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CHINESE FOREIGN DIRECT INVESTMENT  
INFLOWS TO SUB-SAHARAN AFRICA

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### **Chinese Foreign Direct Investment Inflows to Sub-Saharan Africa**

In November 2006 China hosted 48 African nations in Beijing for a trade summit that marked the strengthening of economic ties between the Chinese and African nations. The vivid imagery of towering giraffes posted throughout downtown Beijing marked the diplomatic pageantry that stirred a media frenzy and was a promotional success. This summit was, ostensibly, an announcement to the world that the Chinese are dedicated to expanding trade, foreign direct investment and aid in African countries. This summit was the largest gathering of African nations in China since the beginning of its Communist rule in 1949. China's statement to the world came after Africa tripled its exports to Asia over the past five years while in the same period the European Union halved the number of imports it received from African countries. Asia is now the destination of 27% of African exports—an increase from 13% in 2000. This shift in African trade is particularly significant. China's population of over 1 billion people presents a massive market for the African continent, which has seen its share of world trade fall steadily since World War II (see fig. I). Africa has taken advantage of its labor-intensive production to serve the Chinese market and exports resource-extractive as well as non-traditional goods such as light-manufactured products, food and tourism. With the rapidly-increasing trade relations between China and Africa, it is logical that foreign direct investment (FDI) from China to Africa accompanies trade flows as Chinese firms integrate themselves into African markets.<sup>1</sup>

The purpose of this paper is to identify the policy implications of Chinese FDI inflows into sub-Saharan Africa (SSA). This issue is particularly important to economists interested in the development paths of both African nations and China. South-South investment—investment

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<sup>1</sup> All trade statistics are cited from Harry Broadman

from one developing country into another—is potentially a paradigmatic shift in the way investors move capital into developing countries, as well as the way developing countries build presence in international markets. Though China is a developing nation it is certainly a rising economic power. Implicit in SSA FDI policy is the knowledge that the Chinese have an asymmetrical economic advantage.

We will present China’s incentives and goals for investing into SSA and then examine the potential benefits and costs that SSA countries face when receiving FDI packages from China. We will conclude by proposing policy adjustments and considerations that could maximize the inflows of Chinese FDI for SSA countries.

### **Defining Foreign Direct Investment in the Chinese Context**

A general definition of FDI is one country’s acquisition of assets and resources in a host country. The majority of FDI comes in the forms of cross-border mergers and acquisitions (M&As) or Greenfield investments. In the former, the foreign investing firm takes over existing home country assets. Greenfield, however, creates new investment through, for example, the construction or expansion of plants. M&As are thus the less desirable form of FDI for a host country because they do not capture direct benefits that accompany Greenfield FDI. Such benefits include job creation, increased production capacity or skill and technology transfer which increase the host country’s ability to compete in a globalized market.

Economic theory assumes that multinational companies (MNCs) entering foreign markets must have cost and productivity advantages that enable them to compete with domestic host country firms. MNCs from developing countries derive their advantages from production process capabilities, networks and organizational structures (UNCTAD xxv). The primary determinants

behind a MNC's international strategy to claim a stake in foreign economies include market seizing opportunities, increased efficiency and resource-seeking motivations. That is, investing firms may hope to capture a larger consumer base, economies of scale or raw materials that will improve their economic activity.

In the context of Chinese and SSA relations, however, Chinese FDI cannot be simply defined as either M&A or Greenfield, although it does entail similar advantages and motivations. Chinese FDI is packaged with aid and complemented by its geo-strategic trade and political objectives (Kaplinsky 14). It generally originates from state-owned enterprises (SOEs), which can work to long-term commitments thanks to easy access to cheap government capital. This FDI contrasts with Western- and Japanese-sourced FDI, which typically originates from private firms which operate to shorter time frames to maximize profits. Economist Raphael Kaplinsky notes that Chinese FDI is primarily motivated by a strategic state-driven quest to secure vital inputs that will sustain the country's growth rather than a drive for markets or low-cost production platforms (Kaplinsky 14; UNCTAD xxvii).

Perhaps the most noteworthy element of Chinese FDI is that it is not given conditionally upon meeting any investor-set performance standards. This element of non-interference is in accordance with the Five Principles of Peaceful Coexistence, China's policy of state sovereignty and security (Garner 4, 5). Of the five, the most pertinent for the purposes of this paper are the principles of mutual respect for territorial integrity and sovereignty, mutual non-interference in each other's internal affairs and that of equality and mutual benefit. The policy provides an "ideological framework [to] encourage international support for [China's] domestic policies, [which] thus promotes its own security and legitimacy in the international system" (Garner 5). Beginning in the early 2000s China's active diplomacy focused on increasing its trade and

influence in third-world countries, especially those with natural resources (Traub 3). Yet the Five Principles Policy as manifested in China's overseas investment has drawn criticism from the global community. For example, China's activity in Sudan, Eritrea and Zimbabwe bypasses world economic sanctions and ignores international condemnation of the respective countries' governmental abuses (Traub 3).

Angola is a good example of the distinctive nature of Chinese FDI inflows to SSA. In 2006 China gave Angola a \$2 billion oil-backed loan—a risky deal that the International Monetary Fund (IMF) frowns upon—in which future Angolan oil production secures the credit (Traub 3). China needs the oil to sustain the growth of its gross domestic product, which has purportedly averaged nine percent for the past three decades<sup>2</sup> (WDI). Angola then used the loan to finance the construction of large infrastructure projects like railways and schools, agreeing that the work would be performed by Chinese construction companies.

### **South-South Trends and High-Magnitude Chinese Growth**

FDI inflows into SSA economies have sharply increased in recent years, reflecting a general South-South FDI trend that is also demonstrated by the aforementioned increased trade flows. In the 1980s, Latin America was the main source of developing country FDI outflow into other developing nations. In recent years, however, Asia has replaced Latin America as the main South-South source: by 2002, 78 of the top 100 MNCs in the developing world were from Asia (UNCTAD 126). Chinese FDI in particular has been attracting much attention; in 2005 its FDI outward stock totaled \$46 billion, more than an 11-fold increase from fifteen years prior (UNCTAD WIR 1). Although this number is a pittance compared to the United States' \$2 trillion

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<sup>2</sup> Chinese statistics are not always consistent and many economists believe that their growth statistics are inflated. However, the country is undoubtedly growing in economic power and influence in global markets.

outward total in the same year (UNCTAD WIR 1), the increase in China's FDI, while not surprising, is significant. Its acceleration has been partly attributed to increased foreign currency reserves (UNCTAD 54).

Although the actual percentage of total Asian-sourced FDI sourced into SSA is small, it is similarly growing. Increased Chinese investment is part of a growing trend of Asia-to-Africa FDI, but it is the magnitude of the increase that is most striking. Graph I in the appendix shows that Chinese inflows between the periods of 1990-1997 and 1998-2002 have risen almost five-fold. Chinese FDI growth is projected to continue: the United Nations' Outward FDI Performance Index<sup>3</sup> showed that China has considerable future expansion of FDI outflows (UNCTAD 114). Assuming that this trend holds, it will play a large role in future Chinese-African relations and in both countries' economic development.

South-South FDI is potentially more beneficial to less-developed countries (LDCs) than FDI from developed countries. The host countries are likely to have similar technology and business models (simple expertise requirements and labor-oriented production) as investing firms, which increases the likelihood of linkages and technological absorption (UNCTAD xxix). FDI from developing countries may be "better equipped to offer appropriate goods and serves to smaller markets with low per capita purchasing power, and to handle risks associated with operating in weakly governed states" (UNCTAD 104). Additionally, Greenfield investment will have more immediate production effects and result in more employment (UNCTAD xxx). In the short run, increased FDI from Asia is unlikely to have much of an effect on the relationship between Africa and industrialized countries, its traditional FDI source. But China's increasing FDI volume diversifies Africa's options and if it can spur stronger domestic production capacity, it will influence Africa's economic relations in the global marketplace.

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<sup>3</sup> The index measures the ratio of a country's share of outward FDI to its gross domestic product

### **China's Incentives, Goals and Abilities**

So, why does China want to invest in Sub-Saharan Africa? There are a number of reasons beyond the traditional benefits to home countries, which include gains from broader benefits, improved export performance and higher national income (UNCTAD xxvi). China hopes to increase trade by exporting cheap final consumption goods for oil and hard commodities while forming direct trade links to bypass trade barriers (Kaplinsky 5, 6). As a result of growing competition in China's domestic markets from foreign MNCs, Chinese enterprises are seeking new markets. These firms that invest abroad are subsidized by the Chinese government as a part of China's "Go Global" two-way investment strategy, which encourages ventures by competitive enterprises abroad (People's Daily). China's SSA ventures are intended to satiate a hunger for natural resources and a desire to increase China's presence as a global leader, particularly in the developing world.

Chinese firms have demonstrated that they have the capacity to enter foreign markets. In Mozambique they have rebuilt the country's roads and bridges at quality standards, but with a 25 to 50 percent discount from Western and South African firms (Kaplinsky 19). Chinese SOE cost advantages are derived from access to state capital, lower margins and lack of (and consequently less costly) environmental and labor standards. Furthermore, China has large reserves of skilled and unskilled labor from which to draw, who are not always treated by international human rights standards.



## **Motivations for Sub-Saharan Africa to Pursue Chinese FDI**

China's 2006 Africa Policy reaffirmed its adherence to the Five Principles (Garner 9) It "offers a pragmatic partnership between equals" and relations "premised on 'mutual benefit, reciprocity and common prosperity'" (Traub 9). The policy rooted in the language of partnership is undoubtedly appealing to SSA governments, who have in the past been subject to multi-tiered conditions that accompany aid and loans from the World Bank and the IMF.

In the past it has been difficult for SSA governments to meet such requirements. For example, in 2001 Angola received \$3 billion in IMF loans, but later denied taking out any such loans; "the IMF reported that despite years of assistance, the government's finances remained hopelessly opaque, that officials had fended off all demands for reform and thus that 'it would be very difficult for Angola to formulate a meaningful poverty-reduction strategy'" (Traub 2). As a consequence of such corruption, the Bank and IMF have consequently halted loans to struggling countries such as Zimbabwe of long-standing arrears and failure to establish reforms to meet performance requirements. Thus, SSA countries look to China not only from an economic perspective and from a desire to escape Western development prescriptions, but the more fragile states have no choice but to turn East for assistance.

## **Potential Costs and Benefits to Sub-Saharan Africa**

Sub-Saharan African governments must weigh the costs and benefits of Chinese FDI. Potential benefits to SSA countries include China's policy of non-conditionality, which allows the governments to hypothetically apply the money where it is most needed to promote development efforts. Native policy-makers, after all, should have a better understanding of the local economic climate. However, some states focus on the wrong goals. While promoting an

atmosphere conducive to FDI is important, it should not be an end, but part of a comprehensive policy that will better a country's welfare and reduce poverty.

A definite gain to SSA countries is infrastructure improvements. Improved infrastructure is an essential aspect of development and increases the ability of SSA industries to participate in a competitive global economy. Angolan Aginaldo Jaime, a former senior official for the African Development Bank, noted, "If you don't have roads, if you don't have bridges, if you don't have the energy system, electricity, water, how can you expect the private sector to invest in such a country?" (Traub 7). Indeed, a lack of good roads makes transport of goods and services expensive or impossible; poor education results in a low-skill labor force; and excessive bureaucratic procedures act as obstacles to potential entrepreneurs. Chinese MNCs have incentives to keep the region stable through development to protect their interests. The Chinese are efficient at providing public goods, and thus are able to provide them when they may otherwise have not been available. For example, the only way to accomplish things in Angola is to "pay the Chinese to build things" because the state channels and "machinery has rotted away" (Traub 7).

Economic theory states that with entry of foreign firms comes new technology and labor skills, benefits which will "spill over" to the rest of the host industry. For example, if Chinese firms promoted their invention of a more powerful drill in foreign markets, then SSA firms, by means of reverse engineering, could copy the innovation. Also, since the drill can only be assembled by trained workers, local firms could obtain the technological know-how of foreign investment-related firms by "stealing" their skilled workers. Finally, the drilling company's mere presence in the domestic markets could inspire and stimulate local innovators to develop their own drills at less risk.

However, spillover effects are not guaranteed, and there is little or no short run gain. A case study in Venezuela, for example, illustrated the fact that there can even be negative spillover effects. The inflow of FDI crowded out domestic investment and led to a lopsided redistribution of resources into flourishing sector, reflecting a “Dutch disease” phenomenon. (Aitken & Harrison). Furthermore, Borensztein et. al note that significant spillover effects only occur when the home country has enough human capital to absorb the new technologies. The 2006 UNCTAD World Investment Report states that “most African countries lack linkages between foreign MNCs and local enterprises” and that “efforts to promote regional integration have been too limited” to reap benefits from economies of scale (45). However, as part of a broader SSA movement towards liberalization, Ghana and Mali have attempted to improve the investment climate by streamlining bureaucratic procedures and South Africa has encouraged investment in labor training (UNCTAD 46).

Significant spillover effects or not, Chinese activity in world trade will indirectly affect SSA economies as global competition increases. SSA is indirectly affected by China’s infiltration of global markets, and many SSA countries have seen their import prices drop with the increased competition, while China’s thirst for commodities have pushed up some countries’ export prices and led to some export expansion (Kaplinsky 5).

Another potential cost is reflected in the political realm; despite China’s seemingly “hands-off” policy, it is seen by some as a new form of imperialism via economic means. It is questionable if Chinese-run infrastructure development and resource extraction is an appropriate growth path for SSA countries, and while it may promote GDP growth in the short run, it may not be sustainable. As writer James Traub notes, China offers SSA a model of development different than that of the IMF, one “driven from above and powered by high-tech investment,

vastly more gratifying and reassuring to third-world elites than the Western gospel of unleashing growth through democratic and marketplace reform” (Traub 3). Traub goes on to say that “if [the Western world] believes that a model of development that strengthens the hand of authoritarian leaders and does little, if anything, to empower the poor is a bad long-term strategy for Africa, then [it is] going to have to come up with a strategic partnership of [its] own. And it is not only a question of what is good for the African people” (9). Chinese FDI is a current, ongoing activity and its long-term effects unfortunately cannot be foreseen in a crystal ball.

### **Sub-Saharan African Policy Considerations**

SSA governments must consider the end goal of their trade and investment relations with China. It is reasonable to assume that these nations will move towards sustainable growth projects and the eradication of poverty in their countries. These countries will certainly try to institute policies that will maximize the economic benefits of Chinese FDI in order to reach their development goals. But before the SSA nations can utilize FDI, they must first attract investments. Among the policies that SSA nations might consider are tariffs, subsidies, free trade zones and tax breaks to Chinese corporations.

#### **Tariffs**

Tariffs are essentially a tax on all goods brought in from foreign countries into a host country. Tariffs raise the cost of imports, which make them less competitive in host country markets. SSA countries could impart tariffs on Chinese products to stimulate FDI. Tariffs can stimulate FDI by encouraging foreign firms to circumvent them by building manufacturing plants and producing goods within the host country (Obadan 69). The introduction of the new

means of production as a result of the tariff is an economic benefit for the host country because new jobs are created. Increasing tariffs, in the case of oil-producing nations such as Angola and Sudan, may also convince foreign firms to increase investments in domestic oil-producing firms before tariffs reach even higher levels (Obadan 79). It is, however, important to note that increasing tariffs is a gamble. Tariffs increase the price of goods within a host country, and these price hikes are felt by consumers. If new jobs are not created by firms wishing to produce within the country from firms attempting to avoid the tariffs, then the overall economic welfare of the host nation's citizens is advanced only to the extent that domestic producers become more competitive in domestic markets foreign firms' goods become more expensive.

### **Subsidies**

Subsidies granted by host countries take the form of financial incentives to foreign firms in order to encourage FDI. Host countries encourage these firms to come because they envision technology spillovers. Subsidies give foreign firms a cost advantage against domestic firms. The inherent attraction to the MNC is that they can produce at higher quality or at lower cost (or both) in comparison to domestic firms, and thus capture a segment of the market. Unfortunately, these subsidies can not only attract MNCs, but may serve to drive out the domestic firms due to the unequal advantage awarded to subsidized firms. It is for this reason that SSA governments should be very selective of the MNCs they subsidize. They should carefully examine the spillover potential of the firms, and also provide the same subsidies for domestic firms as MNCs in order to maintain balance in competition. (Blomstrom & Kokko 17)

### **Tax Incentives**

Tax incentives can be provided to foreign firms under the same rationale as providing a subsidy. China can credit much of its own growth and incoming FDI due to tax breaks.<sup>4</sup> Only recently has China leveled the tax playing field due to the outcry of domestic firms. Though tax incentives are an effective means to attract investment, domestic firms are put at an economic disadvantage.

### **Free Trade Zones**

Free trade zones are physical locations permitted by governments to allow designated goods to be brought into the country duty free (usually raw materials). Domestic labor is paid to assemble and add value to the intermediate goods before they are shipped to their ultimate destination. Governments often sacrifice the potential revenues from tariffs on incoming goods in order to encourage investment from firms that will provide jobs for host country laborers. Foreign firms often use this opportunity to take advantage of lower labor costs and relaxed environmental and labor standards. Unfortunately, the host country receives very little economically besides the labor wages and benefits provided by the employers.

Host countries have a number of tools to attract foreign investment. However, they must keep in mind that attracting investment will markedly change the dynamics of their markets. They must especially consider the impact of special advantages given to foreign firms. Countries that are competing to attract foreign investment may reasonably provide incentives to MNCs—provided that these MNCs complement their economic activities by bringing plenty of positive spillovers—but should also consider providing the same investment incentives to their domestic firms.

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<sup>4</sup> Over the last two decades China has received over \$700 billion dollars in foreign investment (MSNBC, 2007)

## **Data**

The consequences of SSA policy considerations could be better articulated if good data were available. Often times the data is simply anecdotal or at the very best in the beginning stages of empirical analysis. Unfortunately, since Chinese FDI into SSA is still a new and growing phenomenon, it is difficult to gauge the long-term impacts of this economic activity. FDI is a particularly difficult economic activity to measure since different countries have various definitions for FDI versus what constitutes the simple movement of money into international “tax shelters.” It is for this reason that we recommend that future researchers might consider using a singular data source our definition when researching FDI.

## **Conclusion**

The 2006 Chinese-Africa Trade Summit was a declaration to the international community that marked the sincerity of China’s role as an economic developer and trade partner to other developing nations. The announcement followed a trend of increased Chinese-African trade and investment relations which has the potential to assist the development of all countries involved.

Despite problems with accurate data and a lack of hindsight, we can note that SSA governments should remember that China is a rising economic giant when negotiating terms of FDI. Chinese policies will affect SSA economies both directly, through FDI and aid, and indirectly through various trade channels, in the years to come. SSA countries must enact comprehensive development plans to reap maximum benefits from FDI. Potential policy considerations for SSA nations to attract FDI include tariffs, subsidies to MNCs, tax breaks and free trade zones. SSA nations must balance incentives to foreign investors and those available to domestic firms.

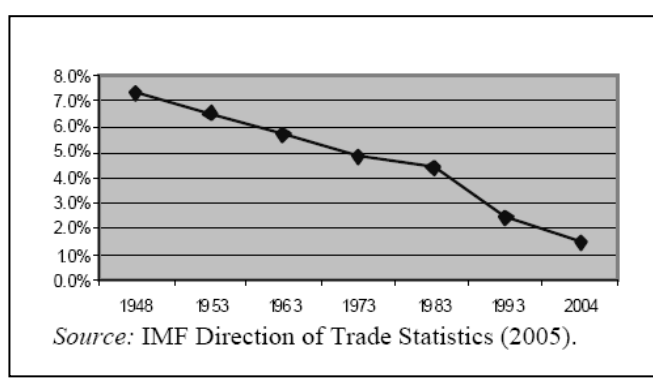
In addition to weighing the costs and benefits of providing incentives to foreign firms, natural resources should be carefully managed, transparency in bureaucracy and business further improved, and regional economic integration promoted to improve the investment climate. That is to say, a country like Angola should not focus its economic activity solely on oil, but it should take measures to decrease the risks associated with investment and work to liberalize trade with its neighbors to maximize their economic benefit from FDI.

SSA nations must remember that FDI is one means to achieve their development goals, and not an end in itself. To achieve economic development and welfare gains beyond GDP growth, a holistic approach to foreign economic policies and lasting dedication to poverty reduction is required.

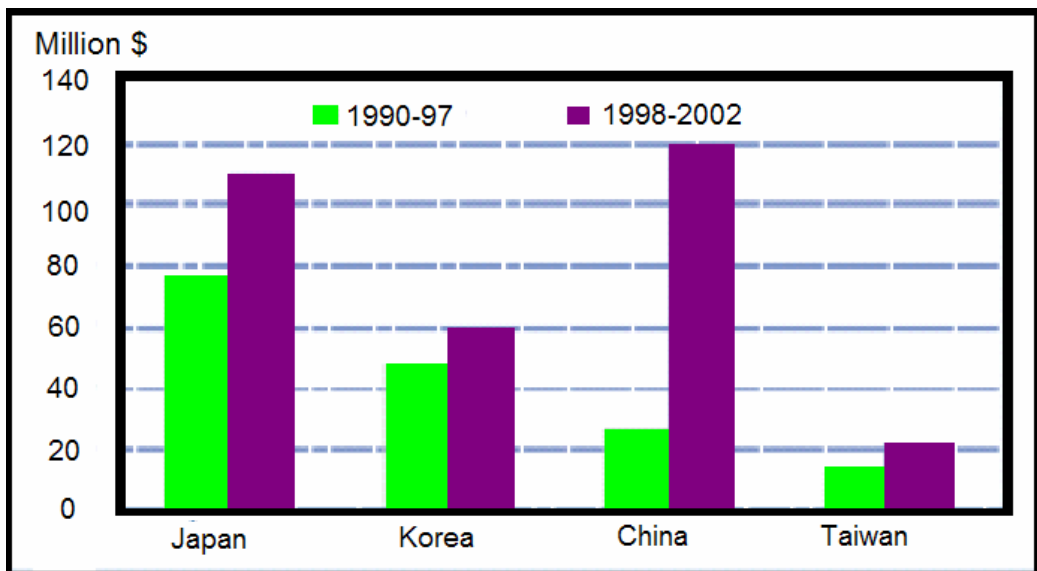


### Appendix

Figure I. African Share of World Trade



Graph I: Annual FDI Flows from Selected Asian Countries to Sub-Saharan Africa, Aggregate Annual Value



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