.

Table 7.12: Distribution of capital value of FDI projects within service sector, (1992-2018)

Sub-sector	Percent
Education	2%
Health	2%
Hotels and Restaurants	9%
Tour Operation, Transport and Communication	1%
Real estate, Machinery and Equipment Rental and Consultancy Service	23%
Construction Contracting Including Water Well Drilling	59%
Electricity (Generation, Transmission and Distribution)	0%
Others *	4%
Total	
Capital value (in nominal terms) (in '000 ETB)	19,903,115

Sources: EEA Staff computation and EIC.

7.4.8 Employment Opportunities Generated by Service Sector FDI Projects

One benefit of FDI to a host country is to generate jobs. In this report we also look at the number of jobs created by service sector FDI projects. In looking at the employment opportunities created by foreign firms only projects which are either in operation or implementation phase are considered. Table 7.13 presents the descriptive results. In terms of employment creation from the period 22 August 1992 – 12 March 2018 a total 448,947 individuals got employment opportunities from service sector FDI projects. Among these individuals, 230,314 or 51.3% are permanent and 218,633 or 48.7% are temporary employees.

As can be seen in Table 7.13, number of total jobs generated by services sector FDI projects is larger than number of jobs obtained from FDI projects in agriculture sector but less than those of the manufacturing sector. However, when we disaggregate total employment, we find that agriculture sector FDI projects created the largest number of temporary jobs, followed by the service sector FDI projects. However, the total number of jobs (i.e. 448,947) generated by all FDI projects across all sectors is almost equally divided between permanent employment and temporary employment.

Table 7.13: Comparison of employment generated by FDI projects in service and other sectors (1992-2018)

Sectors	Permanent employment	Temporary employment	Percent
Agriculture	49,470	97,434	32.7
Manufacturing	136,532	56,411	43.0
Services	42,738	59,239	22.7
Other	1,574	5,549	1.6
Total	230,314	218,633	100.0

Sources: EEA Staff computation and EIC.

Table 7.14 indicates distribution of employment opportunities generated by the FDI projects within the service sector. As would be expected projects differ in terms of their capacity to generate jobs. According to our data, the largest number or 60% of FDI jobs within the service sector is found in the Construction Contracting including Water Well Drilling sub-sector followed by Real-Estate, Machinery and Equipment Rental and Consultancy sub-sector. Out of the total number of FDI jobs found in the Construction Contracting including Water Well Drilling, about 67% are in temporary employment. In contrast, the lowest number or about one percent of FDI jobs in the service sector is found in Tour Operation, Transport and Communication sub-sector.

Table 7.14: Composition of employment opportunities generated by service sector FDI projects (1992-2018)

Sector	Permanent employment	Temporary employment	Total	Percent
Electricity (Generation, Transmission and Distribution)	10	5	15	0.01
Education	2,100	1,852	3,952	3.88
Health	1,820	385	2,205	2.16
Hotels (Including Resort Hotels, Motels and Lodges) and Restaurants	4,620	2,371	6,991	6.86
Tour Operation, Transport and Communication	844	487	1,331	1.31
Real-Estate, Machinery and Equipment Rental and Consultancy Service	13,147	12,728	25,875	25.37
Construction Contracting Including Water Well Drilling	20,197	41,411	61,608	60.41
<i>Total</i>	<i>42,738</i>	<i>59,239</i>	<i>101,977</i>	<i>100.0</i>

Sources: EEA staff computation and EIC.

7.4.9 Distribution of number of employment opportunities from and value of invested capital per operational FDI Project, 1992-2018

One of the key questions to explore in relation to FDI is to explore factor labor- and capital-intensity of the FDI projects. Table 7.15

provides a summary of descriptive findings on this issue. On average, FDI projects in operating in the service sector are the most labor-intensive capital intensive. The average FDI project in the service sector has an investment capital value of about 114 million Ethiopian Birr and tends to generate about 600 jobs. The second most labor intensive FDI projects, on average, are found in the agricultural sector. On the other hand, the second most capital-intensive FDI projects, on average, are found in the manufacturing sector.

Within the service sector, FDI projects differ in number of jobs they generate and in value of capital invested. As can be seen in Table 7.15, the largest number of FDI jobs per project is found in the Construction Contracting Including Water Well Drilling sub-sector followed by the education, and the Hotels (including Resort Hotels, Motels and Lodges) and Restaurants sub-sectors, in that order.

Table 7.15: Capital and labor intensity of operational FDI projects, 1992-2018

Sectors	Total operational Projects		Factor intensity per project		
	Operational projects (#)	Capital invested ('000 ETB)	Jobs generated (#)	Capital ('000 ETB)	Labor (#)
Agriculture	311	9,232,080	146,904	29,685	472
Manufacturing	1,307	73,189,193	192,135	55,998	147
Mining	15	453,843	808	30,256	54
Services	1,202	19,903,115	109,100	114,044	679
Electricity (Generation, Transmission and Distribution)	1	1,000	15	1,000	15
Education	61	383,542	3,952	6,288	65
Health	56	475,614	2,205	8,493	39
Hotels (Including Resort Hotels, Motels and Lodges) and Restaurants	143	1,824,797	6,991	12,761	49
Tour Operation, Transport and Communication	71	248,670	1,331	3,502	19
Real-Estate, Machinery and Equipment Rental and Consultancy Service	624	4,513,125	25,875	7,233	41
Construction Contracting Including Water Well Drilling	188	11,742,570	61,608	62,460	328
Others *	58	713,797	7,123	12,307	123
Total	2,835	102,778,231	448,947	36,253	158

Source: EEA staff computation and EIC

7.5 Summary

Since the first-half of the 1990s, the GoE has liberalized the country's economy. The government has implemented various policy measures to attract and support FDI into the country. As a consequence, the country has been able to attract an increasing number of FDI projects including service FDI projects.

According to the data examine in this report, the service-sector FDI projects in Ethiopia are the most labor intensive. In addition, service sector FDI project has the largest investment capital per project. This result implies that attracting more service-sector FDI projects is a useful tool to meet the rapidly growing demand for jobs in the country, especially in urban areas. However, the service sector, unlike the agriculture and manufacturing sectors, still remain less-liberalized and much more could have been achieved if the GoE had chosen to further open the country's service sector for foreign investors. As compared to most African countries, Ethiopia still has the largest number of service sub-sectors which are not allowed for FDI ownership. In this regard, the recent announcement by the GoE to allow private investors (both domestic and foreign) ownership in some of the previously prohibited service subsectors is a useful step. However, although necessary, opening-up for foreign investors is not sufficient by itself. Available evidence demonstrates that there is a huge gap between licensing FDI projects and realizing them. According to available from the EIC, for instance, we observed that only less than 60% of the total number of licensed FDI projects has been able to become operational. Available data sources do not provide answers to why such a huge gap exists between licensing and

realization of the service sector FDI projects. Further systematic studies are highly required for a better understanding of why a significant number of approved or licensed service FDI projects have not been realized or become operational.

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Annex

Table 6.4: Unit root test for stationarity of variables

Variables	Level					First Difference				
	Test Statistic	p-value for Z(t)	1% Critical Value	5% Critical Value	10% Critical Value	Test Statistic	p-value for Z(t)	1% Critical Value	5% Critical Value	10% Critical Value
lnFDI	-0.8424	0.1998	-2.190	-1.990	-1.880	-7.5300***	0.0000	-2.210	-1.990	-1.890
lnGDPPC	6.0004	1.0000	-2.190	-1.990	-1.880	-5.4869* **	0.0000	-2.210	-1.990	-1.890
lnDomestic Investment	4.9565	1.000	-3.8085	-3.0206	-2.6504	4.9565***	0.0001	-3.8085	-3.0206	-2.6504
lnLACOST	-0.3107	0.3780	-2.190	-1.990	-1.880	-6.2925***	0.0000	-2.210	-1.990	-1.890
lnPOP	-1.2085	0.1134	-2.190	-1.990	-1.880	-1.3146**	0.0943	-2.210	-1.990	-1.890

Note: ** and *** shows the stationarity of the variables at 5% and 1% respectively

Annex Table 6.9: Some Statistics on Licensed Large Scale Commercial Agriculture,

Investor Name/ Company Name	Nationality	Region	Investment Type	Land Transfer Area of Ha	Capital registered/ Mill Birr/	Land Rent Per Year (Birr)	Agreement Signed Date	Agreement document
Adama	Ethiopia	SNNPR	Cotton	18516	323	2,925,528.00	18-Dec-02	Download
Daniel Agricultural Development Enterprise	Diaspora	SNNPR	Cotton & grains	5000	65	790,426.60	11-Jan-02	Download
Lucci Agricultural Development PLC	Ethiopian	SNNPR	Cotton	4003	83	632,474.00	30-Mar-02	Download
Mela Agricultural Development PLC	Ethiopia	SNNPR	Cotton	5000	42	790,000.00	10-Mar-02	Download
Rahwa	Ethiopia	SNNPR	Cotton & grains	3000	14	474,000.00	07-Sep-02	Download
Reta	Diaspora	SNNPR	Cotton & grain	2137	13	337,740.00	11-Jan-02	Download
Ruchi	Indian	Gambella	Soya bean	25000	1451	2,775,000.00	27-Jul-02	Download
Tsegaye Demoze Agricultural Development	Diaspora	SNNPR	Cotton, Sesame & Soybean	1000	9	158,000.00	17-May-02	Download
White Field	Indian	SNNPR	Cotton	10000	32	1,580,000.00	25-Nov-02	Download
BHO	Indian	Gambella	Edible oil crops	27000	918	2,997,000.00	03-Sep-02	Download
Sannati	Indian	Gambella	Rice	10000	160	1,580,000.00	24-Jan-03	Download
Verdanta	Indian	Gambella	Tea	3012	631	334,332.00	13-Aug-02	Download
Shmporji	Indian	B/Gumuz	Pongamia (Bio fuel)	50000	984	7,170,000.00	22-Jun-02	Download
Keystone	Diaspora	B/Gumuz	Horticultural & Crops	431	66	307,134.91	26-Apr-02	Download
CLC (Spentex)	Indian	B/Gumuz & Amhara	Cotton	25000	1177	5,548,750.05	17-Apr-02	Download
Access Capital	Ethiopian	B/Gumuz	Sesame & beans	5000	61	3,288,750.00	01-Feb-03	Download
Karuturi Agro Products PLC	Indian	Gambella	Palm cereals, rice & Sugar cane	100000	2110	2,000,000.00	26-Feb-03	Download
Saudi Star Agricultural Development	Saudi	Gambella	Rice	10000	37640	300,000.00	22-Feb-03	Download
Huana Dafengyuan Agriculture	China	Gambella	Sugar Cane	25000	2973	3,950,000.00	05-Nov-02	Download
Kehedam Trading	Diaspora	B/Gumuz	Oil Crop	3000	13	1,013,400.00	28-Mar-03	Download

Dr. Tamie Hadgu	Diaspora	SNNPR	Cotton, Seeds	5000	74	790,000.00	09-Apr-03	Download
Bruhoye	Ethiopia	B/Gumuz	Cotton, Soya bean	5000	60	960,000.00	08-Apr-03	Download
ASKY Agricultural Development	Ethiopia	B/Gumuz	Cotton	3000	60	333,000.00	13-Jul-03	Download
Tracon Trading Pvt. Ltd/ Co.	Ethiopia	B/Gumuz	Cotton	5000	61	1,972,500.00	13-Jul-03	Download
Saber Farm PLC	Indian	Gambella	Cotton & Soya bean	25000	436	3,950,000.00	9/2/2003	Download
Getafan Mechnaized Farming	Ethiopia	B/Gumuz	Cotton, Fruits, Oil crops & pulses	3000	21	855,450.00	11/4/2003	Download
Tigabe Agro industry	Ethiopia	B/Gumuz	Cotton	3000	49	697,500.00	12/3/2003	Download
Toren Agro industries PLC	Turkey	Gambella	Cotton & Soya bean	6000	1000	948,000.00	1/12/2004	Download
AGROPEACE BIO ETH PLC	Israel	Somali	Production of Castor oil & cotton as principal	2000	253	33292500	8/24/201	Download
AL-MEHADI MATCH MARKS PLC	Pakistani	SNNPR	Match Stick tree Plantation	1000	79	19489500	7/30/2012	Download
GASHAW BEZU TAKELE	Diaspora	B/Gumuz	Cotton	3000	44	333000	3/14/2004	Download
GREEN VALLEY AGRO PLC	Indian	Gambella	Cotton farming & related activities	5000	171	555000	1/25/2012	Download
HASH AGRO INDUSTRY PLC	Ethiopian	SNNPR	Cotton	14704	140	2058	11/30/2003	Download
HORIZON PLANTATIONS PLC	Ethiopian	B/Gumuz	Ground nut farming& related	20000	1630	3160000	9/1/2012	Download
JVL OVERSEAS PTE LTD	Indian	Gambella	Cotton farming & Related Activity	5000	74	790000	6/25/2012	Download
MAMAY MIHRET NEGA	Diaspora	B/Gumuz	Cotton	3000	255	333000	1/12/2004	Download
OMO VALLEY FARM COOPERATION P.L.C	Turkey	SNNPR	Cotton	10000	750	1580000	6/25/2012	Download
TIKIMT AGRICULTURAL PLC	Ethiopian	B/Gumuz	Cotton	3000	56	333000	1/26/2004	Download

Source: Investment Directorate, MoARD