EFFECTS OF REMITTANCES AND MARKET SIZE ON FOREIGN DIRECT INVESTMENT TO AFRICA

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1. Introduction

As global economies have become more integrated, there has been an ongoing push by nations to increase foreign direct investment (FDI)[1]. Indeed, global FDI has increased dramatically since the late 1980s. Despite the recent global economic and financial recession, countries have continued to liberalize their economies and promote FDI since it is viewed as one of the most critical external sources of development finance. FDI, as part of private investment is crucial for stimulating economic growth and employment, especially as nations compete to attract transnational corporations (TNCs) as the preferred location for outsourcing production and services. Bengoa and Sanchez-Robles (2003), Campos and Kinoshita (2002), Hansen and Rand (2006), and Li and Liu (2005) report a positive relationship between FDI and economic growth.

FDI inflows are viewed as contributing to the economic performance of the host country by providing additional resources to augment existing physical capital so as to create additional production and employment. Additionally, by serving to increase the size of physical stock, FDI increases a country's output and productivity by encouraging more efficient use of existing resources. FDI tends to also improve local skills and promote technological content so as to enhance overall economic growth and development (Kumo, 2009).

2. Background and Literature Review

Global FDI inflows are projected to reach more than $1.2 trillion in 2010, rise further to $1.3-1.5 trillion in 2011, and head towards $1.6-2 trillion in 2012. However, because of the global financial crisis and economic recession, FDI declined by 16% in

[1] FDI refers to investment in domestic structures, equipment and organization by foreign private businesses or government.

2008 and fell further by 37% to $1,114 billion in 2009 (UNCTAD, 2010). Therefore, the projected FDI prospects quoted earlier could be plagued by risks and uncertainties associated with the global economic recovery. Developing and transition economies attracted half of global FDI flows in 2009, and are expected to continue to be favorable destinations for future FDI. FDI to Latin America and the Caribbean (LAC) rose to $117 billion in 2009, with Brazil being the largest destination of FDI.

Following almost a decade of uninterrupted growth, FDI flows to Africa fell to $59 billion in 2009 – a 19% decline from the 2008 high of $72 billion. This is attributed to the contraction in global demand and falling commodity prices (UNCTAD, 2010). Although much of African FDI has gone toward prospecting for petroleum and precious metals, recently the telecommunications sector appears to have become the largest recipient of FDI inflows. Projections are that recovering commodity prices and continued interest from emerging Asian economies, led by China for natural resources and agricultural products, would feed a slow upturn in FDI inflows to Africa in 2011 and beyond. In fact, TNCs from developing and transition economies have gained inroads in investing in Africa in the past few years, and accounted for 21% of flows to the region over the 2005-2008 period, compared to 18% in the 1995-1999 period (UNCTAD, 2010). Investors from China, Malaysia, India, and the Gulf Cooperation Council (GCC) are the most active. In 2009, investors from South Africa also accounted for $1.6 billion in FDI flows to Africa. These new sources of investment are providing additional development opportunities, and it is the hope that they will transform Africa from being so dependent on foreign development assistance.[2] If current trends continue, then Africa would also be

[2] This will bode well for Africa since foreign development assistance has been dwindling recently, following first the 2001-2003global recession and the latest global economic recession.

able to leverage its emerging regional integration efforts in offering the scale economies and enabling political and economic policy environments to attract investment, both from domestic and foreign sources, to strengthen the supply-side of African economies.

The motivation in seeking investment for development by the host country is confronted by three key challenges. The first is to strike the right policy balance (for example between political and economic policy liberalization versus regulation; rights and obligations of the state and investors). The second is to enhance the critical interfaces between investment and development, such as those between foreign investment and poverty, and other national development objectives. The third is to ensure coherence between national and international investment policies, and between investment policies and other public policies. In summary, the key challenge is for host countries to develop highly competitive and flexible business environments to attract investment while at the same time ensuring adequate regulatory framework is put in place. According to UNCTAD (2010), these call for a new investment-development paradigm and a sound international investment regime that effectively promotes sustainable development for all.

There is extensive literature on the determinants of FDI, mostly impinging on host country characteristics. Some relate to the effects of exchange rate on FDI (Barrel and Pain, 1996; Cushman, 1985 and 1988); labor costs and FDI (Culem, 1988; Cushman, 1987); political factors and FDI (Haggard, 1989; Nigh, 1985; Tuman and Emmert, 2004); trade openness, protection and agreements on FDI (Agosin and Machado, 2006; Waldkirch, 2003); and host country market size and FDI (Barrel and Pain, 1996; Love and Lage-Hidalgo, 2000).

Measures of either gross domestic product (GDP) or gross national product (GNP) are usual proxies for host country market size. These variables capture the effect of the host country's income on FDI; therefore, an increase in, for example, per capita GDP is expected to increase the market size for the goods and services produced by the TNC's subsidiary. Nevertheless, Dornbusch and Fisher (1994, p.59) have argued that not only the level of output (GDP) is related to consumption demand, but also the money available for spending. This has thrust workers' remittances into the host country from abroad as important sources of external financing for its residents. According to the World Bank (2007, p. 54), remittances are second only to FDI as a source of external financing. Therefore, it is important to explore the likelihood that remittances and market size explain recent FDI inflows to African countries by increasing the amount of money available for spending.

3. Proposed Study Objectives and Approach

The main objective of the study is to empirically assess the effect of remittances through per capita GDP on net FDI inflows to African countries. The researcher proposes to catalogue trends in FDI and remittances flows to Africa relative to overseas development assistance since 1980. Most African countries began the process of undertaking structural political and economic reforms in the 1980s through the 2000s. The study will also dissociate flows into sub-regions in Africa, and determine the key sectoral sources of FDI inflows. In particular, the study will reveal how emerging/non-traditional sources of FDI compare to traditional sources such as the U.S. and EU. The empirical research proposes to follow Bajo-Rubio and Sosvilla-Rivero's (1994) cost minimization framework to derive the TNC's optimal level of capital at the foreign plant.

It will assess the effect of remittances on FDI using an unbalanced panel data set for all the sub-Saharan Africa (SSA) countries (as designated by the World Bank) and use a panel generalized method of moments (GMM) approach. If time permits, the study will be extended to include FDI inflows to the key regions in Africa. Recommendations on enhancing FDI flows to Africa will follow the results.

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