

Foreign Direct Investment and Economic Development in Ethiopia



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Executive Summary

Scholars have long debated the impact of foreign investment on the economies of least developed countries. Many argue that foreign investment is beneficial for the investment receiving country (host). On the other hand, others argue that dependence on foreign capital is detrimental. The crucial role of FDI is presented in terms of enhancing capital formation, spillover effects, linkage, technology transfer, growth and thereby curing development problems. This has led to the development of several theoretical and empirical literatures studies, and conversely, to the prevalence of mixed empirical evidence. With this in mind, this thesis attempts to add to the body of empirical evidence fueling the debate as to whether FDI has positive influence on economic development or not.

The objective of the study is to theoretically and empirically investigate and quantify the relationship between FDI and economic development. Economic development in this thesis is measured in terms of real GDP growth, export, and spillover as FDI is said to affect economic development through these channels. Both quantitative and qualitative approaches have been conducted in order to complement and strengthen the analysis to capture different perspectives.

The analysis conducted provides evidence that there is a positive and significant relationship between FDI and real GDP growth, a moderate positive association between export performance and FDI, and a negative and insignificant association between FDI and spillovers in Ethiopia. Since 1992, the current regime has made enormous efforts to attract FDI and to facilitate its positive developmental effects.

The government's policies play a significant role in determining economic development and FDI inflow in Ethiopia. However, although it might seem natural to argue that FDI in Ethiopia has a positive and significant impact on economic growth, such gains differ across primary, manufacturing, and services sector. The findings discussed in this thesis provide a starting point to understand FDI effects on economic development in Ethiopia.

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1. Introduction

Foreign direct investment is one of the key economic features of the modern globalized world. In the United Nations Conference on Trade and Development's (UNCTAD) World Investment Report 2014, foreign direct investment (FDI) projects globally could increase to 1.7 trillion USD in 2015 and 1.8 trillion USD in 2016. In 2013, 54 percent (778 USD billion) of the total global FDI flow went to developing countries: Africa saw a 4+ percent increase in FDI inflow, although developing Asian countries continued to be the region with the highest FDI inflow. In East Africa, FDI increased by 15 percent to 6.2 billion USD because of rising flows to Ethiopia and Kenya. This is due to the increasing integration of developing countries into international trade and the global market as it is accompanied by a dramatic influx of foreign capital into developing countries in the form of FDI. The attitude of many developing countries towards the importance of FDI has changed remarkably and they have taken steps to ease restrictions on FDI inflow. These countries' supportive policies towards FDI base themselves on the assumption that FDI increases the country's output, productivity, produces externalities and technology transfer (Damooei et.al, 2006).

Thirty years ago, all eyes were on Ethiopia. "Live Aid" concerts were held in cities around the world to raise funds for the millions of people, mothers and children dying from hunger and disease brought about by extreme poverty. Fast-forward to thirty years later, Ethiopia has experienced rapid economic development and today, has become one of the world's fastest growing, non-oil producing economies. Recognizing the importance of FDI in the development of its economy, Ethiopia has, since the early 1990s, taken significant steps towards liberalization of the economy and of private investment. Indeed, the country sees FDI as an important source of capital to fill the resource gap between domestic investment and saving which remains wide due to low levels of income and domestic saving. It is reported that between 1990 and 1997, gross domestic investment as a proportion of GDP rose from 12 percent to 19 percent whereas gross domestic saving remained the same (World Investment Report, UNCTAD, 2002). This implies that the gap needs to be filled either by loan/development assistance from multilateral organizations or from private foreign investment. Nevertheless, trends in development assistance show its reduction as a source of funds.

According to Asiedu (2003), development assistance to Sub-Saharan African countries declined from 17 billion USD in 1990 to 10 billion USD in 1997. Likewise, data from UNCTAD shows that official development assistance (ODA) to Ethiopia has declined almost by half from 1,162.51 USD million in 1992 to 578.31 USD million in 1997 at current price. On the other hand, Ethiopia is Africa's third largest recipient of FDI. In UNCTAD's (2005/06) report, the FDI inflow to Ethiopia increased from 0.17 USD million in 1992 to 545.1 USD million in 2004 and prior to 1991, FDI flows were negative or near zero. Since then and to this date, yearly FDI inflow has varied between 545 million USD to 953 million USD dollar in 2014 (UNCTAD, 2008 & Tsegaye, 2014). This is in part because the Ethiopian industrial strategy is attracting Asian capital to develop its manufacturing base (UNCTAD 2014). Indeed, foreign investment in light manufacturing from China, Turkey, and India is the major cause of the increase in FDI coming into Ethiopia.

The role of FDI has been widely recognized as being a growth factor in the economic development of developing countries. More significantly, it is seen as a means of transferring modern technology and innovation from developed to developing countries. FDI enables host (investment receiving) countries to achieve investment levels beyond their own domestic saving. Nevertheless, the development impacts of FDI in developing countries should not be presumed to be a given, much of the desired outcome depends rather on host country characteristics, industries, motivations for placing an investment, and on all stakeholders involved. According to Nunnenkamp et.al. (2004), recipient countries with a better endowment of human capital are more likely to benefit from FDI-induced technology transfer, as spillover from foreign affiliate to local enterprise is more likely. This is also known as the host country's absorptive capacity. Likewise, institutional development such as the rule of law, level of corruption, protection of property rights, the quality of public management and unrestricted government interference are crucial factors that determine technology and know-how transfer from foreign affiliates to domestic firms.

1.1. Problem Statement

Investment in general is seen as one of the most important variables in driving economic growth and development. Hence, foreign direct investment is believed to serve as a strong mechanism for the encouragement and spread of business opportunities throughout developing and industrialized economies thereby enhancing economic development. It has been argued in numerous studies that FDI contributes positively to economic development in host economies.

This is particularly true where FDI brings in invisible financial resources and fills the gap between desired investment and domestically mobilized savings, when it facilitates technology transfer and entry into export markets, as well as strengthens the export capabilities of the host country resulting in productivity gains (Caves 2007; Ayanwale, 2007; Borensztein *et al*, 1998). Yet, high FDI ratios do not always lead to rapid economic development as the quality of FDI, its productivity, the existence of appropriate policy, of political and social infrastructure are crucial for the effectiveness of foreign investment (Artadi et al., 2003). Findings on FDI's effect on economic development, whether positive or negative, remain an area of intense debate and are highly controversial among scholars.

The crucial role of FDI in terms of enhancing capital formation, spillover effects, competition, linkage, technology transfer, and thereby curing development problems has led to the development of several theoretical and empirical literature studies. Mixed empirical evidence is prevalent. Some scholars argue that FDI has an adverse effect on development. They argue increased FDI does not always contribute to upgrading but sometimes may even act to reduce the host country's long run potential, leading to a crowding-out effect whereby domestic firms are displaced or outcompeted by foreign-owned MNEs, hence affecting economic development negatively (Tang et. al., 2008). Such conflicting evidence is not an exception in the Ethiopian economy. In spite of limited research on the effect(s) of FDI on macroeconomic variables, recent empirical finding shows a negative association between FDI and economic growth in Ethiopia (Wondoson, 2011). The purpose of my study is to examine the developmental effects of FDI in Ethiopia measured through real GDP growth, export performance, and spillovers.

1.2. Objectives of the Thesis

There are few studies analyzing the empirical relationship between FDI and economic development in Ethiopia. However, the existing empirical evidence focuses only on the direct macroeconomics impact of FDI such as economic growth. To my knowledge, there is no

empirical analysis done that incorporates the effects of FDI as regards growth, export and spillover in Ethiopia. I believe that this study will shed more light on the benefits and costs of the existing FDI, thereby revealing possible policy implications. Thus, the contribution of this thesis will be the combination of empirical study with a theoretical explanation, to investigate the developmental effects of FDI measured through export performance, spillovers, as well as real GDP growth. This work is motivated by the importance of the issue of economic development for developing countries and for Ethiopia especially. Hence, the purpose of this thesis is to capture the impact of foreign direct investment on economic development in Ethiopia, more precisely:

"How does inward Foreign Direct Investment impact Ethiopian economic development?"

The paper will look into the following sub-questions in an attempt to answer the above research question.

- 1. What policies has Ethiopia adopted to facilitate FDI and the positive development impact of FDI?
- 2. How has FDI in Ethiopia evolved over the past decades?
- 3. What are the development effects of FDI in Ethiopia?
- 4. What are the implications for extant literature of findings?
- 5. What can Ethiopia do to promote further developmental FDI, that is what are the possible policy implications given the contribution of FDI?

This study is based on quantitative approach analysis; however, attempts have been made to complement the findings with qualitative data such as interviews.

1.3. Organization of the Thesis

The rest of the thesis is structured as follows: the next section will start with the methodology applied in this paper. After that, the literature on the topic is reviewed in order to position this thesis within the existing debate. An outline of the analytical framework applied is subsequently presented. After that, background information about Ethiopia, development, policy, FDI trends

and regulation is presented. The results of the analysis will then be presented followed by a discussion, some reflection about these, and possible policy implication. Finally, the conclusion wraps up this thesis' findings. The figure below shows the logic in the paper's progression.



2. Methodology

This section outlines and justifies the methods chosen to answer the research question. It informs the reader of the approaches utilized to collect data, including what types of data were collected and why this was considered appropriate. The aim is to explain the motivation and suitability of the chosen methods to the reader. However, before going into outlining the methods applied in this paper, it is necessary to briefly consider the philosophy of science. Then the econometrics measurements and statistical methods applied in the analysis will be described. Finally, the section closes with a critique of the applied methods and outlines delimitations

2.1. Philosophy of Science Position

There exist two main philosophical paradigms when conducting social science research: that of positivism and that of constructivism. The positivism approach is based on the assumption that social reality studied exists independently of the researcher and the research subject (Ross, 2010). It is built up on the assumption that there is only one world rather than a multiple parallel realties. It is assumed that the world is a structure of objects that exist independently of our conceptions of them and that this assumption applies to the social world just as it does to the natural world (Bryant, 1985). The positivist research tradition moreover assumes that knowledge can be observed by the researchers' senses and that knowledge about social phenomena can be observed and recorded objectively rather than being dependent on the observers subjective understanding (Ross, 2010). According to Hindess: "positivism asserts the claims of experience as the ultimate foundation of human knowledge and denies the possibility of meaningful discourse concerning super sensible objects" (Hindess, 1977). Additionally, positivist argues that there exists an objective reality, independent of construction as social actors that can be measured. Hence, research should be conducted using natural science methods. The emphasis here is on explaining causality via quantifying data in order to determine effects or outcomes and arriving at generalizable conclusion (Bryam, 2001).

In contrast, constructivists believe that there is no such thing as an objective reality. Reality is socially constructed by our subjective perceptions and interactions with each other and thus is continually reshaped based on new interactions. A phenomenon can be ascribed vastly different meanings in the minds of those who experience it as well as multiple interpretations of the data (multiple realities); thus the researcher neither attempts to unearth a single "truth" from the realities of participants nor tries to achieve outside verification of their analysis (Ponterotto, 2005). However, they do tend to rely on the "participants' views of the situation being studied" (ibid). Therefore, research is based on understanding and developing contextual situated knowledge.

The thesis attempts to uncover how FDI impacts economic development in Ethiopia. This does confer with the positivistic notion that there is an observable reality that can be quantified, analysed and explained using a quantitative data which relies on econometrics analysis. However, the research has also elements of a constructivist approach in the sense that it uses the subjective perceptions and interpretations of the interviewees as a source of supporting the empirical analysis and findings. Given that the thesis does investigate how material factors (economic macro-conditions in Ethiopia) affect FDI inflow and economic development, i.e. the study features a positivist approach and highly relay on quantitative data. In order to break free of the rather dogmatic binds of the two philosophies, and to be able to answer the research question in a manner that accounts for both material (econometrics data) and ideational factors (perceptions, responses to events etc), an alternative approach known as critical realism has been utilised.

2.2. Critical Realism

Popularised by Bhaskar (1978) and Sayer (1984), critical realism argues that a world, independent of our own subjective knowledge does exist, but our knowledge and understanding of the world is shaped by our differing perceptions and interpretations. Understanding phenomena is only possible if one understands the social structures that have given rise to it (Sunders et al. 2009). Yet, there will always be competing explanations of what caused a phenomenon. The human nature is such that individuals interpret data in different ways. Indeed, considering competing explanations and competing interpretations of data is essential in order to arrive at what Easton terms the "best" current interpretation (Easton, 2010). Thus, critical realism can be considered as a compromise between the opposing poles of positivism and constructivism.

When conducting social science research, a critical realist approach entails the analysis of relationships among mechanisms, contexts, and outcomes (Pawson et.al., 1997). Easton (2010) elaborates on this, stating that entities (such as organisations, people, ideas, relationships or attitudes etc) can be seen to have particular causal powers ("mechanisms" in critical realism terminology) that operate in distinctive ways when accompanied by other entities that may trigger, mediate, or contradict these powers ("context" in critical realist terminology) to produce distinctive effects ("outcomes" or "events" in critical realist terminology).

In this thesis, this can be understood as analysing how Ethiopian government (the entity), by making a shifts in policy (the mechanism) affects the inflow of foreign investment, given a host of other factors such as development level that may or may not influence the developmental impact of FDI (the context). Uncovering causality is the driving force of a critical realist approach, although not stated explicitly, it is about analysing events or phenomenon that have occurred in the past and trying to explain what processes and mechanisms caused specific outcomes. This thesis empirical analysis studies the patterns and occurrences of FDI in the past to predict an outcome. Likewise, it focuses on uncovering causality between FDI and economic growth, FDI and export performance, FDI and spill over effects in Ethiopia. As Moses & Knutson (2007) note, the different paradigms are ideal types. Thus, no research design can sufficiently claim to stick strictly to one methodological paradigm, and this is definitely the case for this study.

All in all, critical realism allows for greater freedom in the choice of research methods than the narrow confines of constructivism or positivism do. It can be considered as a compromise between the opposing poles of positivism and constructivism: marrying positivist ontology with a constructivist epistemology.

2.3. Role of Theory in Analysis

In the methodological literature, two directions of reasons are identified, the inductive and the deductive research approach. According to Saunders (Saunders, 2003), the deductive approach developed a theory and/or hypothesis and designs a research strategy to test this hypothesis, where as in the inductive approach data is collected and theory developed as a result of data analysis. Usually, Critical realists rely on what is known as retroduction or abduction. In this paper, deductive, in accordance with the positivist research paradigm, where a hypothesis is developed as a research strategy is adopted as a starting point. Both descriptive and inferential analyses are conducted in order to be able to test the linkage between FDI and economic development in Ethiopia. Another distinction is made between exploratory, descriptive, and explanatory studies (Gummesson, 2000).

Exploratory studies are defined as a way of better comprehending the nature of the problem since very few information is available in that area. A descriptive study enables to explore new issues and to describe the characteristics of the variables of interest in a situation. Explanatory research is defined as an attempt to connect ideas to understand cause and effect, i.e. researcher wants to explain what is going on and how things come together and interact (Sekaran, 2003).

This thesis applies the explanatory research design method when designing the research question and the descriptive research design method for the different sub questions. Likewise, this study seeks to provide an accurate description of observation about policies adopted to facilitate FDI in Ethiopia, and how FDI evolved over the past years. Given that the aim of my research was to explain and to understand the relationship between different variables in order to assess whether FDI has developmental impact in Ethiopian economy, thus, explanatory and descriptive research design fit this purpose.

2.4. Data Collection

The study cannot rely on only one source due to the research richness and explanatory characteristics. This thesis will make use of quantitative time series data for answering the research question to register quantifiable change. To complement this approach, qualitative interviews were conducted. The inclusion of multiple sources also allows for what is known as data triangulations (Yin, 2009); where both quantitative and qualitative data are contrasted in order to strengthen the conclusions. Data collection started as a desk-based research, gathering both primary and secondary data to answer a number of strategic questions. Subsequently, empirical data was collected through independent research and through personal visit of government institutions in Ethiopia.

2.4.1. Primary Data

Primary data is new data gathered to help solve the problem at hand and collected by the researchers themselves, whereas, secondary data has been collected previously by others. Primary data was used in the empirical part of this study through interviews, discussing with different government institutions and my supervisor. A semi-structured interview method has been employed when conducting the interviews with the five foreign companies in Ethiopia. A

semi-structured interview include a flexible approach to the interview process, where key concepts are devised and a number of suggested questions that relate to the key concepts are drafted (Kvale & Brinkmann, 2009) but may be modified or omitted from the interview, depending on the insights or new knowledge that arise during the actual interview process. Semi-structured interview process allows for new perspectives and new connections that might not have been immediately apparent to the researcher to be uncovered during the interviews.

Qualitative interviews are used to discuss the empirical and descriptive findings, and to get an idea about why the findings appear as they do. Dealing with macro statistics helps, one understands the broader picture, but it does not go very far in terms of getting at why things happen. Interviews are used in two ways: 1) To back up findings from the economic regression analysis and 2) to discuss my findings, and attempt to see practitioners' understandings of how FDI interacts with the Ethiopian economy. All interviews have been conducted personally face to face. Two of the interviews were conducted in English, while the other three were in Amharic, although the questions were presented in English. Except for one interview, all the other four did not want me to record the interview. Almost all the interviews lasted for one hour. The table below summarizes the list of interviews conducted through a personal visit to each of the companies in Addis Ababa, Ethiopia.

Interviewee and date of	Position and company	Int	terview focus
interview	background		
Samuel Bekele	Employee Engagement Manager,	\triangleright	Motivation behind the
August 20, 2015, Addis Ababa			investment in Ethiopia
	Meta Abo Brewery A DIAGEO	≻	Locational appeal of the
	Company; Diageo is a global leader		Ethiopian market
	in beverage alcohol with iconic	≻	Opportunities and challenges of
	brands in spirits, beer and wine		the Ethiopian market
		≻	Company contribution to the
	M&A of state owned brewery for		development of Ethiopian
	400 million USD capital		economy
	investments.	۶	Business culture in Ethiopia
Mohammed Ahamed	Managing director of MAERSK	≻	Government role and
September 8, 2015, Addis Ababa	headquarter for Somalia, Sudan, and		bureaucracy

 Table 1: List of Interviewee, Position, and Interview Focus

	Djibouti.	\triangleright	Business culture in Ethiopia
	MAERSK has operation in Ethiopia	≻	Motivation behind the
	as an agent and consultancy service		investment in Ethiopia
	since 2007 and office is located in	≻	Opportunities and challenges of
	Addis Ababa.		the Ethiopian market
			Company contribution to the
		,	development of Ethiopian
			economy
Binvam Hailu	Head of Finance.	\triangleright	Locational appeal of the
September 8, 2015, Addis Ababa	ENGSKO Ethiopia		Ethiopian market
			Motivation behind the
	Since 2007 the factory in Denmark		investment in Ethiopia
	closed permanently and moved its		Opportunities and challenges of
	production and export business to	Í	the Ethionian market
	Addis Ababa Ethionia	2	Business culture in Ethionia
	Addis Ababa, Editopia.	<u> </u>	Company contribution to the
		-	development of Ethiopian
		~	
Brooks Washington	Founder and Chief Executive	>	Motivation behind the
September 16, 2015, Addis Ababa	Officer (CEO) of Juniper Glass		investment in Ethiopia
	Industries		Opportunities and challenges of
	Factory located in Debre Brihan and		the Ethiopian market
	head office in Addis Ababa and		Company contribution to the
	Nairobi		development of Ethiopian
	Greenfield investment and initial		economy
	capital investment of 45 million	≻	Locational appeal of the
	USD.		Ethiopian market
		۶	Government and institutions role
Minase Abate,	Human Resource Manager	≻	Motivation behind the
	Morrell Agro Industries,		investment in Ethiopia
September 20, 2015, Addis Ababa	PLC (MAI); Paul Morrell found the	≻	Opportunities and challenges of
	company in 2008.		the Ethiopian market
	Introducing Dry farming in Ethiopia	≻	Company contribution to the
	Location: 10,000 hm. in Bale area,		development of Ethiopian
	in Ethiopia		economy
		≻	Business culture in Ethiopia

2.4.2. Secondary Data

Initially, the data used in this study is a time series/historical data collected from different sources such as Ethiopian Investment Agency, United Nations Conference on Trade and Development, World Bank and International Monetary Fund. Yearly time series data on the different variables under investigation ranges from 1980-2015. The length of sample period is limited by the availability of data for some of the variables. This means the period over which data is available for all of the variables, is taken to be the sample period of analysis in this paper. Secondary data is also the main source of information on the theoretical part of this study. For data on macroeconomic variables, and country profile, the internet, and CBS library database are used to review relevant articles and books.

All data used in the estimation are in real terms at constant 2005 price and manipulated for use in terms of levels or growth rates in empirical and descriptive analysis. A problem with datasets available from international organizations, such as the ones from IMF, World Bank, and UNCTAD is that they often have a missing data points, especially for least developed countries (LDCs) like Ethiopia. Likewise, data inconsistency across sources was the main and major challenge faced in this thesis but maximum effort has been made to verify from the multilateral organization where UNCTAD and World Bank have nearly similar data sets.

The time required for data collection, analysis and interpretation was lengthy. I had to collect data on FDI, export, GDP, total investment, domestic investment, trade etc. by physically visiting different government institutions in Ethiopia, and comparing this with different international organization from different sources in order to rearrange and choose the most appropriate and reliable data. Beyond the problems with the statistics on inward FDI flows and stocks in Ethiopia, any systematic statistics on outward FDI flows and stock are essentially nonexistent in Ethiopia. Thus, any systematic analysis of outward flows and stocks in the case of Ethiopia in relation to the IDP framework is impossible, and is not the purpose and the aim of this paper either.

2.5. Method of Empirical Analysis

The methods of the empirical analysis employed in this thesis are both descriptive and inferential analysis based on log-log regression model, correlation and causality analysis. Descriptive analysis helps describe, show, or summarize data in a meaningful ways that patterns from data might emerge. This includes trends of dependent and independent variables of interest in tables and different graphs to depict the trends of data. In the regression analysis, the following steps are followed, first, the collected time series data are tested for Stationary; second, long run relationships (co-integration) are estimated and tested.

The first step in time series data of econometrics analysis is to check whether the variables under consideration are stationary or non-stationary. If the variables follow a non-stationary process, the regression results might be spurious; there is a possibility of finding a positive relationship of variables in the absence of true relationship (Gujaraty, 2003). Hence, before running the regression, all included variables were tested for stationary using Augmented Dickey-Fuller (ADF) test for unit root test. Following the stationary test of the data, a co-integration test was applied to examine the long run relationships of the variables of interest. The co-integration tests implemented in this study is based on the two-step Engel-Granger residual based methodology. That is, first estimating the relationship of variables by Ordinary Least Squares (OLS) method and then applying a unit root test on the predicted residuals (ε) to see if the residuals found to be stationary at level, I(0).

2.5.1. Causality Analysis

In causality analysis, first optimal lag lengths is determined and then pair wise causality test, using Granger Wald test in VAR mode was used to run the causality test. The available lag length selection criterion: Likelihood ratio (LR), Final Prediction Error (FPE), Akaike Information Criterion (AIC, Schwarz Bayesian Information Criteria (SBIC) and Hannan-Quinn Information Criterion (HQIC) were used to identify optimal lag length. One variable is said to Granger cause the other if it helps to make a more accurate prediction of the other variable than had we only used the past of the latter as predictor. Granger causality between two variables cannot be interpreted as a real causal relationship but it shows that one variable can help to predict the other one better. Given two time series variable Xt and Yt, Xt is said to Granger cause

Yt if Yt can be better predicted using the histories of both Xt and Yt than it can by using the history of Yt alone.

2.5.2. Correlations

When it is assumed that there is a liner relationship between two variables, Pearson's coefficient of correlation (simple correlation) method is the most applicable to measure degree of relationship between the two variables (Kothari, 2004). Hence, for FDI-export and FDI-spillover analysis, the Pearson correlation was employed. A Stata 11, a statistical and data analysis software was employed when conducting the econometrics and statistical analysis.

2.6. Reliability and Validity of Research Strategy

In order for the research strategy to be valid and reliable, it needs to link the data collected to the initial research questions of the study, i.e. methodology and theory need to provide a balance. This is fulfilled when the paper covers the conditions of reliability, constructed validity as well as external validity (Yin, 2003). Reliability is defined as: "The extent to which results are consistent overtime and an accurate representation of the total population under study is referred to as reliability and if the results of a study can be reproduced under a similar methodology, then the research instrument is considered to be reliable" (Golafshani, 2003). This means, reliability is about the "replicability" of the results. This applies as the results are based on facts and hence another researcher following the same research strategy would arrive at more or less the same results. Validity is defined as: "validity" determines whether the research truly measures that which it was intended to measure or how truthful the research results are (Golafshani, 2003). To guarantee validity and reliability, data is collected from divergent sources of information, including primary and secondary data as well as academic material.

The findings of this thesis are not based on prior assumption but on appropriate research methods that allow for an objective interpretation of the results of the data analysis. The paper links existing theoretical and methodological reflections with empirical evidence, in order to retrieve valid and reliable information. I am aware of the subjective nature of the information made available by exemplification and that data can be manipulated for various reasons in itself. Likewise, the influence of my own expectations and interest on the topic must be balanced through consulting different sources. I critically analyzed the enormous amount of data received, structured it and flittered out the most relevant and reliable information. Regarding reliability of secondary data, authors and articles consulted are from trustworthy sources such as academic journals and reports, well known and often cited.

2.7. Strengths, Weaknesses and Limitation of Research Design

Before moving on to theories and literature review on the impacts of FDI on economic development in Ethiopian, it is worth mentioning some shortcomings and strengths of the research design.

One of the primary beliefs of the positivist method is the claim of certainty and objectivity. This claim is in many ways problematic for the application of positivist research designs within the field of social sciences. However, critics of this can also be found within the natural sciences. Heisenberg and Bohr for example worked on quantum theory and claimed that it was impossible to accurately determine certain qualities of subatomic particles, and that the observation of particles alters them, clearly going against the claims of the positivistic tradition. (Houghton, 2014). I would therefore like to stress the fact that while applying this methodology and research paradigm, I do not believe that I am able to explain all aspects of the subject of FDI impact in Ethiopian economic development.

Furthermore, a quantitative analysis will analyze variables the researcher selects, whereas using qualitative interviews means that the interviewees may raise new issues that the researcher has not considered which can lead the research into a different direction. Furthermore, quantitative analyses would not answer how individual companies respond to the institutional reforms/policy changes and how it guides their decision process. Similarly, relying solely on the qualitative interviews is unsatisfactory. This is because there exist no definitive criteria to judge the "truth" of a particular version of explanation uncovered during the interviews. This thesis attempts to incorporate both approaches thereby more likely to strengthen the findings and the conclusion of this paper.

The assessment of FDI impacts depends on many factors, conditions and determinants of FDI. FDI can influence recipient countries in many levels, various ways can be identified and classified to measure FDI impacts. For instance, macro-level effect such as balance of payment and productivity of economy, meso-level effects like industry structure and competition, and finally micro-level effect such as resources and skill of firms. The dimension of the impacts could be on growth, capital formation, poverty alleviation, industry structure, environment etc. The intentionality of the impact can be distinguished as direct (job creation, export, investment), indirect (linkage between the foreign firm and the local firm) and spill-over effects (positive externalities from the presence of foreign firms that arises on local firms) (Hansen, 2014). Nevertheless, due to limitation of space, time and especially data availability, this paper mainly focuses on the macro-level (direct and indirect) effect of foreign direct investment on economic growth, export performance and the spillover factors of FDI inflow into Ethiopia through empirical and theoretical analysis. The result could be more accurate if it was based on disaggregate data as aggregate data cannot be able to capture the sectoral effect of FDI in export performance and/or spillover of the different sectors as this phenomenon can vary from sector to sector. Hence, a sector level analysis will be beneficial to policy makers and academics.

There are several important determinates of economic growth such as human capital, technological advancement, population growth, measures of rule of law, governance, democracy, infrastructure, taxes, government consumption expenditure and inflation. Nevertheless, a single country time series analysis cannot incorporate all these factors, as most of the data are not available annually, some of the variables are only available for few years and there is simply also a limit to the number of variables one can feasibly include. Additionally, a great attempt has been made to use an advanced co-integration method (vector error co-integration method (VECM)) in order to clearly understand the short and long run impacts and relationship between the variables of interest. During this attempt, none of the variables made any economical sense and statistical significance due to data insufficiency i.e. limited observation (one at least needs to have above 50 numbers of observation), hence, impossible to use a more advanced co-integration method. The paper opts to use a standard time series Ordinary Least Square (OLS) regression method, causality, and correlation model of analysis.

3. Theory and Literature Review

In the following section, the paper will aim to define what FDI is and move on to introducing the literature on effects.

3.1. Definition of FDI and Conceptual Discussion

There is no straightforward and clear-cut definition of FDI, as different organizations use somewhat different definitions. The inevitable part of the definition is that the investment made must be by a resident entity of one country into a resident enterprise in another. For instance, the International Monitory Fund (IMF) defines foreign direct investment as an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management (IMF, 1977). In a similar token, UNCTAD (1999), define FDI as an investment involving a long term relationship and reflecting a lasting interest and control of a resident entity in one economy other than that of a foreign direct investor. Furthermore, the investment must result in a significant degree of influence and control of the management of the enterprise. This is most often defined as obtaining a minimum of 10 percent of the voting share.

Additionally, FDI can be categorized as Greenfield Project (GP), Merger, and Acquisition (M&A). A GP refers to the establishment of new production facilities or expansion of existing production facilities. This involves a direct substantial capital investment, hence, adding directly to capital stock/formation, employment, and productive capacity in the recipient country. M&A, on the other hand, entails the taking over of an existing enterprise or the merging of capital, asset, and liabilities of an already existing business. M&A is merely a matter of ownership transfer, i.e. it will not add or reduce the physical capital of the enterprise at hand at the time of the transaction. M&A can also take place between companies in unrelated activities seeking to diversify risk and to deepen economies of scope. GP is more likely to contribute to economic development due to its direct impact on capital formation (Mwilima, 2003). Furthermore, the literature also normally distinguishes between two types of FDI, vertical FDI and horizontal FDI (the mixture of both exist and often is the case) when explaining why MNCs engage in FDI. In the case of vertical FDI, a firm "slices" their production chain by allocating different parts of production to countries where production costs are lower. Horizontal FDI is occurs when a

company "duplicates" its production chain in order to place its production closer to foreign markets. The decision to invest in foreign market may result from a tradeoff between fixed cost, a cost of establishing a new plant, and variable costs such as transportation costs, tariff which are associated with exporting to that country (Hansen et al. 2011).

Similarly, Dunning (1993) identified three possible motives for FDI to take place. First, *Market* seeking FDI that refers to the purpose of serving local and regional markets, host countries characteristics that can attract this kind of FDI are the size of per capita income, GDP growth and the growth potential of the market. Second, *resource/asset seeking FDI* refers to FDI for acquiring resources that are not available in the home country. Resources might for instance be like natural resources, raw material, and availability of skilled and unskilled labor. Finally, *efficiency seeking FDI*, this type of FDI occurs when a firm can gain from the common governance of geographically dispersed activities, epically in the presence of economics of scale and scope, and diversification of risk.

3.2. Introducing the Literature on Effects

The purpose of this section is not to provide a summary of everything that has been written in my research area but to review the most relevant and significant literature written in this topic. First, the section will briefly introduce the investment development path (IDP) concept as this framework explicitly link development level and country's FDI stock profile and hence by implication, effects. This approach is intended to analyze broad tendencies rather than providing well-specified predictions of where exactly Ethiopia will be with respect to FDI at any given level of development. Second, the main theoretical perspectives that have been used to investigate the impact of FDI in host country's economic development will be reviewed. Finally, the empirical findings on the effect(s) of FDI in economic development will be reviewed and general findings will be summarized in a table. The purpose of this conceptual and theoretical work will be to develop a model.

3.2.1. Investment Development Path

The IDP is a dynamic concept that relates the international investment position of a given country to its level of development. Dunning initially postulate that a country would go through four stage of development (Dunning, 1981a, 1981b); Narula later added a fifth stage (Narula, 1993). The IDP suggests that the outward and inward direct investment position of a country is systematically related to its economic development and a country may progress through five stages of economic development relative to the rest of the world. The stages are identified by the country's net outward direct investment (NOI) position. NOI is the stock of outward FDI less than the stock of inward FDI and the level of economic development is measured by GDP or GDP per capita (Dunning and Narula, 1996; Enderwick et al. 2005). The framework claims that inward FDI plays an important role in promoting the capabilities that eventually enable domestic firms to take part in outward FDI. Given encouraging environment of the host country conditions, inward FDI flow provides momentum for the upgrading of domestic firms O advantage. Upgrading of O advantages can arise, as mentioned earlier, through the introduction of new technologies, critical skills, knowledge, competition effect (spillovers), and linkages with domestic enterprises. From a development perspective, linkage between MNCs and local firms are better than no linkage, and the more and the deeper are the linkage the better for the host economy (Altenburg, 2000)

The main theoretical perspectives that have been used to explain the impact of FDI on host country economic development can be divided into two groups: the modernization (based on neoclassical and endogenous growth theories) and dependency theories. This division is not only meant for illustrative purpose but mirrors the very real divisions existing amongst the theories.

3.2.2. Dependency Theory

Dependency theory is rooted in the Marxist thought. Dependency/structuralist scholars argue that developing economies suffer negative consequence from foreign investment as a result of profit repatriation, declining reinvestment and income inequality. Accordingly, FDI inflows to the "periphery" distract local firms, stifle technological innovation and "crowd out" domestic firms (Dixon and Boswell, 1996). Similarly, Dixon and Boswell (1996) argue that foreign investment has an initial positive effect on growth in the beginning but in the long run the reliance on foreign investment exerts a negative impact on growth. The infrastructure and institutions that develop with foreign investment support further foreign investment and negative externalities/spillovers such as unemployment, over-urbanization, and income inequality.

Likewise, according to Moran (1978), foreign investors pervert or subvert host country political processes by co-opting the local elites and/or by using their influence in their home countries. It is argued the benefits of FDI are poorly distributed between the MNC and the host country, and MNC draws off an economic surplus that could have been used to finance international development. Throughout the 1970's and 1980's, economist predominantly supported the dependency theory of FDI and its impact on economic development in developing countries. In Latin America, many countries promoted FDI as a means to finance development after the debt crisis. Most of these countries followed the "Washington Consensus" and privatized state run enterprises in hope they would be more efficient. However, in 1970s in Latin America, MNCs were accused for being "imperialist predators" that exploited developing countries and causing the underdevelopment of world's economy "periphery" (Alfaro, 2003). Additionally, in line with the structuralist/dependency theory, Kentor (1998) in his study for the years 1938-1990, found that countries with relatively high foreign capital dependence (measured as accumulated foreign stock) exhibit slower economic growth than less dependent countries, which also support the earlier findings of Dixon and Boswell (1996). Kentor (2003) uses a different measure to foreign investment concentration that is calculated as the percentage of total foreign direct investment stocks accounted for by the top investing country and still finds a long-term negative effect. According to Kentor, foreign investment concentration has a significant, long term negative effect on growth that is strongest over the initial five years and decline overtime.

3.2.3. Neoclassical

The neoclassical growth theory in contrast, which dates back to Solow (1956) and Rostow (1995), assign an important role to FDI as a growth-enhancing factor to developing countries. In the growth model by Rostow (1956), FDI is seen as a way of meeting the capital and technological transfers required for economic transformation. Solow (1956) emphasizes on the increased foreign capital and progress in technology as important variables in output growth, hence development. Moreover, according to this theory, economic growth comes from two sources, factor accumulation, and total factor productivity growth. As a result, FDI plays a twofold function by contributing to capital accumulation and by increasing total factor productivity (Lucas, 1990). Likewise, in the neoclassical growth models FDI promotes economic growth only in

the short run because of diminishing returns to capital in the long-run. Capital moves in response to changes in interest rate differentials between countries or regions. Multinational companies are viewed as arbitrageur of capital from countries where return is low to countries where it is high. Accordingly, investment decision depends solely on rate of return, domestic and foreign direct investments are viewed as perfect substitute (Lucas, 1990).

3.2.4. Endogenous

Endogenous growth literature on the other hand explains how FDI contribute to economic growth through labor training and skill acquisition not merely through capital formation/accumulation and technology transfer. According to this theory, technology transfer, expansion of the level of knowledge arises via labor training and skill acquisition. Similarly, through the introduction of alternative management practices and organizational arrangements, domestic firms can learn or imitate from FDI. Thus, FDI is expected to contribute to output growth by raising total factor productivity due to a perceived diffusion of technology and increased efficiency through better marketing, managerial structure, and superior technology (Blomstrom et al., 1996; Borenztin et al., 1995; de Mello 1997, 1999). In addition, endogenous growth literature has identified country conditions that must be present for FDI to have a positive impact on growth such as the complementarities between domestic and foreign investment, adequate level of human capital, open trade regimes, and well developed financial markets. In the endogenous growth model, several channels are at work at which FDI can effect economic growth. First, via increased of capital formation to the recipient country through introduction of new inputs and technologies. Second, via accumulation of knowledge and skills, this is stimulated through management and labor tanning. Third, via competition, FDI rise competition in the host country industry by overcoming entry barriers and reducing the market power of existing firms (Gorg, 200). This further can be related to growth enhancing effect of FDI through spillovers.

3.2.5. Spillovers

Spillovers take place from non-market transactions when resources, especially knowledge are extended without a contractual relationship, so-called externalities. In the literature, it is common

to distinguish between linkages and spillovers. Linkages are a precondition for spillovers to occur. Although MNCs might, perhaps, be effective at ensuring that firm-specific assets and advantages do not spillover or at least will try to minimize technology leakages. The theoretical literature identifies four means in which spillovers can take place, and thereby, enhance productivity and economic development in recipient countries. The so-called four channels are; imitation, skill acquisitions, competition and export. The extent, however, depends on the complexity level of products and processes, for instance, simple manufacturing and process, managerial and organizational innovation are said to be easier to imitate than production that is more complex. Any upgrading to local technology occurring from imitation might leads to positive spillover effect. The second spillovers channel is skill acquisitions, it can arise when MNCs invest in training local employees, then local workers who has carried out this knowledge move to domestic firms, thereby generate productivity improvement due to adaptation of new technology/knowledge. The third channel is where spillovers take place through competition, it is argued that FDI enhance competition in the economy it enters and thereby put pressure on domestic firms to use existing technology more efficiently, thus, yielding productivity gain in the host country. Finally, spillovers arise via export, if domestic firms learn to penetrate export market from MNCs through collaboration or imitation (Greenaway et al., 2004). Furthermore, Nunnekampe and Spatz (2003) argued that the conclusive evidence to support the growth enhancing aspect of FDI in developing countries is hard to come by. They argued that the growth impact of FDI is vague because of aggregate data and previous studies did not differentiate between the different types of FDI (resource, market, and efficiency seeking FDI) and their stability under different host economy circumstances.

All in all, modernization theory scholars, on one hand, argue that FDI raises income level and provides employment opportunities to the host country thereby boosting overall economic growth. On the other hand, dependency theory scholars argue that MNCs may prevent economic development by squeezing out local entrepreneurs, by worsening the distribution of income, by reducing consumer welfare and introducing inappropriate consumption pattern in the host countries. Alternatively, favorable effects of FDI is not a given fact, it perhaps depends significantly on host country enabling environment, political and macro economics stability, institutional capacity, infrastructure and educational system. Thus, there are numerous factors

that conditions FDI impact such as, the right policy framework, absorptive capacity of recipient country, MNC investment motives, MNC entry strategies or the extent to which MNC interact with local firms and industries (Hansen et.al. 2006; Hansen et.al. 2011).

3.3. Empirical Literature

The empirical macro level literature on FDI and economic development has been occupied on either measuring the effect of FDI on variables such as GDP/productivity growth or measuring the determinants of FDI. The approach on this thesis is closely aligned with the former approach. Most empirical studies on FDI and economic development measured by economic growth are cross country studies and especially panel-data.

A study by Zhang (2001) on 11 developing countries of Latina America found that a significant benefit of FDI to recipient countries is due to technology transfer and spill over efficiency. They scrutinize the 11 Latin America countries using co-integration and Granger causality test. In their analysis, they found that FDI has a positive impact only in five of the eleven countries. The author indicated that the benefits does not happen automatically instead depends on host country absorptive capacities, liberal trade policy, human capital, and export-oriented FDI policy. Likewise, Bengoa and Sanchez-Robes (2003) found that FDI has a significant positive effect on economic growth of developing countries. In order for a positive effect to be achieved from FDI, the host country must have an adequate level of human capital, economic stability and liberalized capital market.

De Mello (1999) and Borensztein et.al. (1998) found that there is a relationship between foreign direct investment and economic growth, though this tends to be so because of the host country characteristics such as human capital. Thus, the favorable growth enhance impact of FDI is dependent on the conditions and characteristics of a host country enabling environment. Investment recipient countries with better endowment of human capital and strong institutional capacity are supposed to benefit more from FDI induced technology transfer and thereby productivity gain.

De Mello (1999), on a time series and panel data studies on impact of FDI, a positive effect of FDI in promoting long run economic growth, through technological upgrading and knowledge spillovers was found. The study was focused on 32 individual countries both from OECD and non-OECD countries over the period of 1970-90. He concluded that the long run growth in host countries is determined by the spillovers from knowledge and technology from foreign investment to host countries. However, in the non-OECD samples he found negative short run impact of FDI to GDP and no causation from FDI to growth. This perhaps relate to the claim, by some scholars, the growth promoting effect of FDI is related to the income level of host countries. Likewise, studies by Blomstrom, Libsey and Zejan (1994) found that foreign direct investment promotes growth only in higher income developing countries. The study was a cross-country analysis of 78 developing countries and they found no positive effect for lower income developing countries.

Balasubramanyam et.al. (1996) investigated how foreign direct investment impacted economic growth in developing countries using cross-sectional data and the Ordinary Least Square (OLS) regression method. They found that FDI has a positive impact on economic growth only in countries that have export promoting strategy. This supports the "Bhagwati hypotessis" that the growth impact of FDI is positive for export promoting countries than import substituting countries, emphasizing on the role of trade regime on FDI impact.

Kokko et al. (2001) investigated the possibility of spillovers to local firms using a cross sectional data of 1,243 manufacturing firms in Uruguay in 1998. The study distinguishes the difference in spillovers effect in different trading regimes. This was defined in terms of the number of years in which the country was under import substitution and export promoting trade policies. They found that exporting tendency of locally owned firms appeared to be positively related to the presence of outward-oriented MNCs; however, the case was not the same for MNCs established during the import substituting regimes.

Likewise, Greenway et al. (2004) provide evidence on export spillovers effect from MNCs to local firms in an industrialized economy. The method used a pooled data of 5 years at firm level in UK. The evidence provided by this study was that export-enhancing effect of FDI was not

only limited to the export performance of MNCs but also related with higher export orientation of domestic firms. Similarly, a study conducted by IMF(2011) on Eastern Central and South Eastern Europe countries indicate that the impact of FDI on trade depends on whether the sectors are tradable and non tradable. The paper defined manufacturing, agriculture, mining, retail, hotels, and restaurants as tradable sectors and electricity, transport, communication, real estate and financial intermediation as non tradable sectors. They study was conducted by applying both a cross sectional and time series econometrics method. This study found a high positive correlation between export performance of host countries and stock of FDI going to the tradable sectors, in contrast, FDI stock in the non-tradable sectors is positively associated with import.

The sector impact FDI on economic growth has not been studied extensively; the earliest research to consider this matter was Alfaro (2003). The study was based on 47 countries in the primary, secondary and service sectors for the period from 1981-1999 in cross country regression. In his finding, positive growth effect of FDI was found on manufacturing sector, negative in the primary sector and the service sector was found to be vague. Nunnenkamp et al. (2006) also found that the growth impact of FDI varies across sectors. The study was based on panel co-integration framework for 15 industries in the primary, secondary and service sector in India. They found no causal relationship in the primary sector, temporary growth effects of FDI in the services sector, and FDI stock and growth were mutually reinforcing in the manufacturing sector.

Jacques (2010), examine the long run relationship and causality of FDI and growth for ten Sub Saharan African (SSA) countries by applying a co-integration and non-causality test approach in the periods from 1970-2007. They find a long run relationship between FDI and economic growth in Angola, Cote d'iVoire, Kenya, Liberia, Senegal and South Africa. However, FDI was statistically signification and positive only in Angola and Cote d'iVoire and insignificant in Kenya. In Senegal and South Africa the direction of causality run from GDP to FDI, GDP affects FDI significantly and positively. An empirical work of Magnus and Fosu (2008) for Gahanna economy found that there is a one way casual relationship between FDI and GDP growth in Ghana and the direction of causality is from FDI to growth. A few scholars have also emphasized on the way in which the growth effects of FDI depends on the financial market conditions of the recipient country. Alfaro et al. (2004) and Durham (2004), emphasize that growth effect of FDI depends on sound financial markets of the host country. Alfaro et al. (2004) used cross-country data for the period of 1975-1995 and found that FDI alone plays a vague role in promoting economic growth, however, when several financial development measures are included positive effects are found. Durham (2004) used data for 80 countries from 1979-1998 and found that it is also necessary for a country to have a strong institutional capacity and investor friendly legal framework for FDI to have a positive effect on growth. Similarly, Olofsdotter (1998) argues that the beneficial effect of FDI is stronger in those countries with higher level of institutional capacity. Likewise, Chang (2009) applied panel co integration and panel error correction model for 37 countries using annual data from 1970-2002, found positive relationship between FDI and growth when financial development measurement are included. When a country has a solid financial system as its foundation, it follows that it is in a better position to more effectively reap the benefits from FDI inflows.

Overall, foreign direct investment may have profound effects, that there effects are of various kind such as growth, export, technology, know-how transfer etc. Yet, these effects are found to vary across countries and depends on several circumstances/factors such as institutional development, human capital development, government policies, sector, MNCs investment motives etc.

Author	Type of data	Countries and time	Empirical	Results
		period	approach	
Alfaro (2003)	Cross section and	47 developing	OLS regressions	Sector effects of FDI
	panel data	countries 1981-1999		and negative effect
				on primary sector,
				positive in
				manufacturing sector
				and ambiguous
				effect on service
				sector

Table 2: Summary	of Main Findir	ngs of the Empirica	I Literature Reviewed

Bengoa and	Pabel data and time	18 Latin American	Regression analysis,	FDI has positive
Sanchez-Robels	series	countries 1970-1995	fixed and random	effect on growth but
(2003)			effect	it depends on human
				capital, economic
				stability and
				liberalized capital
				market.
Borenszteni et al.	Cross section	69 developing	Regression	FDI has positive
(1998)		countries 1970-1989	estimation using	effect but its
			SUR technique	magnitude depends
				on human capital in
				host country.
Balasubramanyam	cross section	46 developing	OLS regressions	FDI has positive
et.al. (1996)		countries 1970-1985		effect only for
				export promoting
				countries.
Blomstrom et al.	Cross section and	78 developing	OLS regressions	FDI has positive
(1994)	panel data	countries 1960-1985		effect on growth
				only in higher
				income developing
				countries.
Chang (2009)	Time series annual	37 countries 1970-	Co-integration and	Positive relationship
	data	2002	panel error	between FDI and
			correction model	growth when
				financial
				development
				measurements are
				included
Durham (2004)	Cross	Data for 80 countries		Strong legal
	section/country data	from 1979-1998		framework and
				institutional capacity
				are necessary for
				FDI to have positive
				effect on growth.
Greenway et al.	Pooled data at firm	United Kingdom 5	OLS regressions	Export enhancing
(2004)	level	years data		effects of FDI is not
				only limited to

				MNCs export
				performance but also
				domestic firms
				export orientation.
De Mello (1999)	Panel data and time	32 developed and	Stationarity tests	Only weak evidence
	series	developing countries		for FDI effects on
		1970-1990		economic growth.
Kokko et al. (2001)	Cross section data of	Uruguay 1998	OLS regressions	Spillover effects
	1243 manufacturing			depends on trade
	firms			policies, domestic
				firms export more in
				the presence of
				outward oriented
				FDI and trade
				regimes
IMF (2011)	Cross section and	Eastern Central and	Correlation analysis	The study found
	time series	South Eastern		positive correlation
		Europe countries		between export
				performance and
				FDI stock in tradable
				sectors
Jacques (2010)	Time series	Sub Saharan African	Co-integration and	Long run
	approach	countries (SSA)	non causality test	relationship between
		from 1970-2007		FDI and economic
				growth in 5 African
				countries but only in
				two countries,
				statistically
				significant and
				positive relationship
				between FDI and
				growth
Nunnenkamp et al.	Panel co-integration	For 15 industries in	Non Causality test	Sector based study,
(2006)	framework	India		no causal
				relationship between
				FDI and the primary
				sector, mutually

				reinforcing the
				manufacturing
				sector, and
				temporary effect on
				service sector
Zhang (2001)	time series	11 developing	Analysis of causality	Evidence of growth
		countries in East	between FDI and	enhancement from
		Asia and Latin	economic growth	FDI in more open
		Asia and Latin America 1957-1997	economic growth using Granger	FDI in more open countries

3.4. Positioning this Thesis within the Debate

In spite of the fact that the effects of foreign direct investment on economic development has been the subject of much research in recent years, the majority of these researches have been limited to investigating the impacts of FDI on economic growth by applying cross sectional or panel data method for various countries in one study. This thesis however differentiates itself by investigating the impacts of FDI in a single country study and relating effects of FDI to the country's development level and government policy. At the same time, this thesis attempts to provide a wholesome picture of FDI in a least developed country like Ethiopia by investigating economic growth, export performance and spillovers impacts of FDI given the development level and government policy role that may or may not influence and facilitates the impacts of FDI on economic development in Ethiopia. This is done by applying an interdisciplinary analytical framework, which will be described in the next section.

4. Analytical framework

In the following section, the important linkage between theory and practice will be developed as well as the approach that will be applied when answering the research question. It has been argued by different scholars that foreign direct investment can affect economic development directly and indirectly. FDI can be assumed to directly affect growth through capital accumulation, export, and indirectly via the incorporation of new inputs and foreign technologies ino the production function of the host country (spillovers). The relative importance of these impacts however depends on the nature of FDI, the host country's level of economic development, government policies, industrial characteristics, etc. (Alfaro, 2003).





The figure above depicts the analytical framework of the FDI, growth, export, and spillover nexus. The empirical section of this thesis will apply methods from the neoclassical thoughts. It is the relevant method, which exist to focus on and evaluate the growth of factor inputs, as it is easier to quantify. In this paper, the relationships in the nexus are divided into three main impacts such as growth, export, and spillovers. These are the three measurements for economic development in this thesis and FDI is said to impact economic development in Ethiopia through these channels. Development level and economic policy are exogenous variables, i.e. they will not be tested in this model, but rather explained in relation to the IDP framework. Real GDP growth, spillover, and export are dependent variables where FDI and other controlled variables are used as independent variable to explain the different scenarios using econometrics models.

In a conventional production function, output (Y) is a function of capital (K) and labor (L). This implies FDI directly affects output through capital accumulation and an increase in K. The direct impact of FDI is explained using the neoclassical growth model. Identifying the direct impact only gives a partial understanding of the linkage between FDI and growth. The indirect impact, which is also directly impacted by foreign investment, is explained through the spillovers effect of FDI, this is linked to productivity gains and thereby influencing economic development positively or negatively. Although, spillovers exist and make up some part of the residual that

appears in the growth equations, current statistical methods and data sets are unable to identify them. The arrow going both directions, from FDI to economic development is said to occur when economic development leads to FDI, i.e. a large amount of FDI inflow because of economic development in the host country. This reverse impact has been shown by several studies that have investigated causality between FDI and economic growth, which leads to economic development.

Additionally, the IDP framework is used and interpreted in the broad sense, as it is a tool to analyze the interaction between FDI and economic development. The evolution and patterns of inward and outward FDI in Ethiopia will be examined in the IDP framework of Dunning's and Narula (outward FDI is none existence in the Ethiopian case). Hence, the IDP provides a dynamic framework to examine the relationship between a country's stage of development, the nature of FDI depending on which stage a country is in, and the extent of inward and outward FDI activity. In this thesis, the IDP framework/concept is applied in order to assess government policies and the Ethiopian development level and it will only serve as an organizing framework. The subsequent section will highlight some facts about Ethiopia and the economy in general.

5. Country Profile

"Ethiopia is a mountainous land" is the typical introduction to the country, referring to the massive plateau at its centre that stands at an average elevation of 2000-2500m above sea level and boasts of peaks soaring above 4000m (Markakis, 2011). Ethiopia with a population of about 99+ million is the second most populous economy in Sub-Saharan Africa. The country is the only country in Africa that has never been colonized, except from the Italian occupation in 1936-1941. Ethiopia is known to be the "cradle of humanity". Human kind is very likely to have its roots in Ethiopia. Lucy, the most well preserved version of the man's predecessors is approximately 3.5 million years old, and was found in the Ethiopian part of the Great Rift Valley1941 (Markakis, 2011).
Table 3: Facts about Ethiopia

Ethiopia at Glance	
Official Name	Federal Democratic Republic of Ethiopia
Political System	Federal State with multi- party democracy
Head of State	President Mulatu Teshome
Head of Government	Prime Minister Hailemariam Desalegn
Official Language	Amharic, English is widely used in business,
	universities, colleges and the professions
Population	99,465,819, and expected to be 120 million in 2030
Life Expectancy at Birth (total population)	61.48 Years
GDP Per Capita	1600 USD
GDP Composition by Sector	47.7 percent Agriculture, 41.9 percent Service, 10.4
	percent Industry
Population Below Poverty Line	39 percent
Agricultural Land (percent of land area)	36.3 percent
Export Partners	China 13 percent, Saudi Arabia 8.3 percent, Germany
	8.3 percent, US 8.1 percent
Import Partners	China 15.3 percent, Saudi Arabia 8.1 percent, India 7.2
	percent and US 5.6 percent and Belgium 7.1 percent

Source: CIA Fact book, August 2015

The country has improved its position in providing excellent market access for many products. Ethiopia is a member of the African Union, New Partnership for Africa's Development, Common Market for Eastern and Southern Africa and is eligible for the United States' African Growth and Opportunity Act and the European Union led "Everything But Arms" initiatives (UNCTAD, 2011).

5.1. The Ethiopian Economy

One of the basic premises of the IDP model is that the inward and outward flows of FDI are influenced by the state of economic development of the host country and its growth overtime. This state and growth in turn is fluctuated by the government policy and its administration. Thus, government has a major role within the IDP framework of analysis. The Ethiopian case supports the importance of government in influencing FDI flows. Dunning and Narula have highlighted the government's role in influencing macro economic variables such as growth rates, inflation rates, infrastructure development, education level, tariff structure and levels.

In the Ethiopian case, the government's role in the "micro-management" of the economy at the firm and industry level has also had a significant influence in the inflows of FDI beside macroeconomics structure. For instance, government regulation on foreign equity ownership, its limitation of foreign ownership, its restriction of the sectors a foreign company can invest in, the amount of required capital and state enterprise ownership have had a major impact on FDI flows. To analyze the impact of various regulation/regimes on FDI inflows in Ethiopia, this chapter will take a largely historical approach tracing the history of FDI in Ethiopia through the different regimes. Before embarking on this task, a very brief description of the Ethiopia economy and its development overtime is necessary.

5.2. Development

From 1974-1991, Ethiopia was one of the poorest countries in the world, however, in the last decade; it has become one of the world fastest growing none oil producing economies. In 2012, Ethiopia was the twelfth fastest growing economy in the world (Zerihun et.al.2014). Ethiopia has witnessed vast economic growth accompanied by the development of infrastructure and growing demographic rates, as well as a reduction in poverty, unemployment, inflation, and corruption.

The Ethiopian economy has produced a double-digit growth rate trajectory since 2004. Real GDP grew by an average of 10.4. to 11.4 percent in recent years, which places Ethiopia among the top performing economies in Sub Saharan African countries (African Economic outlook, 2012). Growth has broadly been due to the service and the industrial sectors growing at unprecedented rates. Agriculture, industry, and service grew at annual average rates of 9 percent, 15 percent and 12.5 percent respectively during the past years. The five-year Growth and Transformation Plan (GTP) of 2010-2015, emphasizes agricultural transformation and industrial growth. It projects for the economy to grow at a rate of 11.2 percent (minimum) up to 14.9 percent (maximum), well above previous years plan (MOFED, 2010). The 2010/11 fiscal year

saw an 11.4 percent real GDP growth rate that shows the GTP's successful stride. However, the country is suffering from a high inflation rate because of escalating food price, imported goods and weak monetary policy (African Economic Outlook, 2012).

In recent years, growth performance and development gains in Ethiopia come under threat due to the emergence of challenges such as high inflation and a deficit of the current trade balance account. According to the National Bank of Ethiopia (2010) annual report, rapid structural transformation in domestic economy, growing demand, and hikes in the world commodity prices are among the major factors that contributed to inflation. This is because the economy is highly vulnerable to exogenous shocks as the economy is dependent on primary commodities and rain fed agriculture (ABDE, 2010).



Figure 2: Inflation

Source: own computation based on data from World Bank

According to World Bank (2010), the increase in worldwide food prices and the economic crisis of 2008 were major factors that exacerbated these twin macroeconomic problems. They occurred

in the same year in Ethiopia, in addition to the structural problems of the country's economy. Growth in demand must be accompanied by the same increase on the supply side. Otherwise, the economy will suffer from supply-demand gap, which creates an opportunity for inflation and fast growth in imports to meet domestic demand thereby leading to the balance of trade deficit (ABDG, 2010).



Figure3: Import and Export of Ethiopia Percentage to GDP

Source: own computation based on data from World Bank

Thus, such supply-side rigidity and the world economic crisis of 2008 contributed to the high inflationary crisis and the high current account deficit which is still an ongoing problem. Additionally, due to the fact that Ethiopia's main export goods are agricultural products and import goods are mainly industrial products, the economy's growth process suffers from foreign exchange shortage with terms of trade disadvantage. Foreign exchange shortage is what all the companies I have interviewed explained to be their biggest challenge to business operation in Ethiopia.

"FX is a problem. It is a very big problem. For us, it is a problem and it is an opportunity. It is a problem because we are going to spend 40 million USD for machines we have to import, so finding that is difficult. It is going to be good for us because we are going to be producing locally, almost 90percent of raw material is from local, that means we can be sure we have good production, we will not have interruptions, and we can also provide a product that is cheaper and in birr [local currency] to local companies. This is our biggest competitive advantage. Right now our biggest competition is in import and you have to get dollars for import" (Washington, Interview).

"Waiting time to get foreign exchange is really long and there are times where we stop production because we cannot import raw materials (Hailu, Interview").

The foreign exchange shortage can partially be explained by foreign exchange rationing and the currency not being set to depreciate naturally but by government controlled devaluation. Thus, the investment climate in Ethiopia is still not as attractive as it could be and policy related problems remain. This is related to policy problems such as competition from informal sectors, black market, and access to finance, land, tax rates, and macroeconomic conditions.

Ethiopia's economy is mostly based on agriculture, which accounts for 42.7 percent of GDP, 90 percent of foreign currency earnings and 80 percent employment, whereas industry, accounts for 12.3 percent of GDP, and services with 45 percent of GDP. The number of people engaged in paid employment very nearly doubled between 2006 and 2013 alone, and these figures are set to expand further in the near future (Zerihun et.al.2014; EIG, 2013). Around 80 percent of the population derives its livelihood directly or indirectly from agricultural production. The climate is a strong asset for activities like floriculture, an area in which the government is particularity keen to attract foreign direct investment. Various studies indicate that agricultural exports, mainly coffee, processed, and semi-processed hides and skins account for over 80 percent of all the export. Coffee alone account for over 64 percent of foreign exchange earnings (EIC, 2015; MoT, 2015).

In summary, Ethiopia, one of the least developed countries in Africa has witnessed a momentous economic growth in the past years. This is accompanied by the development of infrastructure and growing demographic rates, as well as a reduction in poverty, unemployment, inflation (still a major challenges), and corruption. The following section will outline the different policies adopted in Ethiopia to facilitate foreign investment and possible positive development impact from FDI.

6. Policies Adopted to Facilitate FDI in Ethiopia

"The government is doing a lot of interesting things to incentivize investors and I think because of where Ethiopia is and its development, it is a new time for new companies to come in (Washington, Interview)".

Like most least developed countries (LDCs), Ethiopia has been making efforts to improve its investment environment over the years by, for instance, reducing taxes, establishing an Ethiopian investment commission (EIC) to better assist foreign investors and by abolishing FDI-related restrictions. Essentially, the country has established a "one-stop" shop for dealing with investor requests. Furthermore, increased attention has been paid to policy initiatives at the bilateral, regional, and multilateral levels in order to enhance international cooperation and/or integration in matters relating to FDI. The state has adopted new measures and revised old foreign investment legislation, making it progressively more liberal and development-oriented. As a result, the investment environment for FDI and MNCs in Ethiopia has gradually improved over the decades (UNCTAD, 2002; EIA, 2013).

Implementing market oriented development strategies encourages the role of the private sector involvement in the development process (UNCTAD, 2011). The process of liberalization has picked up sharply the past few years. As one indication, the service delivery by the EIC (a government office mandated in promoting investment in Ethiopia) is incredibly efficient and effective. In the past, the issuing of investment licenses took well over three months, now it takes a little over three hours. This is about as clear as a signal as possible that foreign investors are welcome in Ethiopia (UNCTAD, 2004). In Ethiopia, the policy intervention and performance to benefit from FDI received different degrees of attention and recognition by the different regimes

Ethiopian economic performance is directly associated to the political and natural shocks the country has faced. The Ethiopian economy's performance can be classified and analyzed through three periods of political regimes in the country, the imperial regimes from 1960-1973, the Derg regime from 1974-1991 and the Ethiopian People Revolutionary Democratic Front (EPRDF) from 1991-present. None of them was able to bring remarkable growth to the country though the current government is making a significant and promising effort.

6.3.1. The Imperial Period (1960-1973)

Under this regime, the economy was organized in a market-orientated economic system, although, during this period, coffee, tobacco, petrol, and cement were monopolies held by the state. The imperial regime exerted some effort to promote a modern sector in the economy relying on foreign investment. It enacted an Investment Code praised as "one of Africa's most liberal". Under this regime, foreign investment was undertaken in the manufacturing sector for import substitution. The first labor union was organized in 1962 and by the end of the decade; it had more than 50,000 workers signed up (Markakis, 2011).

During this regime, agriculture was the foundation of the export trade, whereas coffee was the leading export, followed by hides and skins. Yet, exports constantly and increasingly fell behind imports, opening a significant deficit gap that became a structural flaw in the country's economy and remains, to this date, a threat to its stability. From 1963-1973 agriculture was allotted 4.2 percent of the state's combined ordinary and capital expenditure. However, the promising growth process of the imperial regime was halted by internal power struggles and revolution. Food production declined steadily, while the population was growing at a higher rate, which led to the shocking famines that swept the country during the beginning of 1970s. This brought massive opposition to the imperial regime and resulted in its overthrow and the declaration of Ethiopia as a communist country under the Derg regime (Markakis, 2011).

6.3.2. The Derg Regime (1974-1991)

This period marked the introduction of the command system of economic management, with radical Marxism as its confirmed ideology. The regime followed a centralized or a communist economic system. The mainly liberal policies of the pre-1974 imperial regime were replaced by centralized policies that discouraged a market economy and private property. The land reform measure undertaken in 1975 was one of the major policy reforms that took place immediately. Private ownership of land ceased as well as medium and large size enterprises were nationalized. Likewise, the government nationalized private banks and insurance companies. The economic performance of this regime is characterized by three phases.

The first phase, 1974-78, saw poor economic performance due to the emerging of new policies and the nationalization measures. GDP per capita growth was negative while the average annual growth rate of GDP was 0.3 percent. In the second phase (1978-80), the economy began to recover and the annual growth rate increased to 4.6percent. During this period, agricultural

production increased due to good weather and the economy was characterized by stability. During the third phase (1980-85), the economy performed badly due to severe drought that affected almost all the regions of the country and especially the Northern part of Ethiopia. Following this period, the economy continually stagnated. The government adopted a long-term plan, the Ten Year Perspective Plan, to tackle the structural problem. The plan aimed at diversifying the country's export sector as well as reducing the share of agricultural production in GDP while increasing the share of industry and foreign exchange earnings. During the target period, real GDP was 6.9 percent per annual, however, as most of the target was not realized, growth remained at about 2 percent and GDP per capita was negative (Geda et al. 2002).

The investment environment in general and FDI in particular were not encouraging during this period, due to political instability, insecurity and the nationalization of major industries, which severely discouraged foreign private investment. In 1983, the government attempted to revive FDI by introducing the Joint Venture Proclamation. The proclamation offered incentives such as a five-year period of income tax relief, import and export duty relief, tariff protection and repatriation of profit and capital. Nevertheless, the proclamation was unsuccessful in attracting foreign investors due to some of the conditions that did not favor foreign investors. For instance, one of the conditions was that in public-private partnerships, the state had to have at minimum a 51percent share and the manager of such an enterprise was to be an Ethiopian (Haile, 2006). During 1989, the government revised the 1983 proclamation by allowing majority foreign ownership in many sectors, and provided more protection to investors. However, the prolonged civil war and the political instability at the time further discouraged foreign investment. The political instability and the civil war consequently led to the overthrow of the Derg regime in 1991 by the current regime (EPRDF) (Markakis, 2011).

6.3.3. The Ethiopian People's Revolutionary Democratic Front (EPRDF)

The post-1991 period saw a series of reform measures in order to change the command economic system to a free market economy, in order to speed up the integration of the economy into the world economy and to encourage the wider participation of the private sector in the national economy's development process (MOFED, 2010).

Some of the stated objectives of the government are improving the country's human capital, infrastructure, reducing macroeconomic imbalances, eliminating structural distortion, as well as poverty alleviation. The current government emphasized on the important role of the private sector, and introduced an export promotion strategy to promote trade liberalization. The specific measures taken to promote the export sector and the participation of the private sector include the following:

- > 100% exemption from the payment of customs duties and other taxes levied on imports
- > Investors in agriculture and agro-based industries get tax breaks of up to eight years
- Investors engaged in manufacturing, generation, transmission and supply of electrical energy, agribusiness, and ICT are exempted from income tax for a period ranging from 1 to 9 years
- Investors who export at least 60% of their products/services or supply will be exempted from income tax for an additional 2 years
- > No export tax on Ethiopian export products except for semi-processed hides and skins
- Exemption from custom duties and taxes on imported goods and locally purchased raw materials which are used in the production of export goods

Increasing the role of the private sector in the economy is one of the main objectives of the current government, hence, the privatization program started in 1994. The Ethiopian Privatization Agency was established in 1994 and has the power to change and duties of transferring ownership from the state to the private sector (IMF, 1999). Implementing market oriented development strategies encourages private sector involvement in the development process. In order to encourage, promote, and expand private sector development initiatives. Its program highlights the importance of competitiveness as a key to success for sustained economic development in the country. Some of the important factors mentioned as a basis for competitiveness include a conducive investment climate, which focuses on macroeconomic stability, sound policy and an enabling regulatory framework for private investment as well as strong institutions that run and support the system (EIA, 2013). The new government sought to eliminate the constraints on FDI and to establish an enabling environment for foreign investors.

6.3.4. The FDI Regulatory Framework

Since 1992, with the objective of promoting domestic private investment and the inflow of foreign investment, a series of investment proclamations have been issued. The first investment proclamation no. 15/1992 was issued in May 1992, establishing the Ethiopian Investment Office. This proclamation however provided only few incentives for the agriculture sector and no incentives for other sectors.

The Investment Proclamation No. 280/2002 was amended in 2003 and the 2003 regulation of investment incentives constituted the main legal framework for both foreign and domestic investment (FNG, 2002). The framework included forms of investment and capital requirement, investment permits, concessions, incentives and facilities. These proclamations imposed some requirements and limitations. For instance, there was a minimum entry capital prerequisite for both wholly-owned operations and partnerships with local companies and individuals. In the case of joint ventures, the investment proclamation required that domestic partners hold a minimum of 27 percent equity ownership interest. In addition, both domestic and foreign investors were required to give an update of project progress every six months (ibid). However, in recognition of the role of the private sector in the economy, the government of Ethiopia has revised the Investment Code more than four times over the last twenty-one years (1992-2013) to make it more transparent, attractive, and competitive. Major positive changes regarding foreign investment have been introduced with the Investment Proclamation No.769/2012, the latest one that is now in effect.

The minimum capital requirement for the registration of FDI per project depends on the ownership structure and area of involvement to be registered as foreign direct investment. For a foreign investor to have a full ownership of a project, a minimum of USD 200,000 is required per project. Nevertheless, if a foreign investor wants to invest in a joint venture with domestic investor(s), she/he is required a minimum amount of capital per project. A foreign investor can team up with a domestic investor or company for a joint investment, usually in the form of a partnership, or private limited company. Under the Investment Proclamation No.769/2012, a minimum equity capital of 150,000 USD is required from a foreign investor who intends to enter into a joint venture partnership with a domestic investor. The restriction under the previous

Investment Proclamation that required the domestic investor to own a minimum of a 27 percent equity share capital in a joint venture has now been revoked. However, the minimum equity capital requirement for foreign investors investing in areas of engineering, architectural, accounting and audit services, project studies or business and management consultancy services or publishing is only 50,000 USD when it is made jointly with a domestic investor and 100,000 USD when it is wholly owned by a foreign investor. The foreign partner can fulfill this minimum equity capital either in cash, in kind or both (EIA, 2013; FNG, 2012).

In addition, foreign investors who exports at least 75 percent of their production and/or reinvest their profits and dividends are exempted from the minimum requirement of capital. Likewise, as a requirement, a foreign investor must get an investment permit first by submitting a formal application with the required documentation and the capital required (UNCTAD, 2004). Furthermore, under the current regulatory framework, foreign participation in investment maybe carried out either through the establishment of branches or through locally incorporated enterprises. The Ethiopian investment codes also provide guarantees to create a reassuring business environment for potential foreign investors. Specific guarantees that have been issued for FDI include, full repatriation of capital profits including dividends, interest payment on foreign loans, payment for technology transfer and management agreements, or liquidation of enterprises (UNCTAD-ICC-2000).

Foreign investors are encouraged to invest in all economic sectors except those currently reserved for local private and state investment. There is also a continuous review of the investment code regarding the sectors excluded from FDI. The main business sectors which are open and in which the country is currently seeking foreign investment consist of:

- Manufacturing industries such as food, beverages, chemicals , pharmaceutical, plastics, metallic and non metallic products, paper products, leather products, textiles and garments
- > Agriculture, including agribusiness and processing for export
- Real estate development
- Education and the health sector
- > Mining and quarrying of gold, marble and granite

Engineering and management consultancy

6.3.5. The FDI Institutional Framework

Ethiopian Investment Commission (EIC) as mentioned above is meant to promote, coordinate, and facilitate foreign investment in the country. Please see appendix 3 for stages of FDI project implementation. According to the Investment Guide to Ethiopia, the functions of the EIA amongst other include:

- Issuing investment permits, work permits, trade registration certificates and business licenses as part of its one-stop-shop service
- > Providing all the necessary information required by foreign investors
- promoting and facilitating FDI, including the registration of technology transfer agreements and export-oriented non equity based collaborations with foreign enterprises
- > Monitoring the implementation progress of licensed investment projects
- Advising the government on policy measures needed to create an attractive climate for investors
- Negotiating and upon government approval, signing bilateral investment promotion and protection treaties with other countries

Moreover, the market-oriented economic policy of 1992 recognizes the leading role of the private sector in the economy. The government is keen to encourage the participation of foreign investors in the privatization program, particularly in large state owned companies. In recent year, the Ethiopian Privatization Agency and the Public Enterprises Supervising Agency have emerged as one to facilitate and coordinate the implantation of privatization program. During the first phase of privatization in Ethiopia, the EPA privatized 176 small enterprises using in house expertise and government resources. Recently, the last government owned coffee plantation was sold to private enterprises (Capital, 2015). Other government departments that are involved in the attraction of FDI to Ethiopia include, the Ministry of Trade and Industry, the ministries and agencies associated with specific sectors such as mining and tourism, the ministry of Foreign

Affairs and ministries dealing with taxation remits including custom. Additionally, there are regional investment promotion agencies that encourage FDI into their region (UNCTAD, 2004).

All in all, from the imperial period to the present, successive governments in Ethiopia have instituted regulations at the industry and firm levels designed to influence and facilitate the amount and the characteristics of FDI. Nevertheless, the current regime since 1992 has made enormous efforts to attract, and assist positive developmental effects of FDI in Ethiopia.

7. Foreign Direct Investment Trend in Ethiopia

In section 5 on an overview of the Ethiopian economy, we saw that economic development and FDI performance in Ethiopia correlated with the different political regimes and institutions. This is in line with Dunning and Narual's IDP theory that explains the evolutions of a country's in ward FDI position with the level of economic development, and government policies play a crucial role in determining these. This part will attempt to outline the different policy regimes and their interaction with FDI development in Ethiopia.

As mentioned in section 5, the performance of the Derg regime in attracting private investment and particularly FDI was insignificant and unattractive. Policy interventions of the Derg regime were not welcoming for private investment. The regime preferred to nationalize major industries and land. Degefe (1992) explained that the Derg regime did neither rule out the participation of foreign investment in the economy nor encourage it as a policy matter. Discrepancy between policy calls for foreign investment and actions of the government towards investors kept Ethiopia from benefiting from foreign investment. Likewise, in addition to missing policy incentives, the unstable political situation as well as the nationalization of major economic activities impeded domestic private investment and FDI.





Source: own computation in Stata using UNCTAD data on FDI inflow to Ethiopia

As figure 4 above shows a sharp decline of FDI followed the coming to power of the Derg regime. The graph depicts a continuous decline in inflow of FDI, at worst with a negative inflow. Private foreign investment inflow in Ethiopia during the era of Derg remains substantially lower at about an average of Birr 9.23 million per year in real terms, with years that have experienced an outflow or negative inflows. Foreign capital inflow to Ethiopia is more embraced because of a policy shift from a command economy to a market-oriented economy in the 1990s.

The new regime sought to eliminate the constraints on FDI and to establish an enabling environment for foreign investors. The authorities began to promote Ethiopia more vigorously as a location for FDI in the early 1990s and since then foreign investment has certainly been growing in Ethiopia. FDI increased by 15 percent to USD 6.2 billion in East Africa as a result of increasing inflows to Ethiopia. The country adopted several major economic structural changes such as economic liberalization and private sector development. More recently, the government launched a five-year Growth and Transformation Plan (GTP), which aimed at achieving

Millennium Development Goals and enabling the country to become a middle-income country. Yet, Ethiopia's gross domestic savings as a proportion of GDP is quite low, and it is unlikely to achieve its short and long-term objectives by mobilizing the insufficient domestic savings i.e. 9.4 percent (MOFED, 2010). In addition, all the policy incentives mentioned in section 6 imply a considerable effort made by the government to attract foreign capital into the growth endeavor of the country. As a result, the country saw a sharp rise in FDI inflow in the beginning of the 1990's. Likewise, in the first half of the 1990s, FDI inflows averaged USD 8.2 million a year. In the second half of the decade, it expanded to an annual average of USD 155 million. FDI then declined sharply in 2001 and picked up again in 2002 (UNCTAD, 2004).

Likewise, it has been reported that as of July 2015 the EIC has processed and licensed a total number of 5,068 FDI projects, of which 2,280 have become operational while other 1,006 FDI projects are under implementation. The rest 1782 FDI projects are approved foreign investment projects awaiting implementation. Out of the 2,280 FDI projects that have been operational, the manufacturing sector accounted for the highest share in FDI inflow followed by the service sector. The country has attracted significant foreign investment in textiles, leather, commercial agriculture and manufacturing. The majority of FDI flow is in the manufacturing sector, which accounts about 45 percent, the service sector 42 percent, and the agriculture sector 12 percent of FDI respectively (EIC, 2015)





Figure 6: Operational FDI Projects



Source: own computation on Stata and Excel from EIC unpublished data, August 2015

When one compares FDI data from UNCTAD and EIC, there seem to be a difference in the periodic annual fluctuation in FDI inflow. The mismatch is because UNCTAD takes account of

investment flows that become operational in the same year while EIA data takes record of all the licensed investment flows.



Figure 7: FDI Inflow to Ethiopia in millions of USD

Source: own computation using UNCTAD database

Possible explanations for the trends of foreign investment inflow in Ethiopia is mostly none economic factor such as war, drought and political unrest. For instance, as shown in the figure 7 the sharp decline in FDI inflow in 1999 is likely linked to the then border conflict between Ethiopia and Eritrea. Likewise, the severe drought in 2002 could possibly explain the decline in 2002. There is a foreign capital boom in 2004 and 2006, which is directly related to massive petroleum exploration in the country particularly in Ogaden region (UNCTAD, 2007). The decline in FDI inflow in 2005 could possibly be explained by the negative impact of the political unrest due to huge disagreements between political parties following the then election. The decline in 2007/08 reflects the global financial crisis world wide as well as economic instability in Ethiopia.

Foreign investment in Ethiopia remains limited by source country, regional distribution, and sector involvement. In general, the majority of FDI inflows to Ethiopia are from developing countries such as China, India, Turkey, and Saudi Arabia. A single company called MIDROC

group dominate Saudi Arabia's investment. This makes Saudi Arabia take the leading place for the source of foreign investments from the Middle East. According to an unpublished report from the EIC (2015), China takes the leading place as a source of private foreign investment into Ethiopia: 19 percent out of the total number of FDI projects comes from China; Africa as a region takes the second position (14 percent) followed by Europe (13 percent) in terms of the number of foreign investment projects. Likewise, in terms of total capital investment, China again takes the leading place, USD 906.1 million, followed by Saudi Arabia USD 878.2 million.



Figure 8: FDI Projects by Country of Origin

Source: own computation based on unpublished data from the EIC, August 2015. Others* = countries who have project/s jointly, for instance, Algeria/Saudi Arabia/Ethiopia have 3 FDI projects jointly

Additionally, as one can see from figure 9, Ethiopia seems to suffer from large disparities of FDI inflow between the main regions. For instance, more than half (52 percent) of FDI is in the capital city (Addis Ababa) but a further 29 percent is located in Oromia, thanks to the resource reach nature of that region. Such a situation leaves the other 10 regions almost without any

foreign investment; this can create and deepen the imbalanced economic growth and the accompanying social disparities.



Figure 9: FDI Projects by Region

Source: own computation from EIC unpublished data, August 2015.

An important issue in the context of FDI in Ethiopia is sector restriction. Many sectors that have the potential to attract foreign investors remain reserved for public involvement, domestic investors, and for Ethiopian nationals only. According to the EIC, the following areas of investment are exclusively reserved for Ethiopian nationals (FNG, 2012).

- Banking, insurance and micro-credit and saving services
- > Packaging, forwarding and shipping agency services
- Broadcasting and mass media services
- Attorney and legal consultancy services
- Preparation of indigenous traditional medicines
- Advertisement, promotion and translation works
- > Air transport services using aircraft with a seating capacity up to 50 passengers

In summary, foreign direct investment in Ethiopia has increased enormously in the past years. Government policies have played a significant role in influencing FDI inflow into Ethiopia. Under the command economic system, the investment environment in general and FDI in particular was not encouraging during this period, due to political instability, insecurity and the nationalization of major industries, which severely discouraged foreign private investment. In the 1990s, with a new government Ethiopia opens up for FDI. The government took a number of measurements to improve its investment climate and attractiveness to potential investors. Yet, FDI in Ethiopia remains limited by source country, regional distribution, and sector involvement. In the following section, econometrics models will be applied in order to quantify and analyze the impacts of FDI in economic development through real GDP, export, and spillovers.

8. The Development Effects from FDI in Ethiopia

In this section, we will shed more light on the empirical interactions of FDI with economic growth, export performance, and spillovers in the Ethiopian economy. In order to do this, econometric tools of time-series data analysis are applied. Thus, in this section, first, the basic and detailed model that will help to look at the interactions will be specified. Second, the data used in this analysis will be explained followed by the estimation of the models specified.

8.1. Real GDP Growth

It is well known that there is no single way to bring about development. This implies that sources and ways of economic development differ across countries. Governments in different countries take different policy measures in order to accelerate their economic development. Economic development is one of the main objectives of every society in the world and other things being equal, economic growth is fundamental to economic development. There are many variables that contribute to economic development.

Theoretically, FDI in the neoclassical growth model promote economic growth by increasing the volume of investment, in the endogenous growth model, FDI raises economic growth by generating technological diffusion from developed countries to developing countries where lack

of appropriate technologies and financial resource is hampering development (Borensztein et.al., 1998).

In this section, we start from the standard production function and extend to include our variable of interest in order to test to what extent FDI explains economic growth in Ethiopia. In order to test this, a standard production function is used given by: Y = f(K, L), where output is a function of capital and labor. In order to capture the impact of FDI on growth, FDI is explicitly incorporated in the model. The following variables are the variables included in the growth model. The rationale behind the inclusion of these variables is explained below:

Real Gross Domestic Product (RGDP): Real GDP is included to capture the performance of the economy. It is the main outcome variable in this study. Economic growth is conventionally measured as percent rate increase in real GDP. It is measured as a log of nominal Gross Domestic Product (GDP) deflated by GDP deflator.

Foreign Direct Investment (FDI): FDI is measured a as log of FDI stock per GDP in USD, based on theoretical and empirical justification, the relationship between real GDP growth and FDI is expected to be positive although circumstances might influence this relationship otherwise.

Labor (**L**): Total labor force comprises people ages 15 and older who meet the International Labor Organization's definition of the economically active population. It includes both the employed and the unemployed. In this paper, labor is measured as a ratio to GDP.

Domestic Investment (DI): Domestic investment is measured as the difference between total investment and FDI. Domestic investment is seen as one of the major driving forces of economic growth.

Government Expenditure (GExp): Government consumption expenditure (in million USD) captures the effects of government role in economic growth. Most previous research finds a negative impact of government expenditure on growth. The underlying rationale is that public spending crowds out the more efficient private investment.

Trade (T): Trade is taken as a proxy for openness, which is defined as the share of exports and imports in GDP. Openness to trade has been used extensively in the economic growth literature as a major determinant of growth performance. This variable is meant to serve as a proxy for a country's degree of trade openness or "outward-orientation".

Regime Change Dummy (RCD): A dummy variable is used to control for the potential effects of regime changes often instigated by economic reform which change the growth rate or level of one or more variable and alters the relationship.

Y = f(DI, FDI, GExp, T, L)(1)

Taking the natural log of this production function; the growth rate of real GDP, denoted as LnRGDPGR can be specified as a factor of log of domestic investment (LnDI), log of inward FDI stock per GDP (LnFDI/GDP), log of labor per GDP (LnL/GDP), log of government expenditure per GDP (LnGExp/GDP) and log of trade per GDP (LnT/GDP). The empirical model is specified as:

Where t denotes time, α is a constant term and the betas are respective coefficients of the explanatory variables. This model will be modified in order to incorporate a dummy variable for a regime and/or structural change in Ethiopia. As the current regime structural change in terms of FDI policy and Ethiopia's openness to the world has a great impact on economic growth in Ethiopia, to control for this, a dummy is included.

In this model, β s represent the elasticity of real GDP growth rate with respect to each variable they are attached. The effects of independent variables on the dependent variable (real GDP) are expressed via the magnitudes of the coefficient estimates, their signs, and statistical significance. In the above equation, the main variable of interest is LnFDI/GDP, thus β 2 is the coefficient of interest that tells us the percentage response in real GDP growth for a percentage change in FDI/GDP stock.

8.1.1. Unit Roots Test

To do any meaningful analysis with econometrics results, it is important to distinguish between correlation that arises from a share trend and one associated with an underlying causal relationship. To achieve this, the data were tested for Unit Root or Non-Stationary. Regression of none stationary time series will lead to spurious estimates. Unit Root tests deal with the situation where estimation result claim statistical significance of the long run relation between variables in a given regression analysis just because of trending relations among these variables than presence of true momentous casual relations. Thus, one must check for this and avoid the problem by making the variables stationary, where each of the variables has constant mean and variance. This paper uses Augmented Dickey-Fuller (ADF) test to check for Unit Root or Non-Stationary of the variables and apply differencing to avoid the case. The results of unit root for the variables are indicated in the following table (Wolters, 2007).

Variables at level	ADF test statistics	Variables at first	ADF test statistic
		difference	
LnRGDPGR	-3.836**	DLnRGDPGR	-8.445***
LnFDI/GDP	-0.461	DLnFDI/GDP	-3.374***
LnL/GDP	0.366	DLnL/GDP	-3.754***
LnT/GDP	-1.093	DLnT/GDP	-6.533***
LnDI/GDP	-0.918	DLnDI/GDP	-6.078***
LnGovEx/GDP	-2.657	DLnGovEx/GDP	-4.943

Table 4: ADF Unit Root Test Result for Level and Differenced variables

Source: own computation using Stata software

Note: Critical Values are at 5 percent =-2.95 and at 1 percent = -3.64. **= Indicates stationary at 5percent level of significance, and *** = Indicate stationary at 1 percent level of significance

The ADF tests reported in Table 4 reveal that all the variables are non-stationary at the level form. Stationary has been achieved after the first differences. The results suggest that the null hypothesis of a unit root in time series cannot be rejected at 1 and 5 percents significance levels. At difference level, the hypothesis that the variables has unit root is rejected and the time series variables become stationary. Thus, variables are integrated of order one and considered as I(1) processes (Verbeek, 2012).

Following the unit root test and knowing the order of integration, a regression analyses is used to estimate the relationship between FDI and economic growth. The regression equation model is tested for the violation of the major classical assumption so that a meaningful inference can be made from the output. The main classical Ordinary Least Square assumptions (multicollinearity, heteroskedasticity, serial correlation, test for omitted variable and normal distribution) have been checked using econometrically recommended tests (Verbeek, 2012).

Table 5: Classical OLS Assumptions

Ramsey test for omitted variable	F-statistic: 4.43	P-value : 0.0134
Breusch-Pagan test for	$ChiX^2$: 1.48	P-value : 0.2242
heteroskedasticity		
Breusch-Godfrey LM test	F-statistic: 0.326	P-value : 0.5734

In order to verify the classical assumption for using the Ordinary Least Square method the regression equation is first subject to the Ramsey test for omitted variable (specification error). As it can be seen in table 5, the hypothesis that the model has no omitted variable is not rejected at a 5 percent significance level, confirming that there is no omitted variable in the model. The Breusch-Pagan test was conducted for the presence of constant variance of the error term/heteroskedasticity. A large chi square would indicate that heteroskedasticity was present. In this case, the chi square value was small, indicating heteroskedasticity was probability not a problem, hence constant variance of the error term. A test for serial correlation (autocorrelation) was done using the Breusch-Godfrey LM test for no autocorrelation and the results indicate that there is no autocorrelation. Moreover, all the variables are normally distributed and the model does not does not demonstrate a serious multicollinearity problem. One could think of a collinearity problem between openness and FDI, but multicolinearity is less of a concern than omitted variables. Hence, it is better to include both than exclude one because of multicolinearity.

Table 6: Regression Result with Inward FDI Stock

Explanatory Variables	Long run coefficients
Stock of FDI	0.433
	(2.98)***
Domestic Investment	0.188
	(2.59)***
Labor	-1.041
	(-7.27)***
Trade	0.0023
	(0.03)
Government expenditure	0.179
	(1.46)
Regime Change Dummy	-0.0874
	(-2.58)***
R square value	0.71
F value	11.21
Numbers of observation	35

Dependent Variable: Real GDP Growth

Source: own computation using Stata soft wear

Note: ***=significant at the 1 percent level significance, **= significant at the 5 percent level significance, *=10 percent significance. Numbers in brackets are t-values of the corresponding variables

As shown in Table 6, the regression equation result indicates FDI inflow measured in stock is found to affect economic growth positively in Ethiopia and is highly significant at the 1 percent level. This indicates that inflow of FDI stock and economic growth (real GDP growth) in Ethiopia has a positive relationship. Thus, the empirical finding supports the positive interaction between FDI and real GDP growth in Ethiopia. Likewise, domestic investment is related positively to real GDP growth, and it is also found to be significant, at less than 5 percent level. This implies domestic investment has a significant impact as well as FDI in promoting economic growth in Ethiopia. One important observation noteworthy is that FDI in Ethiopia does not have a crowding out effect to private domestic investment.

The result rather shed light on the possibility of FDI crowding in effect on domestic investment. It can be argued that FDI has a complimentary effect on domestic investment in the Ethiopia economy. In fact, FDI and local investment are complementary in many ways, as MNCs need a minimum level of local services and suppliers to operate. Efficient, dynamic domestic business and high level of national investment are particularly significant for "*efficiency seeking FDI*" which Ethiopia needs to attract on a much larger scale and sustainable basis if they are to integrate into global values chains in the future (UNCTAD, 2011).

The coefficient for labor is found to be significant at 1 percent level, but negatively related with economic growth in Ethiopia. This could be due to the lack of unskilled labor in the Ethiopian economy. The two variables, trade (a proxy for the economy openness), and government expenditure are positively associated with real GDP growth in Ethiopia but are statistically insignificant. A dummy variable was used to capture the effects of regime change in Ethiopian economic growth. The variable is highly significant at 1 percent level, however, negatively associated with economic growth. This is somehow counterintuitive as Ethiopia is witnessing a double digits economic growth that has not been seen in Ethiopian history with the current regime and structural changes. One could argue, however, at the beginning of the current regime, Ethiopia has experienced a sharp decline in GDP growth due to political instability within the country and war between Ethiopia and Eretria in the 1990s. Thus, the dummy possibly captures this sharp decline in real GDP growth.

The economic growth empirical finding in this paper is in line with modernization theory scholars, that FDI raises income level, provides employment opportunities to the host country and thereby boosting overall economic growth. In contrary to the dependency scholars where FDI is assumed to have a crowding out effect and reducing countries overall development level, FDI in Ethiopia has been found to have a "crowding in" effect on domestic firms rather than squeezing out local entrepreneurs. The main regression result indicates that FDI has a positive effect on economic growth. The magnitude of this effect, however, might depend on the interaction of FDI with control variables and other uncontrolled variables. This means, if FDI has a positive impact on economic growth, it increases market size, and a large market size attracts more FDI. Thus, FDI and growth are interdependent in a nontrivial way that needs to be

somehow addressed in the econometric analysis. This finding is also in line with Bengoa et al. (2003), where they found significant and positive effects of FDI in economic growth.

8.1.2. Co-integration Test and Result

When we have variables with unit root at level and, they become stationary at first differencing, this in other words is an indication of a co-integration or a long-term relationship between the variables, which is the case for the selected variables on the growth equation model. Thus, to check for the existence of a long-run relationship, this paper has utilized the Engle-Granger co-integration test. This is a residual based co-integration test method, i.e. testing for unit root on the estimated residual using ADF test, and applying the Engle-Granger critical value for unit root testing. When a co-integration relationship is present, it implies that the variables share a common trend and long run equilibrium as suggested by econometric theory (Granger, 1987). The residual is found to be stationary at level indicating the variables are a co-integration regression and the equation presented above is a long run equation.

Table 7: the Co-integration Result on Estimated Residuals

Test statistic	1percent critical value	5percent critical value	10percent critical value
-6.096 ***	-3.689	-2.975	-2.619

MacKinnon approximate p-value for Z(t) = 0.0000 ***= is significant the 1 percent significance level

This verifies the fact that when there is a co-integration in time series variables, there must be either a bi-directional or uni-directional Granger causality between them (Kirchangassner, 2007).

8.1.3. Casual Relationship

The presence of co-integration among the variables implies implicitly causality. Yet, it does not specify the direction of causality. To know the direction of causality (the reverse effect as shown in the analytical framework), a Pair-wise Granger no causality test was employed. In testing for Granger no causality, two variables are usually analyzed together while testing for their interaction. There are four possible results of the analysis: 1) Unidirectional Granger causality from real GDP growth to FDI inflow, 2) Unidirectional Granger causality from FDI inflow to real GDP growth, 3) Bi-directional causality, and 4) No causality. The hypothesis that FDI does

not granger cause real GDP and vice versa was tested. Here, the main results obtained from the Pair-wise Granger causality analysis are presented.

Pair-wise	Observations	F -statistics	P-value	Decision	Type of
Hypothesis					Causality
RGDP growth does not Granger cause FDI stock inflow	31	1.433	0.2564	Do not reject	Unidirectional causality
Inward FDI stock does not Granger cause RGDP growth	31	5.615	0.0029	Reject	Unidirectional causality

Table 8: Pair-wise Granger Causality Test

Decision rule: reject the null hypothesis (H_{0}), if *P*-value < 0.05

Looking at the above table of Granger no causality test result one can see the direction is unidirectional causality between the variables (real GDP growth and FDI). We fail to reject the null hypothesis (real GDP growth does not Granger Cause inflow of FDI stock in Ethiopia). On the other hand, we reject the null hypothesis, that inflow of FDI stock does not Granger cause real GDP growth in Ethiopia. In other words, there is a one-way relationship between foreign direct investment and economic growth in Ethiopia and the direction of this relationship is from foreign direct investment to economic growth. This finding is in line with Magnus and Fosu (2008) empirical works for Ghanaian economy which indicate that the null hypothesis of FDI does not Granger cause GDP were not rejected and that is there is a one way casual relationship between FDI and GDP growth.

8.2. Export Performance

Export performance in Ethiopia has been steadily improving, although with some difficulties. Exporting allows firms in developing countries to enlarge their markets and benefits from economies of scale. Likewise, several scholars have pointed out the importance of exporting as a channel of technology transfer (Shan, 1993).

In Ethiopia, primary and limited products such as coffee, pulses, oilseeds, gold, live animal, and animal products dominate more than 80 percent of the export sector. The current government policy object is toward high value added export products, to increase the volume and composition of manufactured exports as well as to get away from trade deficit gap. Ethiopia is now the second largest flower exporting country in Africa and the fourth in the world. Currently, Ethiopia exports its cut flower to the Netherlands, France, Germany, Italy, Canada, Norway, Sweden, UK, Middle East, and other EU countries (EIG, 2013).

As in the case of many developing countries, Ethiopia's export has been limited to few products, which are mainly agricultural commodities. According to the World Bank (2009), the share of Ethiopia's manufacturers export in the total export is only 9 percent implying primary agricultural commodity to be 91 percent. Nevertheless, export earning in Ethiopia is growing continuously from year to year both in terms of variety and in terms of volume. Export earnings from gold (61.1 percent) fruits and vegetables (0.1 percent), live animals (63 percent), chat (13.7 percent), pulses (6.0 percent), coffee (59.3 percent), meat (86.2 percent), flower (3 percent), leather and leather products (84.1 percent) have been increasing since 2010/11 (EIC, 2013).



Figure 10: Export Performance by Sector





Source: Own computation based on EIC unpublished data, August 2015, others include fruits & vegetables, cereals, spice, tea, chemicals etc.

Theoretically, the export enhancing power of FDI is explained by the existence of multinational corporations and their interaction with domestic firms. The existence of MNCs boosts a country's exports simply by exporting their production while their interaction with domestic firms increases the competitive capacity and provides access to large and new external market. Hence, FDI can enhance the host country export performance and capacity by directly exporting form MNCs themselves and indirectly by stimulating domestic firms export propensity (UNCTAD, 2002). The role of MNCs in expanding export performance of the host country is derived from the additional capital, technology, managerial expertise, and know-how that they bring along with access to international markets.

8.2.1. Correlation

It would have been more accurate to use a disaggregate data, such as sectoral FDI and sectoral export performance; nevertheless, lack of sufficient long run data has made this approach undoable. Hence, this section analyzed the existence of linear association between foreign direct investment and export performance, and then the direction of causality of export and FDI in Ethiopia.

Table 9: Pair Wise Correlation between FDI and Export

	Inward FDI stock	Export
Inward FDI stock (pair wise	1	
correlation)		
Export (pair wise correlation)	0.511***	1
	(0.0077)	
Number of Observations	26	26

Source: own computation in Stata based on data from Word Bank and UNCTAD

Note: Value given in bracket is P-value of the pair wise correlation, *** = significant at 1 percent level of significance

As can be seen from the table 9 above, the Pair-Wise correlation coefficient indicates that there is a positive correlation between foreign direct investment and export performance in Ethiopia, and it is significant at 1 percent level of significance. However, economically the effect can be taken as moderate as the magnitude is 0.5. This could be due to the fact foreign investors have no large and significant share in the export-oriented production which makes the contribution of foreign investors to the country's export performance modest. According to UNCTAD (2008), industrial sector took the largest share of foreign investment flows to Ethiopia about 62 percent, of which three sectors, food, beverage and tobacco account for 44.6 percent, and chemical and chemical products account for 22 percent of this investment (UNCTAD, 2008).

Although, all these sectors, having major shares in foreign investment inflow, they remain far from being export oriented sectors of the Ethiopian economy. Among the main export items of Ethiopia, cut flowers and textile are the areas seen to have large foreign involvement but these sectors account minor share of the export sector. For instance, flowers accounts only 9 percent while leather and leather products claim 26 percent of the total export in 2013/14. Other sectors where foreign investors involved are not even listed as major export items (EIC, 2015). One out of the five companies I have interviewed, only one of them is an export oriented company.

"40 percent of total annual production is exported to different parts of the world but lack of foreign exchange reserved is the main challenges, there are times where we stop production because we cannot import raw materials" (Hailue, Interview). Additionally, one of the major constraints of the Ethiopian export sector includes exchange rate overvaluation. The Ethiopian currency, the Birr, remained rigidly pegged to the US dollar through central bank intervention (Berhane, 2014). Likewise, low level of investment, inadequate marketing infrastructure, high raw material import tariffs, and insufficient adjustment of producer prices are other major limitation to the export sector performance. Moreover, limited competitiveness, lack of foreign exchange reserve and poor infrastructure facilities (although it is improving slowly in the past 2-3 years) are the potential explanation.

Theoretically, export-enhancing effects of FDI can also be viewed as a spillover effect of FDI. This effect can arise via MNCs export activities, often MNCs have better access to information about foreign markets and this can spillover to domestic firms. It is assumed that domestic firms can learn from MNCs management/production techniques through observation and enable themselves to compete more successfully in the export market. In addition, competition with MNCs at home and in the foreign market can induce domestic firms to improve their export performance (Greenway et al. (2004). The next section will investigate the spillover effects of FDI in Ethiopia in relation to productivity growth and FDI.

8.3. Spillovers

The principal objective of this section is to analyze productivity externalities spilling over from MNCs at an aggregative level. Although it is much more accurate to analyze spillover effects on domestically owned firms, this section focuses on overall spillover effects in the Ethiopian economy arising from foreign investment. This is due to lack of data. Spillovers, in terms of transfer of skills are notoriously difficult to measure and evaluate. Hence, the main attempt here is to see if there is any correlation between productivity and FDI in Ethiopia.

It is assumed that foreign investment not only boosts national income but also provides secondary spillovers resulting in productivity growth. Many scholars argue that domestically owned firms might benefit from the presence of foreign firms. Workers employed by foreign firms or participating in joint ventures may accumulate knowledge, which is valued outside the firm. As experienced workers leave the foreign firms, this human capital becomes available to domestic firms, and thereby raising productivity. If foreign firms introduce new products or

processes to the domestic market, domestic firms may benefit from the accelerated diffusion of new technology. In some cases, domestic firms may increase productivity simply by observing nearby foreign firms. In other cases, diffusion may occur from labor turnover as domestic employees move from foreign to domestic firms. Likewise, some firm-specific knowledge of the foreign owner might "spill over" to domestic industry as domestic firms are exposed to new products, production and marketing techniques, or receive technical support from upstream or downstream (Gorg et.al. 2004; and Aitken et. al 1999). Several studies have shown that foreign firms initiate more on the job training programs than their domestic counterparts do. This is also the case found through the interviews with the foreign companies in Ethiopia.

"we are hiring a bunch of people obviously which will be really good for the economy, we have training for them and we are also going to work with Debre Berhan University because our factory is in Debre Berhan. We are going to work with Debre Berhan University to build some courses, some courses will be glass focused and some will be in general mechanical engineering, more general skills that will be help for us (Washington, Interview).

"We go to Ghana and England for training regularly (Bekele, Interview)"

"Workers who provide technical support have been trained by experts from Denmark and went for training to Denmark. The company operates fully by domestic resources from production to packaging (Hailue, Interview)".

According to these interviewees, it could be assumed that knowledge is gained from foreign companies and likely to be transferred to local employees and there by stimulating indirectly the possibility for positive spillover effects of FDI in the Ethiopian economic development. As these workers employed by foreign firms may accumulate knowledge, which could be valued outside the firms.

8.3.1. Correlation

It is argued that the positive impact of foreign direct investment on the labor productivity of host industries is achieved through the establishment of technology, management skills, techniques,

which then spillover on the local firms. On the other hand, FDI can have a negative impact on productivity growth due to the incapability of host country to adapt to technology advancement (Xu, 2000). The approach usually adopted in the empirical literature consists in capturing the spillover effect in econometric analysis where labor productivity is regressed on FDI and other assumed variables. In this thesis, productivity is measured at aggregate level. It is measured as real GDP (calculated as nominal GDP divided by GDP deflator) divided by labor. This thesis has conducted a regression analysis, taking productivity as dependent variable and all the other variables (except for labor) from growth equation model, in previous section as independent variables.

The result indicates statistically insignificant and negative relationship between FDI and productivity growth. The rest of the variables were also found to be statistically insignificant to predict productivity growth. Perhaps, a standard OLS model is not a good fit for this regression equation. Hence, the results are indicative rather than conclusive. One explanation for the apparent lack of correlation between FDI and productivity is that productivity externalities spilling over effects from MNCs to domestic industries from FDI are hardly interzalisable in poor economies like Ethiopia. This finding is in comport with Nunnekamp (2004), that host economy with better endowment of human capital and absorptive capacity are supposed to benefit more from FDI induced technology transfer. Ethiopia being one of the least developed countries, human capital and absorptive capacity are the main challenges for foreign investors (according to my interviews) and yet to be improved. The regression results are not presented here as they do not really make a valid economic sense (please refer to appendix 2), instead, a correlation table is presented to show the negative and insignificant relationship.

Table 10: Correlation between FDI and Productivity

		Inward FDI stock	Productivity
Inward FDI stock	(pair wise	1	
correlation)			
Productivity (pai	r wise	-0.294***	1
correlation)		(0.0868)	
Number of Observation	ns	35	35

Source: own computation in Stata based on data from Word Bank and UNCTAD Note: Value given in bracket is *P*-value of the pair wise correlation, * = significant at 10 percent level of significance

In spite of theoretical arguments supporting spillovers, it may simply be insignificant in reality as MNCs maybe effective at ensuring firm specific assets and advantages do not spillover. Moreover, the bigger the technological distance between the host and home country, the less likely the host country to have the human capital, physical infrastructure, and distribution network to support inward investment. Likewise, suggests that educational level, development of local financial markets, and other local conditions play an important role in allowing the positive effects of FDI to materialize (Borensztein et al., 1998; Xu 2000; Alfaro et al. 2003. Blomstrom and Kokko (2003) concluded that spillovers are not automatic, and local conditions influence firms' adoption of foreign technologies and skills.

8.4. Summary of Empirical Analysis and Discussion

The descriptive part of the analysis examined the performance of the Ethiopian economy by applying the IDP framework with respect to government policies under the different regimes. The command economic system with the import substitution trade regime, and the market oriented economic system with outward oriented policy gave an excellent opportunity to look at the role of different policy factors in explaining the performance of the Ethiopian economy.

In the empirical analysis, the impacts of foreign direct investment on economic development in Ethiopia were investigated. In this thesis, economic development is measured in terms of real GDP growth, export performance, and spillover effects, and FDI is assumed to affect economic development through these three channels as outlined in the analytical framework. The growth analysis applied a standardized production function, in line with the modernization school of thought, based on neoclassical and endogenous growth models. The model was extended to include FDI and other controlled variables to capture the impact. The analysis found that inflow of FDI stock is positively associated with economic growth and statistically significant at the 1 percent level of significance. The analysis also found a positive and significant relationship between domestic investment and economic growth. This could further be argued the possibility of a "crowding in" effect from FDI. This could mean that FDI and domestic investment in Ethiopia complement each other instead of FDI being a substitute for domestic investment. The growth analysis also found that there is a long run relationship among the selected variables in

the growth equation. Likewise, a Engle-Granger causality test was applied to see if FDI causes economic growth or economic growth causes inflow of FDI, the reverse effect as shown in the analytical framework. The result showed a uni-directional relationship i.e. economic growth does not granger cause FDI in Ethiopia.

To investigate the relationship between export performance and FDI inflow in Ethiopia, this thesis applied a correlation test based econometric/statistical analysis. The result shows that there is a positive association between FDI and export growth in Ethiopia, though the coefficient value is moderate, i.e. the relationship is not a strong one. Export performance enhancing effects of FDI in Ethiopia were more or less promising but did not provide a satisfying result perhaps due to lack of foreign investment in major export sectors of the country

This paper also investigated the effects of FDI on productivity growth in Ethiopia in line with spillover analysis. The regression analysis found a statistically insignificant and negative relationship between FDI and productivity growth in Ethiopia. In addition, the spillover correlation analysis indicated a negative relationship between productivity and foreign investment in Ethiopia. On the other hand, one gets the impression from the interviews made in this paper that foreign companies do offer special training, which will enable domestic employees to gain technical knowhow and general skills that could increase the probability of positive FDI spillover effects in a long run, or perhaps this productivity increase is only at the subsidiary level. However, the companies interviewed in this paper represent merely a few instances out of the thousands of FDI projects in Ethiopia. This thesis' empirical analysis studies the patterns and occurrences of FDI in the past to predict an outcome (economic development). It focuses on uncovering causality between FDI and economic growth, FDI and export performance, FDI and spillover effects in Ethiopia. Applying both qualitative and quantities approaches in this thesis has given the possibility to capture impacts of FDI, government policies and economic development from different perspectives. This relates very much to the philosophy of science applied to this thesis, critical realism.

The macro empirical work in this paper has analyzed the effects of aggregate FDI inflow on the Ethiopian economy, but due to data limitations, control for the sector in which FDI is made has
not been analyzed. It was unfortunately beyond the scope of this thesis, even though it is a very interesting topic for further research. Although, it might seem natural to argue that FDI in Ethiopia has a positive and significant impact on economic growth, such gains might differ across primary, manufacturing, and services sector. It is argued that, in the primary sector, the scope for linkages between domestic supplies and foreign firms is often limited, whereas the manufacturing sector has a broad variation of linkage intensive activities (Alfaro, 2003). It is mentioned often that technology transfer and management know-how, the introduction of new processes and employee training tend to apply to the manufacturing sector, rather than the agriculture or mining sectors. FDI in the manufacturing sector has the largest share in Ethiopia's total FDI investment (refer to figure 6). Out of the 2,280 FDI projects that have been operational, the manufacturing sector accounts for the highest share of inflow followed by the service sector. This could possibly be argued to be one of the main justifications for the positive and significant impact of FDI on the Ethiopian economic growth.

In general, the universe of FDI in Ethiopia is extremely diverse, from multimillion-dollar projects in the manufacturing sector to smaller scale projects by cluster with an initial investment below one hundred thousand dollars. Given their small scale and the difficulty to capture their impact from a macroeconomic perspective, the latter form of foreign investors are often overlooked and maybe neglected within policy perspectives. Nevertheless, the "middle ground" foreign investors in Ethiopia, including those from other developing countries such as China, India, and Saudi Arabia have become increasingly important and active. They also prove to be a good match for Ethiopia in the sense that they are able to operate in challenging environments.

The fact that the majority of FDI projects are located in Addis Ababa and the nearby major region of Oromia, leaves most of the rest of the country without any foreign investment, which tends to perpetuate or even deepen Ethiopia's imbalanced economic growth and the accompanying social disparities. Many of the poor live in rural areas and are employed in the agricultural sector. The limited amounts of FDI in poorer regions means that FDI can only be of little help for Ethiopia in the fight to overcome poverty reduction (one of Millennium Development Goals), economic isolation, or stop migration to urban centers, which is the current biggest challenges of the capital city, Addis Ababa.

Ethiopia faces stiff challenges in integrating into global value chain, because the direct participation of local firms or enticing MNCs to use them as production centers by affiliates is not possible. This is due to high operating and trading costs, poor infrastructure, limited human capital and shortage of potential local partners. By essence, participation in global value chains requires a high level of competitiveness, which most firms in Ethiopia have difficulty to in achieving when faced with competition from other developing economies that can offer low labor costs but benefit from higher productivity levels.

9. Implications for Extant Literature of Findings

The main take away from this analysis is that there seem to be a positive effect on real GDP growth from FDI. The empirical result in the growth equation was more or less related to the theoretical perspectives of the modernization theories. The assumption of the possibility of a rise in capital increases output production and thereby economic growth. The analysis in the growth equation did not disapprove this theoretical point of view. A reflection was made about what the effect of economic growth in terms of real GDP might be for the general development in Ethiopia. One cannot assume that things are necessarily getting better i.e. improved life conditions just because more money is spent, in other words as GDP increase, society well being does not necessary increase along with it.

Although the classical theories presented in this thesis seem to paint an overwhelmingly positive picture of the benefits that can be derived from FDI, empirical evidence on the subject is mixed. Some studies have found positive effects of FDI, some no effects, and others negative effects. What in fact emerges from a reading of the literature is that for every argument in favor of or against FDI, there is also a counter argument. A number of scholars acknowledge the importance of FDI and its contribution to the welfare of the host economy and share the view that the benefits derived from FDI depend on the existence of a number of factors. These factors range from the economic policies pursued by the host state, the sectors in which investment is made, the political risks present, the availability of effective institutions and the presence of developed financial markets, to the stock of human capital availability. These factors constitute what is called the "absorptive capacity" of a host country firm and industries (Narula et al., 2004).

On the other hand, dependency theory as mentioned in the theory section of this thesis focuses largely on the relationship between the center and periphery. Well-developed and industrialized countries are deemed to constitute the center and the least-developed countries the periphery. In this regard, FDI is seen, as a conduit through which the center exploits the periphery and perpetuates the latter's state of underdevelopment and dependence.





If GDP growth benefits only the rich, if it makes the rich get richer, if MNCs' earnings are placed in tax havens rather than reinvested, if productivity increases only at the MNC subsidiaries rather than spilling over to domestic firms, then foreign direct investment leads to economic dependency more than the other way around (Kentor, 2003).

To create a middle ground for the two theoretical perspectives, this thesis presents the middle path theory. According to this theory, FDI is analyzed from the perspective of the host country as well as that of the investor. It incorporates arguments from both modernization and dependency theorists. The theory posits that foreign investment must be protected but only to the extent of the benefits it brings the host state, and to the extent to which foreign investors have behaved as good corporate citizens in promoting the economic and social objectives of the host country (Sornarajah, 1994). The theory calls for a mixture of intervention (regulation) and openness in dealing with foreign investment and cautions against too much openness and too much regulation or intervention (Seid, 2002). The theory recognizes that there are instances where the

market is in a better position to act and other instances where government intervention is necessary. What is needed therefore is a balancing act between those activities that can best be handled by the market and those that can be done by the government. In line with this theory, the next section presents learning and possible policy implications for Ethiopia.

10. Learning and policy implications for Ethiopia

This section attempts to address what Ethiopia can do to further promote developmental FDI and the possible policy implications given the contribution of FDI. The emphasis in this section is to seek ways to ensure maximizing the potential of FDI to help Ethiopia achieve its developmental goals. Hence, this part proposes a plan of action or recommendations for possible policy implication in Ethiopia. Recommendations are made around five critical areas of action, as the figure below depicts. This action plan builds on the reforms and efforts that have been taken over the past decades but it also attempts to offer new approaches to addressing old problems.





Source: inspired by UNCTAD LDCs report and modified to fit the Ethiopian case

- 1. Public-private infrastructure development: infrastructural development continues to be one of the biggest challenges and impediments to local and foreign investment in Ethiopia despite the efforts made by government to improve the case. Yet, insufficient electricity, poor roads and lack of ports affects the entire industrial sector and export-oriented sectors. Likewise, low quality, expensive Internet and telecommunication services affect competitiveness of all companies. The Ethiopian government needs to take different measures in order to overcome impediments that arise from poor infrastructures. Such policy could start with a cautious liberalization of some specific infrastructure sectors such as telecommunication.
- 2. Capacity development: Ethiopia, over the past decades has made significant progress in providing basic education all over the country. In quantitative terms, it is remarkable to notice that Ethiopia has almost achieved universal primary education. When we examine the quality of existing public schools, however, the public schools seem to be less conducive to learning. The teaching materials and the teachers teaching in public schools seem to be inadequately prepared. In 2000, there were just two universities but since then, the country has built 29 more. Yet, the institutions suffer from curricula being abandoned due to funding cuts and unqualified lecturers¹. Foreign investors, especially efficiency seeking investors look for locations where they can access a readily available pool of skilled or easily trainable workers. The government needs to place special focus on public investment in technical and vocational education training and on improving the quality of education. General policies may turn out to be the most effective means of boosting the probability of positive spillovers. For example, absorptive capacity is the critical driver, education and training policy is likely to be key to facilitate spillovers (Greenway et al. (2004).
- **3.** Ethiopian investment opportunity: Ethiopia offers untapped business opportunities for nimble and innovative investors as well as potentially high returns on investment. However, operating conditions are more challenging than in other developing countries, which requires a high level of flexibility and adaptability on behalf of investors. The government in Ethiopia should promote the types of FDI that offer a good match with Ethiopia's need and opportunities, perhaps more export-oriented and labor-intensive FDI. This means developing

¹<u>http://www.theguardian.com/global-development-professionals-network/2015/jun/22/ethiopia-higher-eduction-universities-development</u>

tools to measure FDI flows and assess their impact. This could be an essential tool to guide policy making and seek an adequate match between the country's needs and what different types of foreign investors can contribute with. Likewise, specific policies for areas where "leapfrogging" opportunities exist are needed as well as providing incentives where necessary (UNCTAD, 2011).

- 4. Local business and access to finance: the government of Ethiopia should focus on strategies to strengthen local businesses and entrepreneurship to form an integral part of efforts to attract higher and more diversified FDI inflows. Efficient and dynamic local businesses and high levels of national investment are particularly important for *efficiency seeking* foreign investors, which Ethiopia needs to attract on a much larger scale. The government can take different measures to achieve this. For instance, by establishing credit guarantee schemes to support lending to micro enterprises and SME that would otherwise not be attended to. Likewise, government could setup efforts to integrate informal businesses into the formal economy by simplifying regulatory requirements on micro and small enterprises. Furthermore, establishing formal linkages programs to help domestic business and foreign investors team up. This might create a minimum level of local services and suppliers for MNCs to operate (UNCTAD, 2011).
- 5. Regulatory and institutional reform: Ethiopia has implemented major reforms in the regulatory framework for investment over the past decades. The early reform under the current regime emphasizes liberalizing the economy, privatizing commercially oriented state-owned businesses, opening up the economy to FDI, providing incentives and protection of foreign investors. Yet, reforms to the regulatory framework for investment appear to be incomplete in Ethiopia. For instance, the World Bank's "Doing Business Report" shows that Ethiopia ranks 146 out of 183 countries and has many sectoral restrictions on foreign ownership of assets compared to other least-developed countries². Additionally, the results of the significant improvements in the investment climate in Ethiopia have not fully materialized partly due to institutional weaknesses. Although significant reforms have been carried out, much remains to be done, as legal reforms are ineffective unless genuinely implemented by strong institutions. In order to generate a pure improvement of regulatory

² <u>http://www.doingbusiness.org/data/exploreeconomies/ethiopia/</u>

frameworks for FDI in Ethiopia, regulation should be designed in a way to minimize operational constraints on business.

Moreover, the EIC could attempt to systematically analyze regulation and procedures from an investor's perspective, and design regulation in a way to facilitate and minimize compliance costs. Likewise, the Ethiopian government should also put emphasis on the aspects of regulations that shape FDI impact. Ethiopia should concentrate on developing credible enforcement mechanisms instead of trying to get more FDI. Past reforms have emphasized liberalization, opening up for FDI, incentives to attract more FDI etc. Strong significance could be placed on regulations that enable a strengthening of state institutions and public services and that affect FDI impact, for instance, competition and environmental regulations. Competition laws are particularly important to nurture efficient markets and maximize the benefits of foreign investors' participation in the economy, including in terms of crowding in and benefits of local consumers. Also, government should keep pushing for zero tolerance for petty and grand corruption. Rooting out corruption fully might be difficult but it is one of the most effective and necessary measures to promote investment and development in Ethiopia. Likewise the Ethiopian government can try to ensure specified employment targets are hit by MNEs, commit MNCs to invest in R&D and specify that some proportion of value-added or intermediate inputs are locally sourced (UNCTAD, 2011).

All in all, the plan of action for foreign investment in Ethiopia concentrates on five areas of recommendations. The above set of recommendations recognize that a significant boost of private investment in Ethiopia requires a rigorous effort that holistically addresses all the main inadequacies of the regulatory, institutional, business, financial and physical infrastructure. The action plans are not new as they build on existing efforts to improve the investment environment in Ethiopia. Ethiopia being a least-developed country, the government should play a vital role in protecting infant industries from the big MNEs with enough economies of scale.

<u>11. Conclusion</u>

It is usually agreed that foreign direct investment has a role in the developmental process of a country yet whether its effect is positive or negative is highly controversial. Taking this as a

point of departure, this thesis has attempted to investigate the effects of foreign direct investment on economic development in Ethiopia. In this thesis, economic development is measured through real GDP growth, export, and spillovers effects, and FDI is assumed to influence economic development through these three channels. The paper used both descriptive and econometric tools of analysis. Time series data for the study period 1980-2015 was collected, analyzed, and presented in the paper in a way to attain the paper's objectives. Econometrics and statistical methods have been applied in order to answer the following research question:

"How does inward Foreign Direct Investment impact Ethiopian economic development?"

From a critical realist perspective, this thesis has attempted to analyze FDI in Ethiopia to explain what processes and mechanisms have caused specific outcomes, economic development in this case. The analysis conducted found that the development effect of FDI in real GDP growth is positive and statistically significant and the relationship is from foreign investment to economic growth. In the case of export performance and spillover effect, the analysis conducted found a moderate positive relationship between FDI and export growth as well as a negative and insignificant relationship between FDI and spillover effects.

As to the first sub question for the policies adopted in Ethiopia to facilitate FDI and positive development impact, the current regime since 1992 has made enormous efforts to attract, and to facilitate positive developmental effects from FDI. The government adopted a liberalization policy with some restriction, established the first privatization and investment agencies in 1993/4 to promote, coordinate, and facilitate foreign investment in the country. The investment legislation has made enormous efforts to provide a favorable investment climate by offering fiscal incentives and investment guarantees to both local and foreign investors.

The finding on the second sub-question as to the trend of FDI in Ethiopia over the past years is explained in line with the IDP theory. Under the command economic system, the investment environment in general and FDI in particular was not encouraging due to political instability, insecurity and the nationalization of major industries, which severely discouraged foreign private investment. In the 1990s, with the new government Ethiopia saw an increase of FDI from 8.2 USD million a year in the first half of the 1990s to an annual average of 155 USD million in the

second half of the decade. In that same decade, the economic growth rate accelerated to the highest possible rate in Ethiopian history, an annual average of 11.2 percent. The government's policies play a significant role in achieving this.

The classical theories presented in this thesis seem to paint an overwhelmingly positive picture of the benefits that can be derived from FDI. On the contrary, dependency theory focuses largely on the relationship between the center and periphery. Well-developed and industrialized countries are deemed to constitute the center and the least-developed countries the periphery, and FDI is seen as a channel through which the center exploits the periphery. To create a middle ground for the two theoretical perspectives, this thesis presents the middle path theory. The theory recognizes both the market and the state mechanism. The theory calls for a mixture of intervention (regulation) and openness in dealing with foreign investment and cautions against too much openness and too much regulation or intervention. In line with this, and the thesis findings, this paper presented possible policy implications and learning. The possible policy implications could be public- private infrastructure development, capacity development, promoting investment opportunities which offers a good match with Ethiopia's need, perhaps more export-oriented and labor-intensive FDI, encouraging local businesses and their access to finance, regulatory and institutional reform. Ethiopia being a least-developed country, the government should play a vital role in protecting infant industries from the big MNEs with enough economies of scale.

Overall, FDI has in general made a positive contribution to economic development in Ethiopia when it is measured in terms of real GDP growth. It is also clear, however, that FDI could be leveraged to a much larger extent in the coming years and decades, if appropriate strategies and policies are put in place through the concerted and combined efforts of the Ethiopian government and with the active involvement of the private business sectors. FDI in Ethiopia remains limited by source country, regional distribution, and sector involvement.

Topics for further research in the case of Ethiopia could be to replace the methodology used in this study on disaggregate data. For instance, it would be interesting to subdivide foreign direct investment into the manufacturing, agriculture and service sector and assess their impact on real GDP growth, export performance, as well as spillovers effect to make the conclusion more accurate. In a similar fashion, real GDP growth could be disaggregated into different sectors. The findings discussed in this thesis provide a starting point to understanding FDI effects on economic development in Ethiopia.

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<u>Appendix 1</u>

Variables graph in the level form











Appendix 2





OLS Regression result for productivity spillover

. regress lnprodgr dlnfdigdp dlntrade dlngovex dlndi dreg

Source SS df MS	Number of obs = 35
++	F(5, 29) = 0.77
Model .070788442 5 .014	157688 Prob > F = 0.5759
Residual .529961796 29 .01	8274545 R-squared = 0.1178
++	Adj R-squared = -0.0343
Total .600750238 34 .0176	69125 Root MSE = .13518

Inprodgr | Coef. Std. Err. t P>|t| [95% Conf. Interval]

dlnfdigdp | -.2375013 .1690118 -1.41 0.171 -.5831693 .1081667
dlntrade | -.0374425 .141849 -0.26 0.794 -.3275563 .2526714
dlngovex | -.0496348 .1950924 -0.25 0.801 -.4486436 .3493741
dlndi | -.0917011 .1117921 -0.82 0.419 -.3203416 .1369394
dreg | -.0121642 .0556876 -0.22 0.829 -.1260582 .1017298
_cons | -.0203224 .0430212 -0.47 0.640 -.1083106 .0676659



