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# THE IMPACT OF FOREIGN DIRECT INVESTMENT (FDI) ON THE FUTURE SUSTAINABLE DEVELOPMENT OF ETHIOPIA

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# **THE IMPACT OF FOREIGN DIRECT INVESTMENT ON THE FUTURE SUSTAINABLE DEVELOPMENT OF ETHIOPIA**

## **Abstract**

In the light of recent strong global increases of Foreign Direct Investments (FDI), Ethiopia is one of the developing countries having received high FDI inflows in its agribusiness sector especially since 2006. As the agribusiness sector is the base of the Ethiopian economy these increases may considerably influence the total economy. This study aims at giving a first insight of possible midterm impacts of the FDI inflows on the sustainable development of Ethiopia. By analysing former empirical studies, likely future trends of development are derived. It is estimated that the high FDI inflows currently have and in the future continue to have a positive impact on the economic growth and poverty reduction. However, scarcity of agricultural land and water and corresponding environmental problems are bound to increase if no new production technologies and sufficiently strong regulatory frameworks are implemented.

## **Keywords**

Foreign direct investment, Ethiopia, sustainable development, Agribusiness sector

## **1. Introduction**

In 2009, developing and transition economies were absorbing half of global Foreign Direct Investment (FDI) inflows (\$ 500 billion). 2010, global FDI flows into developing countries reached again record highs. (UNCTAD, 2011)

These investments into developing countries appear to a large extent in the agribusiness sector as, through the high global food prices and the global financial crises, investment in this sector becomes more attractive. Profits have increased due to scarcity in land and water limiting food production and rising demand for agricultural commodities (GTZ, 2009). Ethiopia is thereby one of the developing countries which has strongly evoked the interest of foreign investors when regarding the development of the latest FDI flows into its major economic sector – agribusiness accounting for 44.5% of the total GDP in 2008 (WORLD BANK, 2010). A study by WEISSELER (2009) showed that Ethiopia's FDI inflows in the agribusiness sector have increased heavily since 2006 (from under \$ 500 million each year up to \$ 3500 million) leading to a sudden capital accumulation.

Former empirical studies (e.g. DOLLAR AND KRAAY, 2002 and KLEIN ET AL., 2001) indicate that an increase of FDI inflows has the potential to advance a country's economic growth through transmission mechanisms and reduce poverty. As most of the economies of developing countries depend highly on the agribusiness sector, they conclude that growth in the agribusiness sector and its productivity are essential in achieving sustainable growth and significant reduction in poverty in developing countries (RAO ET AL., 2004). Since 2000, the target of achieving a sustainable development has gained weight as developing countries, including Ethiopia, agreed on the Millennium Development Goals (MDGs) which are to be reached by 2015. These goals heavily stress the sustainability of a country's development.

This study aims at identifying possible impacts on the future sustainable development of Ethiopia. As sustainable development goes beyond the traditional concerns for economic growth, environmental concerns about available resources as well as social ones regarding

poverty reduction and increase of labour standards will also play an important role in the analysis.

## **2. Empirical Method**

Taking into account that the changes in the FDI trend have only appeared recently and disaggregated data especially firm level data often used to identify possible impacts of FDI on host country economies (e.g. AITKEN AND HARRISON, 1999, and BORENSZTEIN ET AL., 1998) is not available for a comprehensive econometric analysis, a comparative case study is sensible. Further, the main part of FDI inflows into Ethiopia's agricultural sector are pre-implementation inflows, meaning that up to now only the possibility of producing in a certain agricultural sector is secured, possible effects on Ethiopia's economy will only occur in a future period.

From an extensive literature review, two hypotheses are derived for Ethiopia:

1. FDI stimulates economic growth through transmission mechanisms
2. Through the increase of economic growth FDI has a positive impact on poverty reduction

By taking former case studies of other host countries and theoretical approaches into account, possible future development based on data available up to 2008 is analysed. As the MDGs include main targets for the poverty reduction of developing countries the analysis will further incorporate whether the possible future development initiated through present FDI flows may lead to the achievement of specific MDGs to a certain extent.

## **3. Results**

As the transmission mechanisms cannot be measured directly, the development of the productivity of the agricultural sector and the development of human capital (from 1995 to 2008) are regarded as proxies. Both have increased significantly since 2000, therefore it is concluded that the transmission mechanisms necessary to generate economic growth caused by FDI inflows are in place. Further, Ethiopia has become more integrated in international trade through the investment of MNEs, which also stimulates GDP growth. Negative consequences of FDI inflows on the economic growth such as the crowding out of small farmers through the modernisation of the agribusiness sector will mainly lead to a slowing down of the GDP growth rate in the short term prospect but will not stop the midterm economic growth caused by the FDI inflows. Therefore, it is concluded that parts of the economic growth in Ethiopia appear through FDI inflows.

For the environmental development the picture drawn is different. As no strong regulatory framework is in place and the emphasis of the last years was to attract as much FDI inflows as possible the conflict on land and water resources is about to increase further if no changes appear.

Poverty reduction, the main target of the MDGs, can mainly be seen after 2000. The rate of population with sustainable access to safe drinking water and basic sanitation has increased. Further, equal opportunity for women regarding education is nearly achieved. This development goes along with the high increase of FDI inflows. It can be concluded that FDI inflows in Ethiopia will have a positive impact on poverty reduction defined according to the MDGs even though slowed down through the current government in place. The negative consequence of an unequal distribution of economic benefits will make it more difficult to see the underlying correlation but will in the midterm prospect at the most lead to a lagging of the poverty reduction.

The results found indicate that the impact of FDI inflows on the economic and social development has been positive in the last years and it can be derived that in the medium term this effect is likely to remain positive.

As only the agricultural market has been regarded, conclusions can only be drawn to a certain extent on the development of Ethiopia's economy. Different influence factors as well as the analysis of the other existing sectors are left out which will certainly impact Ethiopia's economy, too. Further, no *ceteris paribus* conditions exist in an ex-post analysis. Therefore, the positive development of the MDGs may occur through other measures such as development aid, which are not linked with the high increase of FDI inflows in the past few years. Still, regarding existing case studies on other host countries, it seems appropriate to derive the existence of the linkage between FDI and poverty reduction.

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