What has been the Impact of Foreign Direct Investment in Ghana?

by

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Introduction

Beginning from a general mistrust of foreign direct investment (FDI) in the 1960s and early 1970s, developing country governments have now come to embrace it warmly within the last two decades or so. The growing interest in FDI is not only a result of globalization but also a consequence of the steady decline in official development assistance. Developing country share of FDI has increased from a paltry 5% in 1980 to 36% in 2004 (UNCTAD, 2005). Foreign direct investment is now viewed as a source of capital and a major tool in the fight against poverty. It is also viewed as a catalyst for technology transfer from the developed to developing countries. According to economic theory, international capital inflows, inter alia, promote efficient allocation of resources, which in turn enhances economic growth.

It has been argued that FDI plugs the savings-investment gap in the host country. It has also been suggested that a foreign corporate presence generates positive externalities such as improvement in human capital and local institutions. The almost universal belief in the growth enhancing effects of FDI is demonstrated by the scramble of governments to attract foreign investments with all kinds of incentive packages. There is now a vast literature on FDI, and the empirical evidence on the size of the gains from FDI is mixed. Although several studies have found that FDI, or FDI in combination with other factors, has a positive effect on economic growth, other studies have found no significant effects, while a few have found that FDI could even have an adverse effect on a country's growth.

The objectives of this paper are twofold. Firstly, it will determine the extent of the impact of FDI on the economic growth for Ghana. Secondly, on the basis of the findings, it will discuss the implications for policy makers. The issue of FDI is relevant at this stage of Ghana's economic development. The basic fundamentals of the Ghanaian economy have improved over the 2004-5 financial year and there are indications that the economy is beginning to head in the right direction. However, in order to eradicate poverty and make substantial progress towards achieving the Millennium Development Goals by 2015, the economy needs to grow at a fast pace, ideally double the current rate. Therefore, understanding the exact nature of the FDI-Growth relationship is crucial for developing an appropriate policy response.
Who is a Foreign Investor?

A foreign investor is defined here as a person/company/group of companies that brings in funds from abroad to finance some form of productive activity in the country. This definition therefore rules out people who come into the country to engage in trade or speculative activities. This definition also rules out individuals or groups who come to provide temporary services.

Types of Foreign Investment

There are four main categories of foreign capital inflows: foreign aid, commercial loans, portfolio investment, and FDI. Foreign aid can be in the form of loans or grants. The difference between the two is that foreign aid in the form of loans carries the burden of future payment (sometimes at concessional rates). Countries or individuals may also acquire foreign capital in the form of commercial loans which must be repaid at market interest rates. Portfolio investment refers to short-term foreign investment, while FDI is of a more long-term nature. Foreign direct investment can be in the form of equity investment, working capital, intra-company loans or re-invested earnings by companies already operating here.

The Advantages of FDI

The benefits of FDI can be summarized as follows:

- FDI brings in new technology which enhances productivity
- FDI has demonstration effects on domestic firms from technology choice and new managerial practices
- By helping to train local staff, FDI contributes to human capital development
- To the extent that FDI increases growth, it contributes to poverty reduction and hence increases political stability
- FDI brings in much needed foreign exchange to pay for capital and intermediate goods

Foreign firms bring in international market connections and generate new export opportunities

- Foreign firms generate backward and forward linkages
- FDI is a source of R&D spillover, including human capital development
- By increasing economic growth; FDI can also increase domestic savings
- By augmenting total resource availability, FDI leads to higher investment
- FDI is more persistent than other forms of foreign capital (e.g. portfolio investment).

It must be noted, however, that these positive effects are not automatic but depend on a set of conditions in the host country’s economy. These include:

- Absorptive capacity: the host country must have sufficient human capital development to absorb the new technology
- Hard infrastructure: roads, railways, ports Soft infrastructure: banking & business services, financial markets, supply networks, strong institutions, intellectual property rights, and
- Macroeconomic and political stability

The Disadvantages of FDI

Whilst extolling the virtues of FDI, we must be mindful of the possible pitfalls. The following are some disadvantages of FDI:

- Foreign firms could capture market share at the expense of domestic firms (i.e. they could ‘crowd out’ domestic firms)
- If foreign capital is financed from domestic markets, this could raise interest rates and ‘crowd out’ domestic investment
- FDI could increase import intensity and increase the current account deficit: a high import content could lead to low domestic value added, which could result in limited domestic linkages
- Excessive outflow of FDI (“decapitalisation”) could have a negative effect on economic growth

Policy Analysis 2
The Impact of Foreign Direct Investment in Ghana

In my initial analysis of the relationship between FDI and economic growth (which was proxied by real gross domestic product (GDP) growth), I found a statistically significant positive correlation between the two variables over the period 1973 to 2003. That is, real GDP increases with an increase in inward FDI. A more in-depth analysis was carried out by estimating an econometric model involving the variables economic growth, FDI, and financial development for the period 1970 to 2003. Financial development, proxied by the ratio of narrow money (M2) to GDP, was included in the model because it is perceived to be one of the channels through which FDI affects economic growth. In the short-run, I found no evidence of a statistically significant effect of FDI on economic growth. However, in the long-run, both FDI and financial development exert a significant positive influence on economic growth. For example, a 1% increase in FDI increases economic growth by about 0.4%, while a 1% increase in financial development results in a 0.95% increase in economic growth. The interaction of FDI and financial development also has a positive impact on growth, leading to the conclusion that the two variables are complementary. The Granger-causality tests established that there is a bilateral or feedback effect between FDI and economic growth. That is, economic growth initially increases the flow of FDI, which then leads to more rapid economic growth as a result of the increased level of aggregate demand.

What is the Way Forward for Ghana?

Although levels of FDI inflows into Ghana have been low in comparison to, say, Latin American and South-East Asian countries, the empirical results indicate that they have had a significant impact on Ghana's economic growth. This suggests that there is the potential for FDI to play an even greater role in Ghana's economic development. Following the re-establishment of democratic government in 1992 and the peaceful change over of government through the ballot box in 2000, there are indications that the political situation has stabilized. Other critical conditions which need to be met to attract FDI are macroeconomic stability, a favourable taxation and investment regime, industrial peace, improved and transparent governance, improved infrastructure (ports, roads, rail, telecommunications), and an educated and healthy workforce.

Within the last few years, various policies have been implemented to address some of the above issues. Some of these measures include tax holidays and import duty exemptions for foreign investors, improved remittance of dividends and profits abroad, and a massive ports and road rehabilitation program. Security of investment is provided by the national constitution, as well as by agreements such as the Multilateral Investment Guarantee and the Investment Promotion Protection Agreements. The historic Bank of Ghana Act, promulgated by parliament in 2002 has created an independent central bank and given it constitutional powers to conduct monetary policy. Among other things, the Act specifies that:

- the prime objective of the Bank of Ghana is to "maintain price stability independent of instructions from Government or any other Authority";
- a Monetary Policy Committee will be responsible for formulating monetary policy; and
- Government borrowing from the central bank in any year shall be limited to 10% of its revenue.

The Act has freed the Bank to focus on its core business of fighting inflation and maintaining price stability. Over the last two years or so, positive results have begun to emerge. The economy has moved from a path of high inflation to one of disinflation and macroeconomic stability. The Bank aims to target a single digit inflation rate in 2006. The fiscal deficit has declined, the external reserves have improved, interest rates have declined, and the exchange rate, particularly with respect to the US dollar, has remained fairly stable. In 2005, Ghana obtained its first sovereign rating, thus laying the foundation for gaining access to international
capital markets. These developments should boost investor confidence.

This study has found that financial development, in combination with FDI, positively affects economic growth. However, the financial sector remains underdeveloped. Ghana's economy is mainly cash-based which creates inefficiencies in business transactions. The cash-based economy also renders the transmission mechanism of monetary policy ineffective and generally makes it difficult for the central bank to control money supply. Three main issues need to be addressed to move from the current system to an electronic transactions system. These are development of ICT systems, public education, and measures to deal with electronic fraud. The central bank is currently supporting the development of an Integrated Payments System for the entire financial sector, including the rural banks and microfinance institutions. Some of the commercial banks currently allow their customers to conduct some transactions on automated teller machines (ATMs). However, these services are only limited to a few urban areas and the number of ATMs is limited. There is the need to extend these systems to every bank in the country. There is also the need for the banks and commercial organisations to exploit the internet to make it easier for customers to make payments. Alongside this development should be a campaign to educate the public about the use of these electronic systems. Fraud is always a problem in the operation of such systems, and the potential for fraud will deter some people from taking advantage of this new technology. Thus, there is the need for strict new laws to deter and deal with fraudsters.

Another important aspect of financial development which needs to be improved is the general availability of banking services. In spite of a fairly large population base, banking services in this country are available mainly in the urban centres, with rural areas lacking in basic services. The presence of a limited number of players in the banking sector and hence the lack of competition, contributes to the large variance between the prime and lending rates and discourages investment in the country. For example, the prime rate is currently 15.5%, while the lending rates are between 20.9% to 27%.

One type of FDI which is growing astronomically and could be mobilised for Ghana's benefit is of private remittances which come in through formal and informal channels. Currently, most of these funds are used to finance private building projects and to maintain family members in Ghana. Locking up thousands of dollars in brick and mortar is an unfortunate waste of financial resources. There is a great potential to tap these funds, as well as those from domestic sources, to invest in commercial/business ventures. These resources could be channeled into the development of small and medium enterprises (SMEs). Another way of tapping these funds is by enabling expatriate Ghanaians to buy shares in public companies that are slated for privatisation. Such investors will have not only financial interests in the survival of the companies but also a social one as well.

Within the last few years, the process of globalisation, coupled with advances in technology, have been transforming FDI activity worldwide. In general, there has been a decline in traditional 'greenfield' FDI where new production capacity is created. Firms are seeking to consolidate their global activities through mergers and acquisitions, with the aim of acquiring both assets and market share. The market for FDI has therefore become more competitive. UNCTAD observed as far back as 1998 that "liberal FDI policy is increasingly losing its effectiveness as a locational determinant of FDI", as "adequate core FDI policies are now simply taken for granted" (UNCTAD, 1998: xxvi-xxvii). Michalet (1997) also noted that:

"Multinationals, . . . , are not seeking to invest in all countries in the world. Rather, they seek to establish a presence in a small number of countries, with world-competitive facilities that together strengthen their regional or worldwide comparative advantages" (Michalet, 1997:31-32).

The 2005 World Investment Report reveals a
new trend in global FDI in the form of internationalisation of R&D. TNCs are increasingly seeking to support expansion of production activities in developing countries with local R&D. For example, some developing countries and transition economies in Eastern Europe are now attracting highly advanced R&D activities. Already, more than half of the world's leading R&D investors have located their R&D activities in China, India, or Singapore.

Given these developments, there is the need for Ghana to develop an FDI strategy which dovetails with a wider economic development programme. I would like to submit that we lack a long term plan and that our development agenda has been heavily influenced by the Breton Woods institutions - The World Bank and the IMP. In the 70s and 80s, we had the Economic Recovery Programme (ERP), which was followed by the Structural Adjustment Programme (SAP). After the SAP wreaked social havoc, they brought in the Programme of Action to Mitigate the Social Cost of Adjustment (PAMSCAD). Now, we have the Ghana Poverty Reduction Strategy (GPRS), supported by a plethora of programmes including the President's Special Initiative, the Medium Term Private Sector Development Strategy, and the Trade Sector Support Programme. The GPRS targets some key sectors that are perceived to bring about rapid economic growth. What is required is a comprehensive long-term development plan which provides not only a vision for where the country should be by 2015, but also a road map for achieving this vision. Within this plan, Ghana should identify its main comparative advantages and develop policies to develop its strengths in these areas with the view to attracting FDI.

On the issue of boosting inward FDI flows, the focus should not be on creating incentives for specific companies or even specific business activities but on improving the general business environment. Providing a good business environment, as well as removing bottlenecks and disincentives in the economy, will benefit both domestic and foreign investors and enhance economic growth.

**Concluding Remarks**

Research to date has established that the conditions required to attract inward FDI include political and macroeconomic stability, good taxation and investment policies, and improved infrastructure. Although these conditions are necessary to attract FDI, they may not be sufficient as the market for FDI becomes increasingly competitive. The way forward for Ghana is to target FDI into areas where she has a comparative advantage. This should be done within the framework of a broad long-term development plan. In general, improving the enabling environment for both domestic and foreign investors would be a better policy option than devising incentive packages for specific firms or projects.