REPORT ON THE ETHIOPIAN ECONOMY

2018

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

Ethiopian Economics Association (EEA)

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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.

TadeleFerede (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. SeidNuru Senior Research Fellow, Mr. Gashaw Desalegn, Mr. Simon Bayu and Mr. YetsedawEmagne 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. SeidNuruand Dr. DegnetAbebawSenior Research Fellows, Mr. Amin Abdella, Dr. Samuel G. Selassie, Mr. KumadebisTamiru,Mr. Gashaw Desalegn, Mr. Simon Bayu and Mr. YetsedawEmagne. 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.

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Many other people have also made very valuable contributions to this report, and we are grateful to them. W/O RahelYilma 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.

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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.

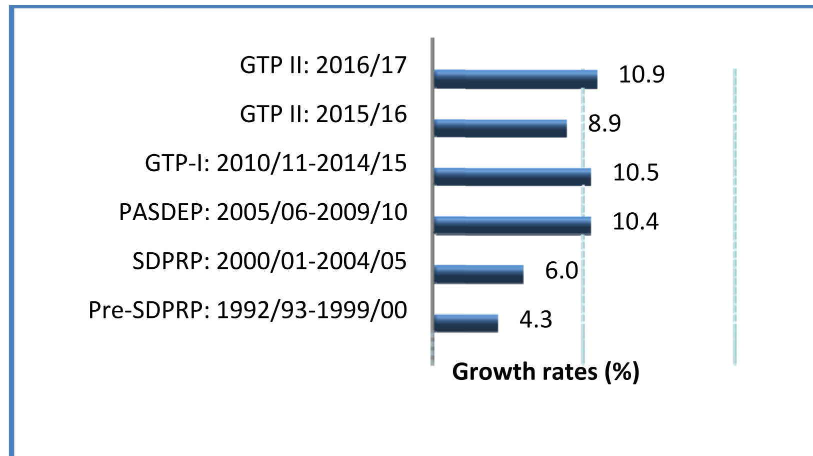
1.1 Growth and patterns of structural change

Official figures from theNational 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 sectorfrom 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 rate[1].

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

Figure 1.1: Growth rates in real GDP



Source: EEA staff computations using data from NPC.

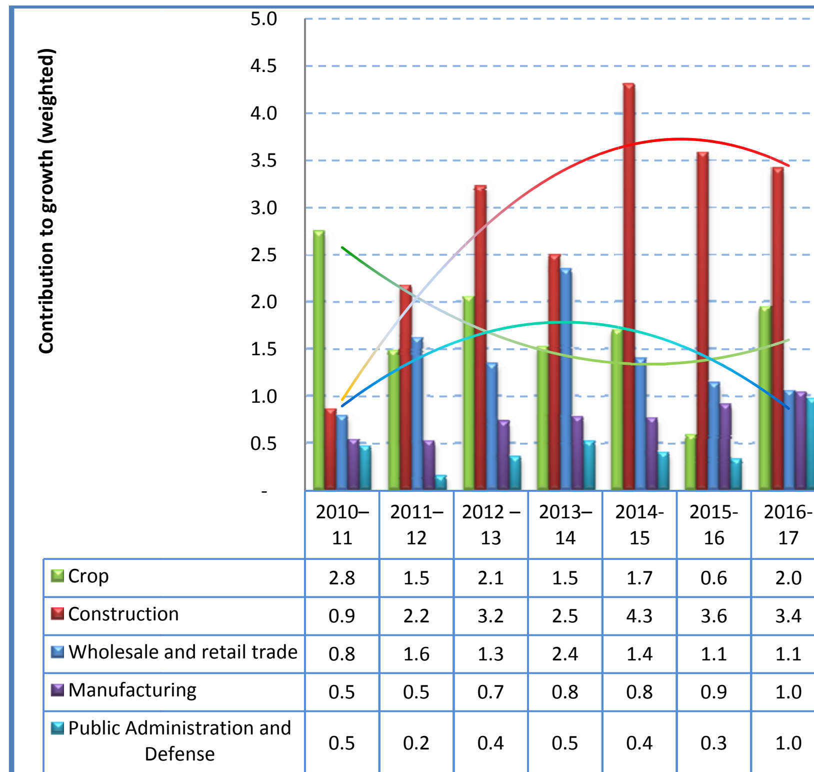
The agriculture, industry and service sectors had a share of 2.5, 4.4, and 4.0 percentage points, respectively, contribution to the 10.9 per cent growth in the total value-added observed in the fiscal year 2016/17. The construction sector alone accounted for 3.4 percentage points (31.2 percent) of the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

[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.

manufacturing, and 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



	2010–11	2011–12	2012 – 13	2013–14	2014-15	2015-16	2016-17
Crop	2.8	1.5	2.1	1.5	1.7	0.6	2.0
Construction	0.9	2.2	3.2	2.5	4.3	3.6	3.4
Wholesale and retail trade	0.8	1.6	1.3	2.4	1.4	1.1	1.1
Manufacturing	0.5	0.5	0.7	0.8	0.8	0.9	1.0
Public Administration and Defense	0.5	0.2	0.4	0.5	0.4	0.3	1.0

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 2016/17due 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 1.1: 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

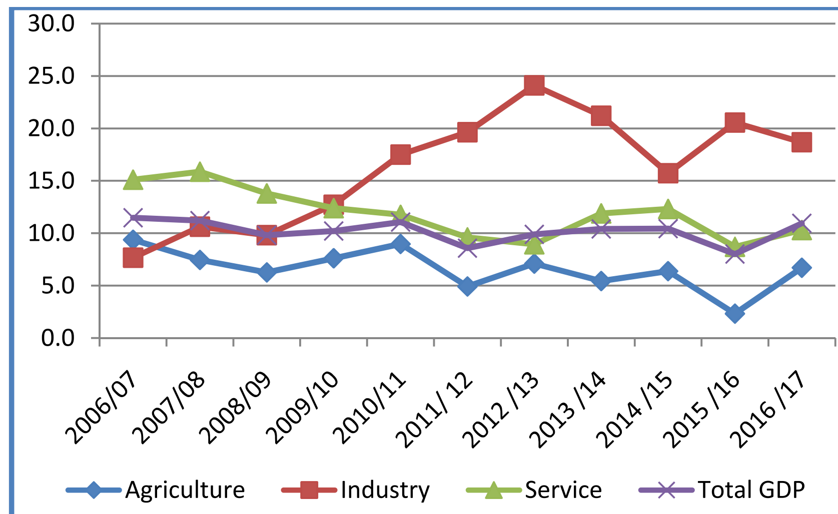
The GTPII anticipated 11.1 of annual GDP growth rate in the fiscal year under review. In this regard, only service sector has showed percentage point margin above the targeted level, whereas, the performance of the agriculture and industry performed at slightly lower rates than the targeted level envisaged 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

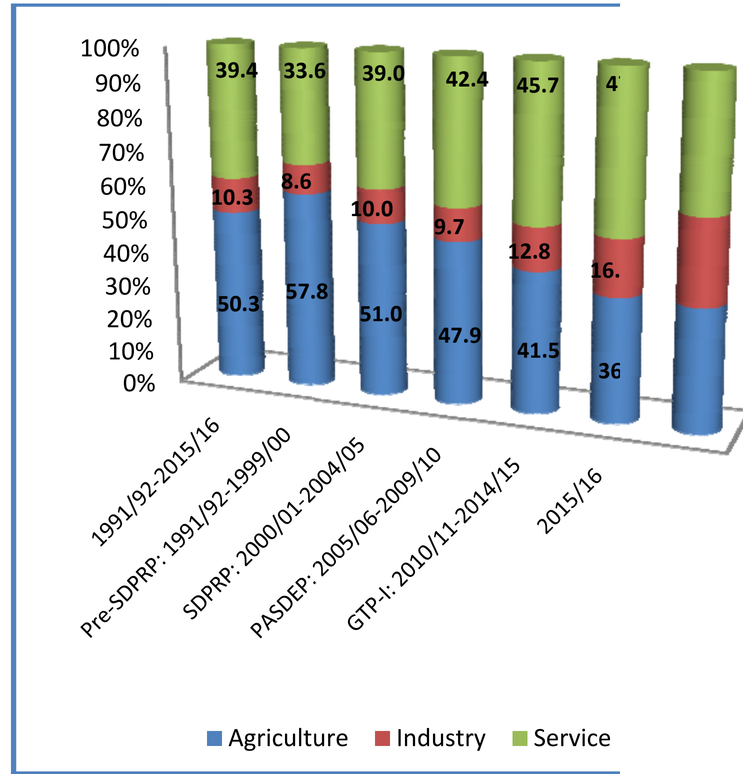
The slower performance of the agriculture sector in terms of growth while it has had the largest share in the GDP by volume

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 and2015/16 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 service sectors than the potential co-variation between mo services and manufacturing sector.

Figure 1.4: Structure of the Ethiopian Economy



Sources: NPC (2018) and EEA staff calculations