Determinants of Foreign Direct Investment in Ethiopia: Systematic Review

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Abstract
The determinants of FDI include any host country's situations that affect the inflow of FDI, like market size, the economic growth rate, real growth domestic product, infrastructure, natural resource, the political situation etc. In recent years, Ethiopia has started encouraging the inflow of FDI by improving the investment climate and by providing different incentive packages. The focus of this review is to identify the major determinants of foreign direct investment (FDI) in Ethiopia. The results show that the variables like real growth domestic product, liberalization, exchange rate devaluation, and trade openness are significant and have a positive correlation with the inflow of FDI in Ethiopia. On the other hand, variables like inflation, poor infrastructure; volatile and high lending interest rate have a significant and negative association with the inflow of foreign direct investment. Finally, the study recommends possible intervention of the government through infrastructure development and formulation of sound fiscal and monetary policies to control the negative impact of inflation, interest rate and other macro variables.
Keywords: FDI, RGDP, Inflation, liberalization, interest rate, Ethiopia.

1. Introduction

Ethiopia has managed to register double-digit economic growth over the past 13 years. This high growth has contributed to a sustained increase in per capita income and a decline in absolute poverty, as well as improvement in standards of living of the population (MOFEC 2017). Investment is, without a doubt, one of the primary engines of development in all economies. Foreign direct investment (FDI) remains a significant source of capital and income generating opportunities for the least developed countries. This is especially true for Ethiopia that does not have enough domestic funds to finance huge investment projects. It is also important for Ethiopia in transferring technological advancement for domestic enterprises, competitiveness and organizational forms, assist human capital formation, international trade integration and to create a more competitive business environment from abroad (Gelawdewos, 2015).

The need to meet the objective of faster economic growth with development and low level of capital accumulation are maladjusted in nature. To come up with a solution, attracting foreign direct investment is served as a source of capital in most list developing countries. (Getinet and Hirut 2006). FDI is particularly important for developing countries like Ethiopia since it provides access to resources that would otherwise be unavailable to these countries. Its contribution to economic development and therefore poverty reduction comes through its role as a conduit for transferring advanced technology and organizational forms to the host country, triggering technological and other spillovers to domestically owned enterprises, assisting human capital formation, contributing to international trade integration, helping to create a more competitive business environment and it may have also some political advantages. In short, FDI works as a means of incorporating underdeveloped countries into the global market and improving capital available for investment (Amanuel, 2014).

The rapid growth in FDI over the last few decades has initiated a number of researchers to conduct a research on the determinants and the growth-enhancing effects of FDI. Similarly, various studies have conducted to identify the determinants of foreign direct in Ethiopia. There is, however, the absence of systematic review evidence on the determinants of foreign direct investment sources. The major objective of this systematic study is, therefore, to review sample empirical studies conducted in Ethiopia and draw logical conclusion and recommendation. On the top of the above statement, this review is expected to come up with convincing and significant information for concerning bodies such as government, policymakers, and other institutions working on the promote foreign direct investment and hence to show the direction of solution for the problem of unemployment and balance of payment deficit of the country.

2. Foreign direct investment (FDI) and related issues

2.1 The Benefits and Costs of FDI

Understanding the avail and ill turn of FDI is imperative to formulate a sound economic policy. Even if, in recent times, the policy that favors FDI dominates, there are two opposing views as to the role of FDI in developing economies. On the one hand, it is argued that FDI benefits the host country, for instance, by creating job opportunities and bringing new technologies, which can be used as a technological transfer. In contrast, the other group argues that the adverse effects of FDI outweigh its benefits (Teshome, 2010). We will try to see the arguments of both groups.

2.1. 1 Pro-FDI Views

Other things remain constant; economic growth depends on the general level of investment and investment in turn largely depends on savings. However, compared to the developed nation, gross domestic savings are too low in the least developed countries (LDCs). As a result, foreign direct investment is the next best alternative source to fill the gap between domestic savings and the required investment for economic growth aweless economic development. Besides, foreign firms bring not only financial capital but also managerial techniques as well as, entrepreneurial and technological skills that lack in LDCs and these skills can be transferred to domestic firms through different channels Even if such advantages highly depends on the strategies of the hosting countries. On top of the above advantages, the government's budget deficits can also be fixed by collecting profit-tax from transnational companies or from foreign direct investors and there is also a room to solve the shortage of foreign currency in the hosting country (Todaro, 1992, Solomon 2008, Teshome 2010). FDI can also play an important role by creating employment opportunities and by integrating the host-country economy into the world economy (OECD, 2002).

2.1.2 Anti-FDI Views

On the other hand, some scholars strongly disagree with the Pro- FDI views. Their first counter-argument state that multinational corporations increase income for low-income groups, which have a low marginal propensity to save (MPS). If individuals do not save enough, the gap between savings and investments cannot be filled. Besides, foreign direct investors may also fail to reinvest the profit they generate in the host country; hinder the growth of domestic enterprises and domestic investment by importing the input and intermediate product from their subsidiaries in other countries and this will have a significant impact to sustain the growth. FDI might also inhibit the development of indigenous skills as a result of multinational companies' dominance over local enterprises (Todaro, 1992, Solomon 2008, Teshome 2010). Generally, the problem of low level of saving and investment will be solved by sound fiscal and monetary policy than FDI.

On the other hand, the expected advantages of FDI is not that much satisfactory. For example, it is expected that the government budget deficits can also be fixed by collecting profit-tax from foreign direct investors. However, when we see the reality governments often enter into exclusive agreements with foreign firms and provide tax holidays, tariff protections, and investment allowances (this is common here in Ethiopia) just to attract FDI. As a result, the taxes that can be collected becomes quite small. Moreover, most of the time foreign direct investors participate in tax avoidance and tax evasion practices with the help of sophisticated fiscal and monetary and fiscal policy and protocols (Thomas A. and Peter H. 2000).

2.2 The motives for foreign direct investment

Researchers conducted on the issue indicates the three possible motives for FDI by referring Dunning (1993) as cited on Amanuel , 2014; Getinet and Hirut 2006; Rozina 2016; Haregewoyn 2016, Henok, 20 14 and Gelawdewos, 2015 and according to those researches, FDI has the following three broad purposes.

Market-seeking or (horizontal) FDI: In this case, the main objective is to supply products to the local and district market. The rationale for market-seeking FDI is the market size and market growth. The investors who are seeking market size for investment need to have host countries, which have a large market size, high potential for market growth and high per capita income so that they can exploit the market advantages of the hosting country.

Resource (asset seeking) FDI: In this case, the main objective of the investing firm's aim is to get access to the resources in the host country (including natural resource, raw materials, and cheap labor), which is not obtainable in the home country of the investor.

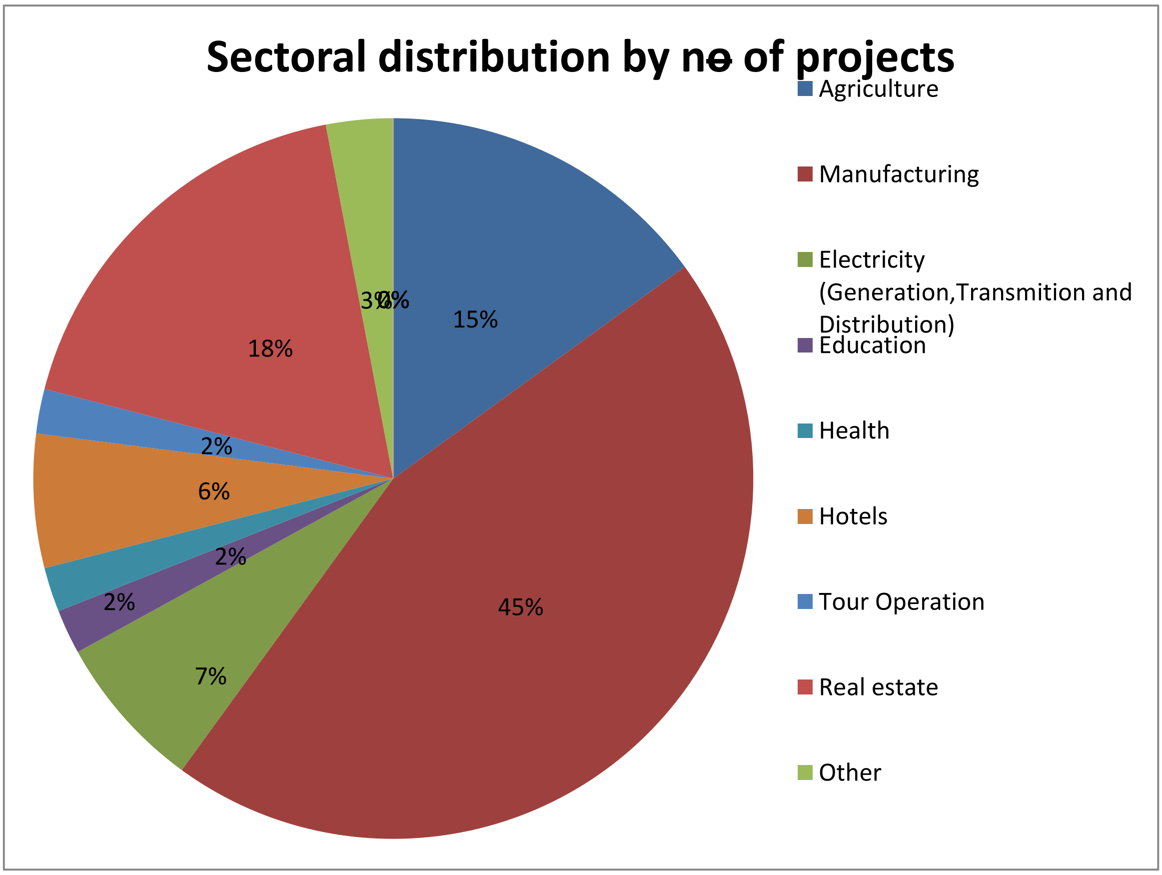
Efficiency-seeking FDI: In this case, the investor will invest to get an advantage when there is a common governance of geographically dispersed activities, especially in the presence of economies of scope and scale and diversification of risk. In this case, we can consider multi-plant companies as an example.

The above three motives of FDI are under economic determinants of FDI. Besides these economic determinants, there are also two other crucial determinants of FDI: which is the hosting country FDI policy framework and business facilitation (Getinet and Hirut 2006).

3. Foreign direct investment in Ethiopia

The government of Ethiopia has established the Ethiopian Investment Authority (EIA) in the year 1992 among other things to promote, coordinate and facilitate foreign direct investment in the country. Functions of EIA, among others, include; providing all the necessary information required by foreign direct investors, cheek and approving foreign investment applications, issuing investment permits, services related to registration, approving expatriate posts in approved investments and issuing work permits to foreign employees. Issuing trade and operating licenses for foreign investments, monitoring the implantation of licensed investment projects of FDI, approving and registering technology transfer agreements between local companies and foreign technology

suppliers, and facilitating the acquisition of land by foreign investors in accordance with the relevant federal and regional government laws and regulations (Getinet and Hirut ,2006; Solomon , 2008 ;and Henok, 2014).
Figure 1: Sectoral distribution by no of projects (1992-2016)

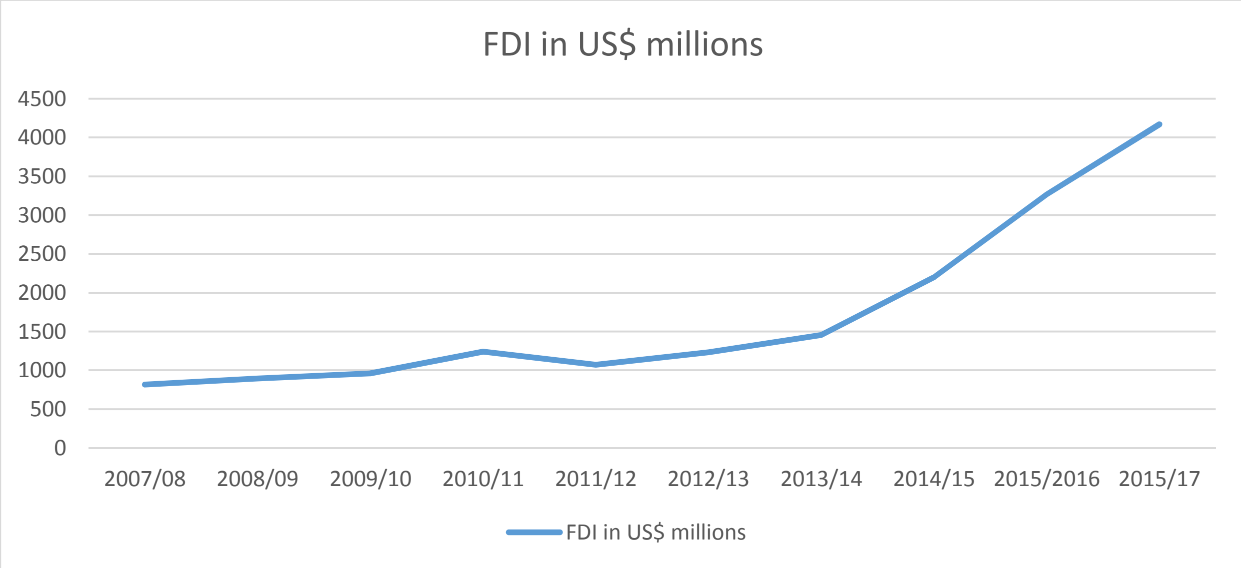


Source: Ethiopian investment commission (EIC), 2017

According to the EIA, the areas with the most promising potential for investment are agriculture, agro-processing, textiles and garment, leather and leather products, tourism, mining, and hydropower (Amanuel Mekonnen 2014). Ethiopian Investment Commission recently announced that the country's FDI increased by 35 % on average over the first last six months of the fiscal year 2016/17 G.C compared to same period of 2015/2016 G.C. FDI flows to the country continued to show the positive track of record in 2016/17 G.C. despite the recent unrest occurred in some parts of the country (MOFC 2017).

Table 1 and Figure 2: Foreign direct investment inflow (in US$ millions) 2007 - 2017

Year	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16**	**2016/17**
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



Source: Ethiopian investment commission (EIC), 2017

3.1 Prospective of FDI in Ethiopia

The trend of economic growth of Ethiopia within the last decade recorded annual average GDP growth of about ten percent and this growth is mainly driven by public investments in agriculture and infrastructure. As a result, the poverty rate has fallen from 44 % in 2000 to 23.5% in 2015/16. Industrial activity expanded, with continued investments in infrastructure and manufacturing. The current account deficit also declined in 2016/17 to 8.2 % of GDP from 9.1 % in 2015/2016, reflecting lower drought-related imports and lower public sector capital goods imports. However, export revenues were largely unchanged despite significant volume growth, the reason for having stagnant export revenue is related to the global agricultural commodity prices, and it remained low. Foreign direct investment (FDI) growth was 27.6 % due to investments in the new industrial parks and privatization inflows. International reserves at end-2016/17 stood at the US $ 3.2 billion, which is 1.8 months of prospective imports cover (IMF, 2018).

Currently, the Ethiopian government has a 5-year integrated plan called growth and transformation plan two (GTP II), covering 2016-2020. GTP II sets a target of an average growth of 11% in the next five years with the objective to join middle-income countries by 2025. In order to change this blueprint to reality, the government should come up with consistent and sound macroeconomic policies. The government should also invest heavily in large-scale social, infrastructural and institutional development projects. Included in the GTP II are incentives for international investors, such as facilitation of repatriation of investment and profit, ease in hiring expatriate personnel, temporary income tax exemptions for investments in selected sectors, duty-free imports of capital goods, components and raw materials for exporting industries and manufacturers in priority sectors (Cole, 2017 Cited by Tesfaye 2017).

Politically, the country is one of the most stable countries in the horn or in eastern Africa. Economically, in order to enhance the export sector, the government has established the Ethiopian commodity exchange (ECX). In addition to this, countless projects are undergoing related to hydropower energy, road transport infrastructure, and railway network. The reputable Ethiopian airline is also playing its role on providing cargo services worldwide. 18 financial institutions and insurance companies are operating in the country. The government also offer different incentives like tax holidays or exemptions, which ranges from 2-10 years depending on the nature of investment (Tesfaye, 2017). On top of the above incentives, the Ethiopia government has a bilateral agreement on investment promotion and protection with a number of African, Asian and European countries (EIC 2014).

However, there are a number of obstacles to investing in Ethiopia**.** Mainly by the following principal obstacles that foreign enterprises face in Ethiopia: Trade regulation and customs clearance efficiency. Perceived foreign exchange rate risks deter investment. Restrictions on foreign currency transaction and conversion, in combination with perceived uncertainty over the foreign exchange rate path, tax administration inconsistency, and inefficiency **(** more than 70 percent of the surveyed firms find the inconsistency of tax law explanation and the frequent law amendment a major obstacle to doing business), Insufficient local access to finance. Ethiopia is also known by nationalizing lucrative business. For example, telecommunication, airlines, shipping, hydropower plants belong to the government and foreign investors not allowed to possess these businesses. Additionally, the financial sector is open only for Ethiopians. The other problem faces foreign investors is the culture of the community. Other obstacles were corruption, infrastructure (Tesfaye, 2017).

4. METHODOLOGY OF THE STUDY

This study based systematic review involved descriptive analysis. The primary data were systematically collected from 6 (six) quantitative studies and from 2 (two) qualitative studies conducted in Ethiopia between 2006 and 2017. On the top of the above researches, the author also used a number of supportive researches, which is conducted in the aforementioned issues. The study used descriptive statistics (like frequency distribution) to analyze the demand side, supply side and mainly the macroeconomic factors affecting the inflow of foreign direct investment in Ethiopia.

This review employed two-stage screening stages, which is the title and abstract screening stage and full-text screening stage. The researcher used the hand-searching method with key search terms from the internet and library. A number of papers were identified with the same topic. Of these paper 6 (Six) studies were found relevant for the review. The study assumed that the dependent variable (Foreign direct investment FDI)) is a function of various economic variables. For this study, however, the study considers real growth domestic product **(RGDP)**, Inflation **(Inf)**, Poor Infrastructure **(PInfra),** Interest rate **(I),** Liberalization (**L**), Exchange rate **(Er)** and Trade openness (**To**).

Real growth domestic product (RGDP)

Investment is the basic element of Gross Domestic Product (GDP) and the only one that allows domestic production to enhance. It also affects the consumer and government spending, especially the latter through increased tax revenues (Carlos and Eddie, 2015). On the other hand, real growth domestic product has also a power to attract foreign direct investors.

Inflation and Exchange rate

When a country's currency devalues, it is considered an opportunity for foreign investors to purchase assets at a reduced cost. This is especially true when foreign firms have identified specific assets in their targeted markets (Blonigen, 1997). Frequent and erratic changes in the exchange rate of the domestic currency affect the inflow of FDI (Goldberg and Klien, 1997). Barrell and Pain (1996) find that investors tend to postpone their investment when the currency in the targeted market strengthens.

Through its effect on the cost of inputs and the price of outputs, inflation reduces the real return on investment and firms' competitiveness. Hence, countries that pursue policies that reduce inflation rate have a better chance of attracting FDI. The low and predictable inflation rate is central for the long-term investment of both domestic and foreign companies. Therefore, higher and unpredictable inflation will decrease the inflow of FDI (Birhanu, 1998). Generally, Inflation rates and exchange rates are used as proxy variables for macroeconomic stability. Low inflation and stable exchange rates are expected to have a positive impact on FDI (Teshome, 2010).

Poor Infrastructure (P Infra)

Infrastructure covers many dimensions ranging from roads, ports, railways and telecommunication systems to the level of institutional development (Getinet and Hirut 2006; Amanuel, 2014). The availability of well-developed infrastructure will reduce the cost of doing business for foreign investors and enable them to maximize the rate of return on investment (Morriset, 2001). Therefore countries with good infrastructures are expected to attract more FDI. Gross fixed capital formation (percent of GDP) has been included to proxy infrastructure development. FDI is expected to have a positive relationship with the infrastructure of the host countries. (Amanuel, 2014)

Interest rate (I)

The interest rate is the amount of money charged by a lender to a borrower. It is often expressed as a percentage of the principal amount (Benson, 2016). Interest rates will be adjusted to reflect changes in inflation. As a result, interest rates are critical determinants of foreign direct investment. Defines interest rate as the cost of borrowing capital and also a measure of return on investment. Traditionally, investors will shop for low-cost credit sources or lower interest rates and invest it in economies that are promising higher returns (Singhania, 2011).

Trade Liberalization (L)

There are reasons to expect that different kinds of trade would influence FDI flows differently. While trade associated with cross-border vertical integration may boost FDI by providing incentives of cost reduction, intra-industry trade may discourage FDI that seeks economies of scale (Bishwanath and Rashmi, 2007). Liberalization of trade and FDI regimes are assumed to have a positive influence on the inflow of FDI since they facilitate a freer trade and investment in conjunction with the repatriation of dividends and profits to home countries (Bende, 2002, cited by Teshome 2010). Ethiopia has been introducing some liberalization measures since 1991 and researches, which include this variable, used a dummy variable to capture the effect of the change in policy environment on FDI. The dummy variable assumes a value of 0 for the pre-liberalization period (i.e. up to 1990) and 1 for the post-liberalization period (from 1991 onwards).

Trade Openness: Trade openness promotes FDI and it is measured as the ratio of export to GDP. Sign and Jun's 1995 study indicates that exports, particularly manufacturing exports are significant determinants of FDI inflow and the test shows that there is a strong evidence that exports precede FDI flows.

5. Result, Conclusion and Policy Recommendation

5.1 Description of Reviewed Literatures

In this section of the study, the reviewer presents some of the general characteristics of literature in terms of title, nature of data, and periods under study.

Table 2: Summary of Reviewed Studies

No.	Authors	Title	Type of Data	Years
1	Rozina (2016)	Determinants of Foreign Direct Investment In Ethiopia: Time Series Analysis	Time-Series (Annual)	1981-2014
2	Haregewoyn (2016)	Determinants of Foreign Direct Investment: Evidence from Ethiopia	Time Series (Annual)	1975-2014
3	Gelawdewos (2015)	The Determinants Of Foreign Direct Investment (FDI) In Ethiopia	Time Series (Annual)	1980-2014
4	Teshome (2010)	Determinants Of Foreign Direct Investment In Ethiopia	Time Series (Annual)	1981-2007
5	Amanuel (2014)	Factors Affecting FDI Flow In Ethiopia: An Empirical Investigation	Time Series (Annual)	1990-2011
6	Getinet & Hirut (2006)	Determinants of Foreign Direct Investment in Ethiopia: a time series analysis	Time-Series (Annual)	1974 - 2001
7.	Tesfaye (2017)	Foreign Direct Investment (FDI) Outlook in Ethiopia: An Evidence from Oromia Region Selected Special Zones	Descriptive statistics	2017
8.	Henok (2014)	Determinants and Impediments of FDI inflows in Ethiopia- A Firm-Level Investigation	Descriptive statistics	2014

Source: Reviewed literature 2018

This study, however, focused on determinants of foreign direct investment in Ethiopia. The sign **(S)** shows that the variable has been found significant from reviewed literature and the **(±)** shows the impact of a variable.

Table 3: Determinants of Economic Growth

No.	Authors	Variables						
		RGDP	**INF**	**PINFRA**	**I**	**L**	**Er**	**To**
1	Rozina	**S (+)**	**S (-)**	**S (-)**		**S (+)**		
2	Haregewoyn				**S (-)**	**S (+)**	**S (+)**	**S (+)**
3	Gelawdewos	**S (+)**	**S (-)**		**S (-)**			
4	Teshome	**S (+)**	**S (-)**	**S (-)**				**S (+)**
5	Amanuel		**S (-)**					**S (+)**
6	Getinet & Hirut	**S (+)**	**S (-)**	**S (-)**		**S (+)**		

Source: Reviewed literature 2018

According to the above table, the independent variable real growth domestic product has positive impact on foreign direct investment (FDI) inflow to Ethiopia (Rozina, 2016; Gelawdewos, 2015; Teshome, 2010; Getinet & Hirut, 2006). On the other hand, one of the major macroeconomic variable 'inflation' is negatively associated with the inflow of FDI (Rozina, 2016; Gelawdewos, 2015; Amanuel 2014; Teshome, 2010; Getinet & Hirut, 2006). According to the regression, poor infrastructure prevails its negative impact on the inflow of FDI (Rozina, 2016; Teshome, 2010; Getinet & Hirut, 2006). Similarly, the interest rate has also a significant and negative impact on the inflows of FDI (Gelawdewos, 2015 and Haregewoyn, 2016). When we see the relation between trade liberalization and inflows of FDI there significant and positive correlation as indicated in the researches of Rozina, 2016; Haregewoyn, 2016 and Getinet & Hirut, 2006. With reference to the exchange rate as the government of home country devaluate its currency there is a possibility to attract foreign direct investors (Haregewoyn, 2016). The last variable, considered within this review is traded openness. According to the findings of Haregewoyn, 2016; Amanuel 2014 and Teshome, 2010 trade openness has a significant and positive impact on the inflows of FDI to the home country.

Tesfaye, 2017 and Henok, 2014 also made a descriptive analysis of the factors affecting the FDI in Ethiopia. Their findings reviled that Ethiopia relatively stable in macroeconomy, secure and safe in the horn of Africa (political and social stability), strategic geographic location with favorable climate, inexpensive, sufficient labor, potentiality on the local market, government incentives, and consistent economic growth and regional market opportunity are the main drivers of FDI to Ethiopia. On the other hand, the major obstacles or challenges that constrain the inflows of FDI are trade regulation and custom clearance (and lack of clear policies and regulatory impediments), shortage of foreign exchange and rate volatility , tax administration inconsistency and inefficiency, insufficient local access to finance, openness of business and culture (Tesfaye, 2017).

5.2 Conclusion and Recommendations

FDI is an important source of investment in an economy. Performance of a host country in terms of GDP is important for investors in an economy, however, the country must do more to improve its GDP (Benson, 2016). Currently, most developing countries are trying to attract foreign direct investment and Ethiopia as a nation with low domestic saving and with high budget deficit needs to be part of this competition. This study aims to carefully review sample empirical studies conducted in Ethiopia to identify factors that determine the inflow of FDI in Ethiopia. As it is stated in the methodology part review applied, two-stage screening process: title and abstract screening and Full-text screening.

Real growth domestic product, liberalization and trade openness are among the major determinants of FDI, which affect the inflow of FDI positively. On the other hand, variables like inflation, poor infrastructure, level of interest rate negatively related to the inflow of FDI.

Based on the reviewed literature, the study recommends that in order to sustain and improve the inflows of foreign direct investment (FDI) the Ethiopian government and another concerned body first should focus on factors that hinder domestic investments. Because foreign investors will be encouraged to invest in a country if the domestic investors are doing successfully. The positive and significant effect of economic growth on FDI indicates the decisiveness of economic growth in stimulating investment by foreign as well as domestic investors. As a result, it's just to keep up the growth momentum and ascertaining its sustainability is a key to increase the inflow of FDI.

The negative and significant impact of inflation indicates the importance of a more focused macroeconomic policy environment that supports the economy and builds confidence for potential investors. Necessary steps have to be taken to contain inflation and stabilize exchange rate through the adoption of sound fiscal and monetary policies. Otherwise, we may face outflow of FDI. Similarly, poor infrastructure has also a negative impact of the inflow of FDI. The government should, therefore, invest more in infrastructure because it is essential for the creation of a productive business environment

The significantly positive effect of liberalization on FDI indicates that an efficient environment that comes with a liberalized economy is likely to attract foreign investors. Until now, a number of policies have been realized about liberalization but still further measures aimed at encouraging privatization. Besides, the government of Ethiopia should also work by giving priority to stabilizing the political environment, ensuring peace and security to citizens.

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