



# Financial Flows

Leveraging foreign direct investment for Africa

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## Leveraging foreign direct investment for Africa

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### Briefly

According to the World Bank, FDI is an investment made with the ultimate objective of possessing a lasting management interest (usually a minimum threshold of 10% of voting stock) in a firm operating in a country different from that of the investor.

The emerging conclusion from the recent FDI-growth literature is that attracting FDI is insufficient to generate economic growth and development. Domestic factors, generally discussed as the absorptive capacity of recipient countries, are often a determining factor in translating FDI inflows into growth and development. Generally, it seems that productivity spillovers of FDI can be materialised only in an environment that promotes quality education (human capital), sound and credible institutions, good infrastructure, and active local financial markets. Weaknesses in these areas undermine the ability of local firms to adopt advanced technologies and reduce their capacity to respond to the challenges associated with **FDI inflows**, such as intense competition, which can have a crowd-out effect on domestic investment.

With appropriate domestic conditions and policies, Asian countries such as China, South Korea, Singapore, Malaysia and Taiwan were successful in orienting FDI into strategic sectors that were in line with their **development** objectives. For example, in South Korea, priority was given to export-oriented FDI with the most potential for generating jobs and foreign exchange. Some sectors were closed to FDI and in the sectors that were opened to FDI, joint ventures with domestically owned firms were encouraged to maximise technology and managerial skills transfer. Thus, in the mid-1980s for example, only 5% of transnational corporations' subsidiaries in South Korea were wholly under foreign ownership while it was 50% in Mexico and 60% in Brazil.

Domestic conditions were improved to maximise technology spillovers and transnational corporations that were ready to transfer technology were selected against those that were not. Screening policies were used to ensure that **FDI** does not hurt domestic investments or firms. China also successfully uses FDI to stimulate domestic investments due to appropriate domestic policies. A study by Agosin and Mayer reports that there is strong 'crowding in' of domestic investments by FDI in Asia, while 'crowding out' of domestic investments by FDI is the norm in Latin America and many African countries. The potential of FDI to unlock growth and development in Africa is, therefore, not straightforward—domestic conditions and policies matter.

In contrast to short-term financial flows such as international portfolio investments, which are generally motivated by profitable hit-and-run strategies or the real boom-and-bust cycles of economies, FDI is more stable, with several benefits for the recipient economies. It brings superior technology, new production processes, managerial know-how, etc. to domestic firms, thereby generating productivity gains.

The potential benefits from FDI are summarised in the Monterrey Consensus, agreed in 2002 at the United Nations International Conference on Financing for Development, as follows:

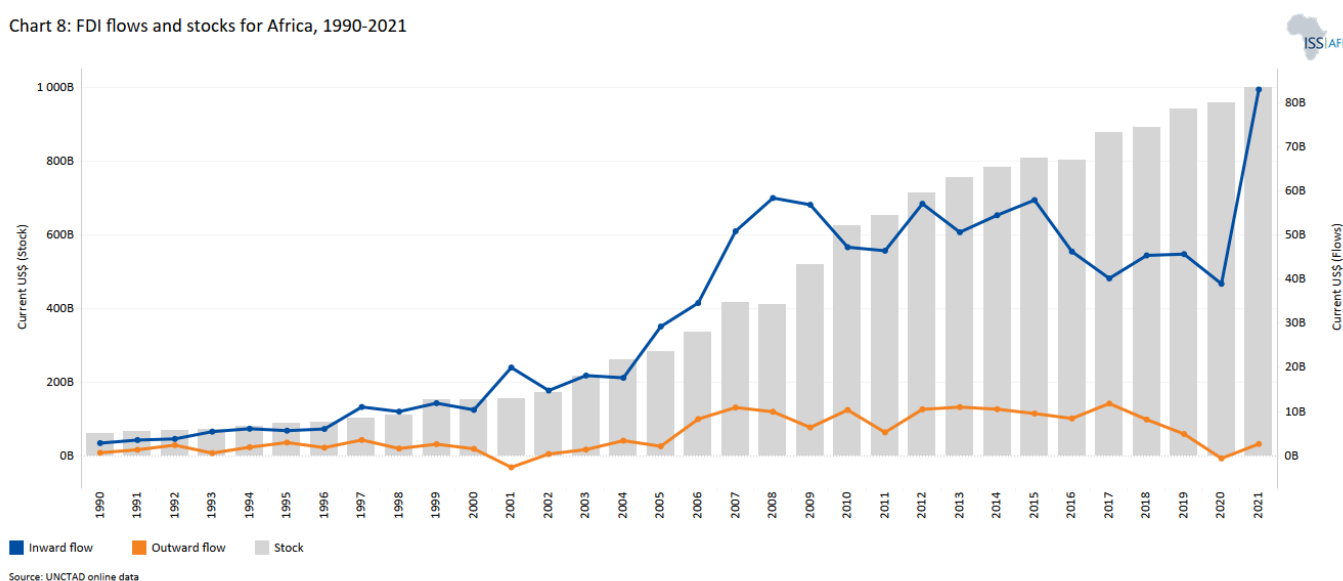
Foreign direct investment is especially important for its potential to transfer knowledge and technology, create jobs, boost overall productivity, enhance competitiveness and entrepreneurship, and ultimately eradicate poverty through economic growth and **development**.

FDI can help recipient developing countries to enhance the development of more sophisticated industries, such as electronics (Costa Rica) and automotive manufacturing (South Africa and Morocco).

Historically, Africa has received less FDI than other developing regions such as South America and South Asia despite the high rate of return on investment it offers. For instance, from 2006 to 2011, the global average rate of return on FDI was 7%, 5.1% for developed economies, and 11.4% for Africa. According to UNCTAD's World Investment Report 2022, FDI flows to Africa accounted for only 5.2% of global FDI in 2021, up from 4.1% in 2020, with the continent's share of global FDI stock less than 3%.

Ayodele Odusola maintains that the explanation for this paradox can be found in poor infrastructure, low levels of human capital and low institutional capital, which serve as an effective tax on returns on investment. Chart 8 shows the trends in FDI flows and stocks for Africa from 1990 to 2019. Most African countries received significant amounts of FDI only from the 1990s following the waves of liberalisation and privatisation brought about by the Washington Consensus.

Chart 8: FDI flows and stocks for Africa, 1990-2021



In 2021, annual FDI inflows amounted to US\$82.9 billion (3.2% of GDP)—a significant jump after dropping to US\$38.9 billion in 2020 due to the effects of the COVID-19 pandemic. The pandemic reduced FDI flows to Africa by about 15% in 2020, compared to its pre-pandemic level in 2019. As shown in Chart 8, Africa recorded a rapid increase in investment inflows during the global commodities boom, which reached a peak of US\$58.4 billion (3.3% of GDP) in 2008 at the start of the global financial crisis. Unlike FDI flows, which might be marked by strong year-to-year volatility, FDI stocks reflect the long-term trends of FDI attractiveness in the considered economy, providing evidence of stable links with foreign investors. According to UNCTAD, in 2021, Africa had an FDI stock of about US\$1 trillion, equivalent to 38.7% of GDP, up from US\$942 billion in 2019 (37.6% of GDP) compared to less than US\$60 billion in 1990.

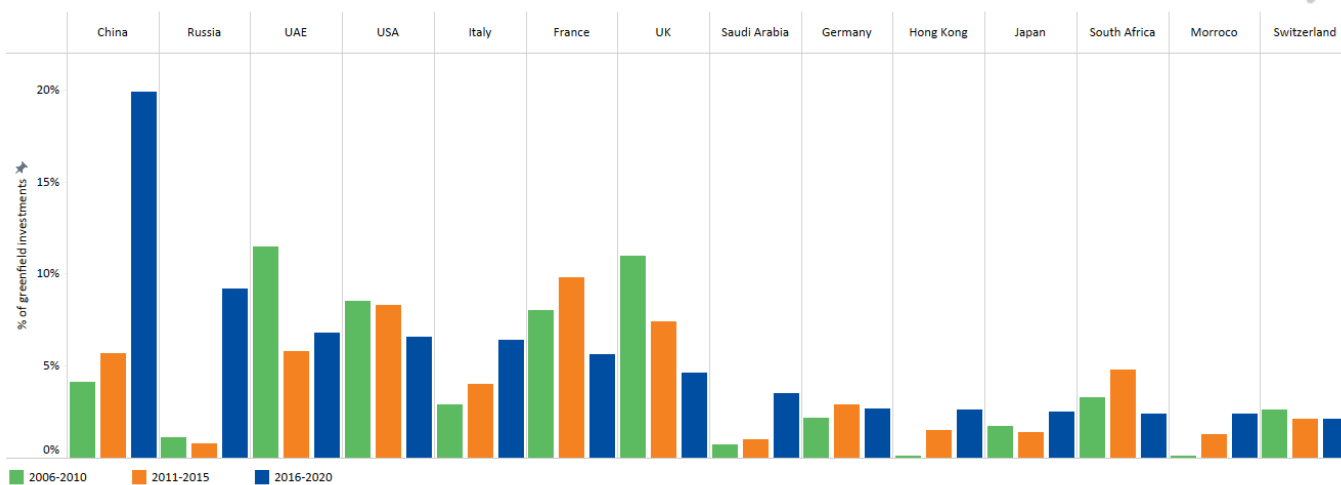
When FDI consists of the establishment or construction of a new firm, it is called greenfield investment, which is different to mergers and acquisitions (brownfield investments) that consist of the acquisition of an existing company in a foreign country. Greenfield FDI is particularly important for African countries where unemployment is rampant because it generates additional production capacity, promotes job creation, and increases the level of capital accumulation in the host country while the recipient economy also benefits from the associated knowledge transfer.

As shown in Chart 9, China has become a leading source of greenfield FDI in Africa, investing more than US\$71 billion from 2016 to 2020, and accounting for about 20% of total greenfield FDI on the continent over the same period. From 2016 to 2020, US greenfield FDI amounted to US\$23 billion, which was 6.6% of total greenfield FDI in Africa. Russian greenfield

investment was also high from 2016 to 2020 due to a one-time announced US\$30 billion investment in 2017 for nuclear power generation in Egypt.

Chart 9: Trends in China's share (%) in total greenfield FDI in Africa, 2006-2020

\*Grouping of rest of investors under 'Other' has been excluded



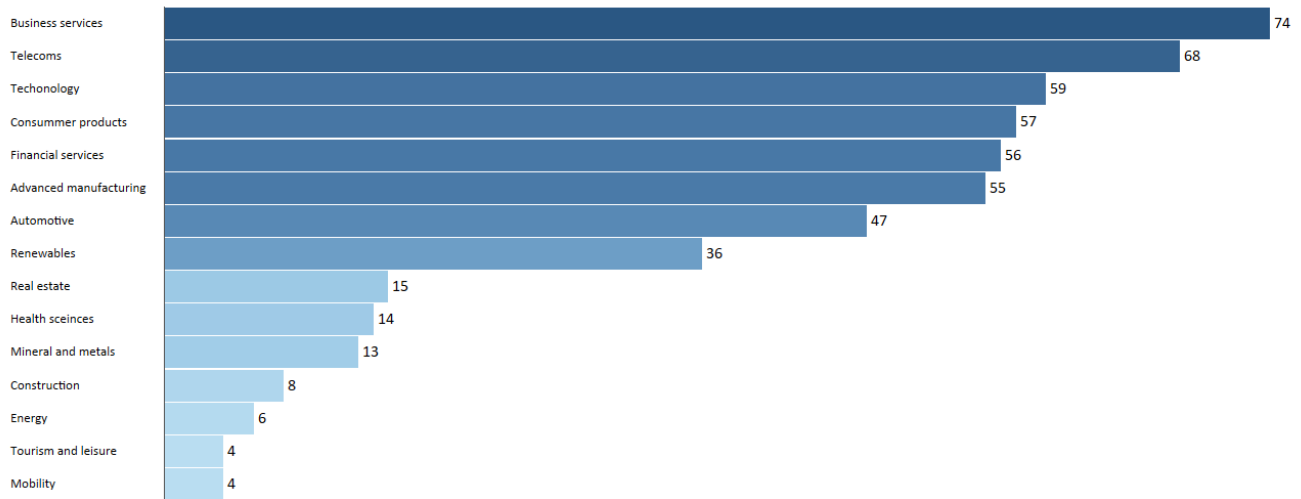
Source: Authors elaboration using data from Morgan et al. (2022). Foreign Direct Investment in Africa: Recent Trends leading up to the AfCFTA. <https://www.ers.usda.gov/webdocs/publications/104996/eib-242.pdf?v=333>

The IFs Current Path forecast suggests that FDI stocks in Africa will likely reach 42.3% of GDP by 2043. The full implementation of the African Continental Free Trade Area (AfCFTA) agreement will attract FDI as a larger market can increase profit margins for external investors. By establishing a subsidiary on the continent rather than exporting from outside Africa, the unified African market can be accessed more easily and at lower costs.

Historically, a large share of FDI flows to Africa has been directed at the extractive sectors (known as resources-seeking FDI). For example, in June 2019, US energy firm **Anadarko Petroleum Corporation** agreed to the construction of a US\$20 billion gas liquefaction and export terminal in Mozambique—the single largest liquid natural gas project in Africa and an amount equivalent to almost half of total FDI to Africa in 2018. By the end of 2019, total **investments in Mozambique** for the next decade were estimated at US\$128 billion—more than the entire amount of aid and FDI to all of Africa in 2018. But an Islamic insurgency in the Cabo Delgado province that started the previous year brought the investments to a shuddering halt in April 2021. After first opting to use mercenary companies to respond to the threat, the government of **Mozambique** eventually turned to Rwanda and the Southern African Development Community to provide military support. Work on the project is scheduled to resume in July 2023.

FDI in Africa is now diversifying into sectors such as manufacturing, technology and services, which is very promising in terms of technology transfer, sustainable growth and job creation in Africa (see Chart 10).

Chart 10: FDI projects by sector in Africa, 2020

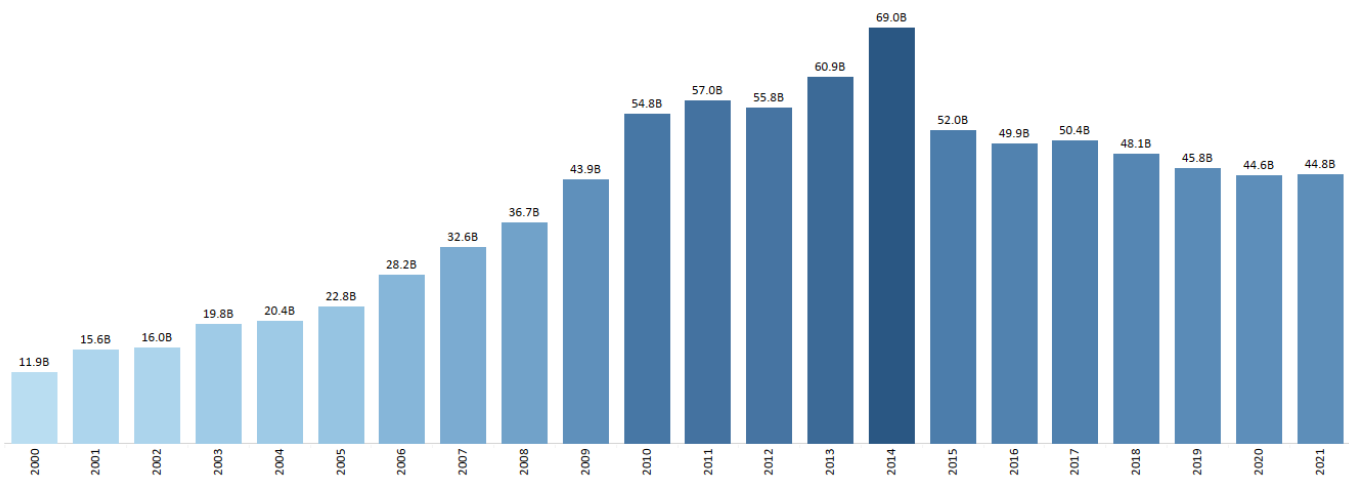


Source: Authors elaboration using data from Ernst & Young (2021). Africa Attractiveness Report 2021

## Trends in US FDI to Africa

In addition to the US being the largest aid donor to Africa, it also leads in the stock of FDI it has built up in Africa, although it has declined since 2014 (Chart 11). However, FDI to Africa only breached 1% of the total US FDI between 2010 and 2014, pointing to the huge potential. At the end of 2017, the Trump administration introduced tax reforms that allowed the large-scale repatriation of accumulated foreign earnings by US multinationals. Companies rushed to shift monies back to the US, with the effect that US FDI stock in Africa amounted to only US\$48.1 billion in 2018—significantly below the 2014 peak of US\$69 billion. As a result of this and other changes such as declining requirements for fossil fuels, US FDI stock in Africa stood at US\$44.8 billion in 2021—still below the peak in 2014.

Chart 11: US FDI stock in Africa, 2000–2021



Source: US Bureau of Economic Analysis

The composition of US investments in Africa has changed over time. While the share of mining FDI accounted for more than 50% from 2000 to 2014, it declined to 32% in 2020 and manufacturing FDI in the food sector rose from less than 3% in 2014 to more than 9% in 2020.

The large stock of FDI in Africa from the US is followed by the UK and France. **Europe** is by far Africa's most important investor, accounting for 40% of FDI stocks, followed by the US at 7% and China at 5%. **Intra-Africa investment** is also gaining momentum: the value of FDI stocks originating from other African countries increased significantly from an average of US\$18 billion from 2004 to 2008 to US\$80 billion over the period 2014 to 2018. South Africa, Morocco, Kenya, Nigeria and Mauritius have become important sources of **FDI** to the rest of Africa. However, observers argue that investment funds from Mauritius may be channelled from third parties due to the country's favourable taxation policies.

Although stocks tell one story, flows are changing. China pumped more than US\$72 billion worth of FDI into Africa between 2014 and 2018, followed by France (US\$34.17 billion), the US (US\$30.85 billion), the United Arab Emirates (US\$25.27 billion) and the UK (US\$17.68 billion). Coming off a low base, the flow of FDI from China to Africa steadily increases its stock of FDI in Africa, although the most recent trend is sharply downward. Chinese FDI flows to Africa have **exceeded** those from the US since 2013.

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### Cite this research

Kouassi Yeboua and Jakkie Cilliers (2024) Financial Flows . Published online at [futures.issafrica.org](https://futures.issafrica.org). Retrieved from <https://futures.issafrica.org/thematic/10-financial-flows/> [Online Resource] Updated 06 June 2024.



## About the authors

**Dr Kouassi Yeboua** is a senior researcher in African Futures and Innovation programme in Pretoria. He recently served as lead author on ISS studies on the long-term development prospects of the DR Congo, the Horn of Africa, Nigeria and Malawi. Kouassi has published on various issues relating to foreign direct investment in Africa and is interested in development economics, macroeconomics, international economics, and economic modelling. He has a PhD in Economics.

**Dr Jakkie Cilliers** is the ISS's founder and former executive director. He currently serves as chair of the ISS Board of Trustees and head of the African Futures and Innovation (AFI) programme at the Pretoria office of the Institute. His 2017 best-seller *Fate of the Nation* addresses South Africa's futures from political, economic and social perspectives. His three most recent books, *Africa First! Igniting a Growth Revolution* (March 2020), *The Future of Africa: Challenges and Opportunities* (April 2021), and *Africa Tomorrow: Pathways to Prosperity* (June 2022) take a rigorous look at the continent as a whole.

## About African Futures & Innovation

Scenarios and forecasting can help Africa identify and respond to opportunities and threats. The work of the African Futures & Innovation (AFI) program at the Institute for Security Studies aims to understand and address a widening gap between indices of wellbeing in Africa and elsewhere in the world. The AFI helps stakeholders understand likely future developments. Research findings and their policy implications are widely disseminated, often in collaboration with in-country partners. Forecasting tools inspire debate and provide insights into possible trajectories that inform planning, prioritisation and effective resource allocation. Africa's future depends on today's choices and actions by governments and their non-governmental and international partners. The AFI provides empirical data that informs short- and medium-term decisions with long-term implications. The AFI enhances Africa's capacity to prepare for and respond to future challenges. The program is headed by Dr Jakkie Cilliers.