

Foreign Direct Investment (FDI)

BACKGROUND AND PURPOSE:

There is a growing consensus that public finances won't be enough to help least developed countries (LDCs) recover from COVID-19. The pandemic is straining Official Development Assistance (ODA) and raising the transaction costs of international trade for LDCs due to supply chain disruptions and troubles in accessing trade finance.¹ Small and medium enterprises in LDCs, which have had to rely on small amounts of funding from their savings, credit or loans from friends and family for their day-to-day operations, are among the hardest hit by these global challenges.

The Enhanced Integrated Framework's Trade Funding Insights series is highlighting innovative financing opportunities for trade in LDCs, in order to help LDCs to take advantage of these opportunities. In this Insight, we explore how foreign direct investment has been impacted by COVID-19 and what LDCs and their partners can do to better attract investment.

WHAT IS FOREIGN DIRECT INVESTMENT?

Foreign direct investment (FDI) is when a company in one country establishes or acquires a business in another country. Since FDI requires a long-term, high level of investment, it is usually only conducted by multinational companies, large institutions, or venture capital firms.

FDI can be horizontal, vertical or conglomerate. A horizontal direct investment refers to the investor establishing the same type of business operation in a foreign country as it operates in its home country, for example, a cell phone provider based in the USA opening an operation in Kenya.

A vertical investment is when the investor establishes or acquires a different, but related business in a foreign country.

For example, a fast food restaurant purchases a large-scale farm in another country to produce meat for their restaurants. A conglomerate type of FDI is one where a company makes a foreign investment in a business that is unrelated to its existing business in its home country. Since this type of investment involves entering an industry in which the investor has no previous experience, it often takes the form of a joint venture with a foreign company already operating in the industry.²

HOW CAN FDI SUPPORT TRADE?

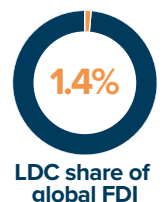
FDI not only provides capital to finance new industries, enhance existing industries as well as boost infrastructure and jobs, but it also:

- Brings in new businesses with connections in different markets
- Opens up additional export opportunities, improving export performance
- Stabilises exchange rates through continuous flow of foreign exchange
- Brings new technologies, leading to technological upgrading
- Creates a more competitive and innovative market

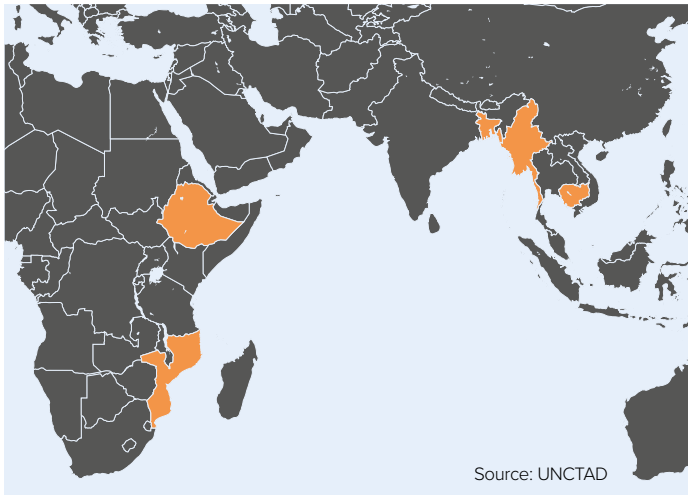
To ensure the above measures contribute as much as possible to sustainable development, FDI needs to take place within a framework of international investment law and policy that is enabling, yet at the same time respectful of host governments' own legitimate public policy objectives.³

HOW MUCH FDI DO LDCS CURRENTLY RECEIVE?

According to the 2020 World Investment Report by the UN Conference on Trade and Development (UNCTAD), foreign direct investments to LDCs have been valued at \$21-22 billion per year from 2017-2019. However, this represents only a small share of global FDI - just 1.4%.⁴



Top 5 LDC recipients of FDI



Source: UNCTAD

The top five recipients – Bangladesh, Myanmar, Ethiopia, Cambodia and Mozambique – accounted for over two-thirds of the FDI received by LDCs in 2019.

Most FDI in LDCs goes towards resource extraction, which brings limited employment or value added benefits to LDC economies, leaving them among the least integrated into global value chains.⁵

When it comes to investors, \$45 billion was invested in LDCs by Chinese businesses and institutions in 2018, followed by \$11 billion from French foreign direct investors and \$10 billion from investors in Thailand. Since 2014, FDI to LDCs by Chinese firms has increased by 66%.⁴

HOW HAS COVID-19 IMPACTED FDI IN LDCS, PARTICULARLY WHEN IT COMES TO TRADE?

FDI flows were already struggling before the COVID-19 pandemic and are expected to drop by 30-50%.⁶

On average, FDI in LDCs has declined by 6% during 2019, however there is substantial variation between regions. FDI inflows to the 33 African LDCs rose by 17% to \$12 billion, while in Asia, it fell by 27% to \$9 billion - the first time the region has seen a decline in eight years.⁴

According to UNCTAD, the outlook for FDI in LDCs over the short-term is 'extremely weak'. The health measures needed to control COVID-19 will hinder the implementation of investment projects. LDCs are also highly dependent on FDI in natural resources, which are being negatively affected by the oil and commodity price shocks. Tourism-dependent LDCs will also see a fall of FDI in this industry.⁴

Announced 'greenfield' FDI projects – when a parent company creates a subsidiary in a different country – is a key indicator of foreign investor intentions, and these were already down in 2019 in LDCs and contracted further during the first quarter of 2020.

Beyond 2021, the outlook for FDI is highly uncertain and will depend on how long COVID-19 takes to get under control⁵.

WHAT CHALLENGES DO INVESTORS FACE WHEN INVESTING IN LDCS?

There are several reasons why LDCs receive such a small share of global FDI. These include:

- Limited investment promotion capabilities means that existing and potential investors are not provided with relevant, accurate and timely information and services.
- Poorly designed investment policy frameworks that result in lower investment competitiveness.
- Poor investment climate conditions and higher perceptions of political risk in LDCs. 84% of investors recently surveyed said political stability was an important or critically important factor in their investment decisions⁷

HOW CAN LDCS ATTRACT MORE FDI THAT ENCOURAGES TRADE?

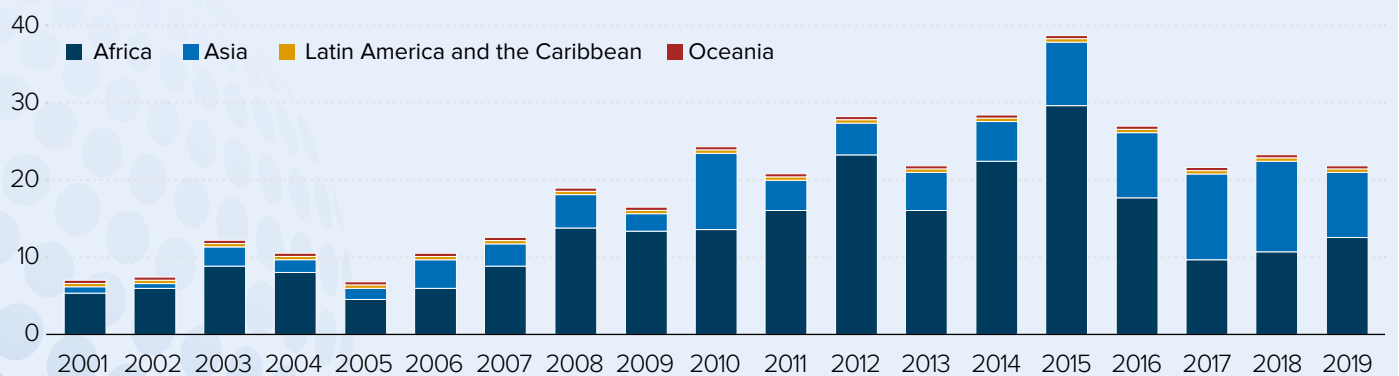
To help meet the investment needs of the future, FDI flows to LDCs need to increase substantially. There are many ways in which governments and businesses can create a strong investment climate that encourages trade.

For LDC authorities in charge of/supporting trade efforts⁸:

- Build LDC business capacity through supplier development programs that bridge knowledge gaps (e.g. ensuring that local businesses know what FDI businesses need as inputs and FDI businesses know what local businesses can provide) and other support programs, such as financing.
- Coordinate with associated ministries to align overall trade and investment policy objectives. The sectors in which each LDC will attract FDI may not be sectors that are conducive to trade. Therefore, it may be necessary to implement trade policies that improve competitiveness for FDI.
- Engage with your national investment promotion agency (IPA). You can find a list of IPAs in LDCs in Annex 1 of a World Bank, OECD and UNCTAD report to the G20 Trade and Investment Working Group.⁶

FDI inflows to LDCs

Source: UNCTAD



For LDC investment promotion agencies⁹:

- Retain current investors by keeping investors informed, solving their operational emergencies, and advocating for critical reforms not only for investors to survive the crisis but also to recover quickly.
- Review your FDI strategy by looking at the sectors that have been attracting FDI up until now. Are you still competitive in those sectors, given what's happened, or has COVID-19 led to a rising of other sectors that you might be competitive in? This will help you get specific with your promotion.
- Reform impediments to the investment climate. Understand the hurdles deterring investors, such as unnecessary screening mechanisms, business registration processes, licensing processes, lack of protections for foreign investors and push for reform.
- Promote investment opportunities to try and attract new FDI into sectors that you're most competitive in.

For LDC businesses:

- Aim to become a supplier to foreign owned businesses. This may require transforming business operations to ensure a high level of quality and consistency.

For government investors through official development assistance, federal ministries or development finance institutions:

- Increase Technical Assistance that supports LDCs to improve their investment policy frameworks by benchmarking key sectors, identifying investment opportunities, diagnosing what needs reform, building the capacity of investment promotion agencies and ensuring linkages between foreign investment and the domestic economy.
- Support calls for a multilateral framework on investment facilitation for development such as extending Aid for Trade initiatives to include sustainable investment or establishing a Sustainable Investment Facilitation Agreement.³

READ MORE

1. World Economic Forum (2020). COVID-19 is exacerbating the global trade finance gap <https://bit.ly/36sWYq5>
2. Investopedia: Foreign Direct Investment <https://www.investopedia.com/terms/f/fdi.asp>
3. Trade for Development News (2019). How can foreign direct investment fulfil its development potential in least developed countries? <https://trade4devnews.enhancedif.org/en/news/how-can-foreign-direct-investment-fulfil-its-development-potential-least-developed-countries>

4. UNCTAD (2020) World Investment Report <https://unctad.org/topic/investment/world-investment-report>
5. World Bank, OECD, UNCTAD (2020). FDI Flows and Investment Attraction Frameworks in Developing and Least Developed Countries <https://bit.ly/3pFxDHT>
6. OECD (2020) FDI investment flow in time of COVID-19 <https://www.oecd.org/coronavirus/policy-responses/foreign-direct-investment-flows-in-the-time-of-covid-19-a2fa20c4/>
7. World Bank (2020) Global Investment Competitiveness Report 2019/2020 <https://openknowledge.worldbank.org/handle/10986/33808>
8. Trade for Development News (2020) Creating a strong investment climate in the wake of COVID-19 <https://trade4devnews.enhancedif.org/en/news/creating-strong-investment-climate-wake-covid-19>
9. Nimac, I (2020). COVID-19 and FDI: How should governments respond? <http://ccsi.columbia.edu/files/2020/10/No-288-Nimac-FINAL.pdf>

KEEPING INVESTORS INFORMED: ETHIOPIAN INVESTMENT COMMISSION'S RAPID RESPONSE TO COVID-19

Investment Promotion Agencies (IPAs) are at the front line of interaction between foreign investors and the government. During COVID-19 IPAs have played a critical role in keeping investors informed and helping solve their operational emergencies.

When it comes to rapid responses to investor challenges in LDCs, Ethiopia led the way.

The Ethiopian Investment Commission rapidly engaged investors via social media, creating a two-way communication Twitter account to hear from investors. EIC also held open-air distanced meetings with investors and stakeholders, encouraged use of its eservices, and kept supporting investors remotely with their daily issues through its Aftercare Division.

It even helped some investors repurpose production lines to deal with COVID19 such as supporting a pharmaceutical company to expand into manufacturing hand sanitizers.

EIC also engaged more actively in institutional coordination, establishing a ministerial-level committee led by the Prime Minister to provide centralised and coordinated leadership to fight the pandemic, and make reforms possible.

It responded to innovative ideas/suggestions from the private sector, waived licensing requirements for existing companies to go ahead with new production lines, allowed for those in industrial parks to supply locally, and allowed for expedited forex approval and the use of companies' own forex flexibly to import raw materials.

It also advocated for better investor protection leading to government ratification of the New York Convention.

Read more about how Investment Promotion Agencies have responded to COVID-19 in this World Bank report: https://waipa.org/waipa-content/uploads/WBG_IPA_Response_to_COVID-19.pdf

We can help

The Enhanced Integrated Framework can provide LDCs with knowledge and information to strengthen their investment promotion efforts.

Contact EIFpartnerships@wto.org

EIF's briefs offer an overview of key trade-related issues and up-to-date analysis based on the programme's work with the world's least developed countries, and offer expertise on essential matters related to local, national, regional and global trade.



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Enhanced Integrated Framework

Trade for LDC development

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International Trade Centre (ITC)

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World Tourism Organization (UNWTO)

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