



**THE EFFECT OF FOREIGN DIRECT INFLOWS ON THE ECONOMIC  
PERFORMANCE IN SOMALIA**



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## **ABSTRACT**

### **THE EFFECT OF FOREIGN DIRECT INVESTMENT INFLOWS ON THE ECONOMIC PERFORMANCE IN SOMALIA**

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Somalia is promoting herself as a viable investment destination in Sub Saharan Africa. Despite the long period of instability and conflicts, businesses are booming in Somalia today. Recently, Somalia woke up to join the rest of the world to start attracting FDI as one of the routes to economic progress. The need to rebuild the economy is pushing Somalia to find development capital which is the driving force behind the push for FDI inflows to Somalia. The present study has examined the concept of international business and it investigated the effect of inward FDI to Somalia's economic growth and development. Empirical evidence indicates that FDI has both a short run and long run positive effect on economic growth in Somalia. It is therefore recommended that inward FDI should be further encouraged into Somalia, by providing incentives to the investors, since it has economic and social value for the country. Other factors that were part of the study model, included exports, domestic investment, labor and inflation. Except for Inflation, all other factors turned to have a positive effect on economic growth in Somalia. Hence, it is equally recommended that Somalia should improve the environment of those factors.

**Keywords:** There should be at least three keywords. Initial letter of each keyword should be in capital letters.

## ÖZET

### DOĞRUDAN YABANCI SERMAYE AKIŞININ SOMALİ'DE EKONOMİK PERFORMANSA ETKİSİ

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Somali, Sahra Altı Afrika'da uygun bir yatırım hedefi olarak kendini tanıtıyor. Uzun süren istikrarsızlık ve çatışmalara rağmen, bugün Somali'de işletmeler hızla büyüme kaydediyor. Son zamanlarda, Somali, ekonomik ilerlemenin yollarından biri olarak DYY'yi çekmeye başlamak ve dünyanın geri kalanına katılmak için harekete geçti. Ekonomiyi yeniden inşa etme ihtiyacı, Somali'yi, Somali'ye DYY girişlerinin arkasındaki itici güç olan kalkınma sermayesi bulmaya itiyor. Bu çalışma, uluslararası işletme kavramını incelemiş ve içe yönelik DYY'nin Somali'nin ekonomik büyümesi ve kalkınmasına etkisini araştırmıştır. Ampirik kanıtlar, DYY'nin Somali'deki ekonomik büyüme üzerinde hem kısa, hem de uzun vadede olumlu bir etkiye sahip olduğunu göstermektedir. Bu nedenle, ülke için ekonomik ve sosyal değere sahip olduğundan, yatırımcılara teşvikler sağlanarak Somali'ye yönelik doğrudan yabancı yatırımların daha fazla teşvik edilmesi tavsiye edilmektedir. Çalışma modelinin parçası olan diğer faktörler arasında ihracat, yurt içi yatırım, emek ve enflasyon yer aldı. Enflasyon dışındaki diğer tüm faktörler Somali'de ekonomik büyümeyi olumlu yönde etkiledi. Bu nedenle, Somali'nin bu faktörlerin ortamını iyileştirmesi de aynı şekilde tavsiye edilmektedir

**Anahtar Kelimeler:** Somali, Doğrudan Yabancı Sermaye Yatırımları, Ekonomi, Etki

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## LIST OF SYMBOLS AND ABBREVIATIONS

### ABBREVIATIONS

AMISOM	: African Union Mission in Somalia
APF	: Aggregate Production Function
ARDL	: Autoregressive Distributed Lag
CET	: Common External Market
CPI	: Consumer Price Index
COMESA	: Common Market for East and Southern Africa
CUSUM	: Cumulative Sum of Squares
CUSUMSQ	: Cumulative Sum of Squares
DI	: Domestic Investment
ECM	: Error Correction Model
EEU	: Eurasian Economic Union
EU	: European Union
FDI	: Foreign Direct Investment
GATT	: General Agreement on Tariffs and Trade
GDP	: Gross Domestic Product
MENA	: Middle East and North Africa
MNEs	: Multinational Enterprises
NAFTA	: North American Free Trade Agreement
OECD	: Organization for Economic Cooperation and Development
OLS	: Ordinary Least Squares
PTA	: Preferential Trade Area
SMEs	: Small and Medium-sized Enterprises
SPRS	: Somali Revolutionary Socialist Party
TFG	: Transitional Federal Government
UNCTAD	: United Nations Conference on Trade and Development

WDI : World Development Indivators  
WTO : World Trade Organization



## INTRODUCTION

This thesis examines the effect of Foreign Direct Investment (FDI) on the economic performance of Somalia. The phenomenon of FDI has in recent years become one of the forces of globalization. Developing countries in particular have a great desire for FDI because they generally have a huge capital deficit in their domestic economies. Over the last half a century therefore, there has been concerted efforts by all countries of the world, but most importantly the developing world to establish an environment that enables them to partake of this global capital movement (UNDP, 2002). Somalia, is one of Africa's poorest countries today. According to the World Bank statistics, by the end of 2020, the country's GDP per capita was USD 225 (World Bank 2021). This implies that there is very little capacity to mobilize domestic capital from within the economy. Hence efforts to mobilize FDI are extremely necessary.

This thesis also deals with the questions of international business and trade. It discusses the concepts and issues of international trade such as global arrangements for multilateral trade, global arrangements for income distribution and regional trade arrangements. However, International business as a concept also involves international investments. These include International Portfolio Investments (IPI) and Foreign Direct Investment (FDI). Chapter one of this study provides a well illustrated explanation of these concepts within the broad area of international business. But this study focused on Foreign Direct Investment which has greater relevance in the case of Somalia.

Chapter two provides a detailed theoretical discussion of Foreign Direct Investment (FDI). Theories of FDI such as the eclectic paradigm, the market size hypothesis, the institutional variables theory are discussed. This provides an understanding of the reasons why multinationals make their way into various global destinations for the purpose of establishing international investments. The chapter also discusses the global trends in FDI over the last 50 years. It traces the history and development of the FDI phenomenon to its present day. It also discusses the challenges

facing FDI as well as the factors to consider in choosing FDI destinations. Lastly, Chapter three deals with the applied or the emperical aspect of this study. It investigates the effect of FDI on the economic growth of Somalia using 22 years data.



## **CHAPTER I**

### **KEY CONCEPTS IN INTERNATIONAL BUSINESS**

#### **1.1 OVERVIEW OF INTERNATIONAL BUSINESS**

International business is defined as the execution of trade and investment undertakings by firms across national borders (Cavusgil, Knight, & Riesenberger, 2017). The variety of undertakings in international business include; Merchandise exports and imports (Visible Trade), service exports and imports (Invisible Trade), Foreign Direct Investments, International Investment Portfolio, Investment Control of assets or companies with active management participation, as well as purchasing of financial assets (Businessdictionary, 2019; InternationalrelationsEDU, 2019).

Since it includes exchange of goods and services between countries as well as investment across borders, it is therefore the umbrella concept for both trade and investments that take place at the international level. International business has a long history. The ideas leading to the development of this type of business, can be traced to the rise of the European states during the 16<sup>th</sup> century. The early discourse on trade was through the Mercantilist theory. Mercantilism argued that national success is a function of an equilibrium of trade achieved by maximising exports and minimising imports (Heckscher, 2013).

Over the centuries, many theories have evolved to explain what motivates International business as well as how countries and individual firms can derive benefits from engaging in international business as explained by Mtigwe (2006). In addition, several changes have happened in the modern world, leading to fundamental variations in the manner in which firms decide to carry out internationalization of their businesses. These include; the international market environment and the diffusion of a managerial and entrepreneurial class (Zucchella, Palamara, & Denicolai, 2007) along with other global changes such as, the interconnectivity of the world economy, the development of trade blocs in the different parts of the world and the introduction of a

global trade organization, the World Trade Organization (WTO), among others (Cavusgil et al., 2017)

## **1.2 THE ISSUE OF INTERNATIONAL TRADE**

International trade is one of the most important forces driving the global economy. Storper (1992) observes that the proportion of traded goods in world output has been rising steadily over the past several decades, leading to the interdependence of the various countries across the world. Today, International trade is one of the forces behind international relations and cooperation between nations. R. E. Baldwin and Kay (1975) have argued that following the conclusion of the second world war, international organizations and alliances have been formed on the basis of trade partnerships. They categorize the trading arrangements that have emerged since then into four groups as follows:

*Existing trading arrangements can be divided into four broad categories: (1) global trade arrangements that focus on multilateral trade expansion on a nondiscriminatory basis; (2) global trade arrangements with a principal objective of international income redistribution through the mechanism of international trade; (3) regional trade arrangements that focus on the economic relations of a particular political/geographic area; and (4) commodity-product trading arrangements that focus on the international terms of trade of a specific commodity or product (Baldwin & Kay, 1975: 2)*

### **1.2.1 Global trade arrangements for Multilateral trade expansion**

Multilateral trade agreements are commerce treaties between three or more nations. The agreements reduce tariffs and make it easier for businesses to import and export (Amadeo, 2018). Prominent examples of treaties in this category are the GATT and WTO. The General Agreement on Tariff and Trade (GATT) was the first global treaty to regulate international trade after the Second World War. It was drafted in 1947 and signed by 80 countries whose exports dominated world trade (R. E. Baldwin & Kay, 1975). Although the GATT laid down rules governing international trade, its coverage was only a limited scope of commercial policy aspects within a wider spectrum of international trade. Initial efforts to expand the agreement through the creation of an International Trade Organization (ITO) failed in Havana in 1948, but

repeated rounds of negotiations finally led to the creation of the World Trade Organization (WTO) in 1994 at Marrakesh city of Morocco (WTO, 2017).

Today, the World Trade Organization (WTO) is the only world-wide international organization that deals with the rules of trade among nations. It comprises 164 members and 23 observer states (WTO, 2017). At the heart of the WTO are agreements, negotiated and signed by the majority of the world's trading nations and approved by their respective parliaments. The aim is to guarantee that global trade is conducted as smoothly and as freely as possible. WTO activities are implemented by a Secretariat with over 700 staff, headed by a Director-General. The Secretariat is headquartered in Geneva, Switzerland. There are three official languages of the WTO and they include, English, French and Spanish (WTO, 2017).

The WTO, collects data and statistical indicators relevant for WTO matters. This data includes time series on merchandise trade as well as trade in services, market access indicators and non-tariff information among others. Accordingly, recent trends from the WTO data portal indicate that global trade is projected to continue to grow but at a more moderate pace than previously forecast. The WTO anticipates a growth in merchandise trade volume of 3.9% in 2019, with trade expansion slowing further to 3.7% in 2020. The new forecast for 2019 has run below the WTO's April estimate of 4.4% but falls within the 3.1% to 5.5% growth range indicated at that time. Trade growth in 2018 fell within a range from 3.4% to 4.4%. The figure below illustrates the most up-to-date trends in global international trade.

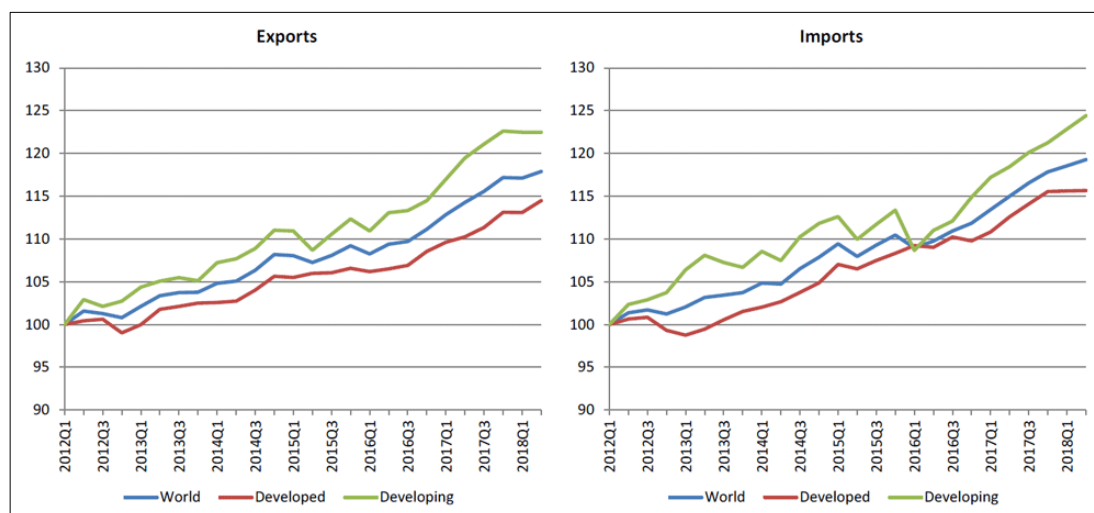


Figure1: World Merchandise exports and imports by level of development, 2012Q1 to 2018Q2. (WTO and UNCTAD)



### **1.2.2 Global Trade Arrangements for Income Redistribution**

These are the trade agreements which aim to achieve redistribution of international income through international trade (R. E. Baldwin & Kay, 1975). The United Nations Conference on Trade and Development (UNCTAD) is the foremost global treaty in this category. During the 1960s, there was a serious disquiet regarding the place of poor countries in international trade. This influenced many countries of the developing world to call for the holding of a conference to particularly tackle these challenges and identify suitable international actions (UNCTAD, 2016). The premier United Nations Conference on Trade and Development (UNCTAD) took place in Geneva in 1964. Due to the enormous amount of challenges as well as the need to solve them, the conference was regularized to convene once in four years, with interstate bodies meeting between the four year sessions and a permanent secretariat providing the relevant substantive and logistical support (UNCTAD, 2016).

UNCTAD is composed of all member countries of the United Nations. Its primary objective is to improve the relative income position of developing countries through promoting the economic growth rates of these countries via better conditions of trade at the international level (R. E. Baldwin & Kay, 1975). UNCTAD is managed by a trade and development board with four working committees. These include a committee on commodities which focuses on raising export earnings for developing nations; a committee on manufactures whose duty is to obtain tariff preferences for developing countries from the developed countries; the committees on shipping and the one on invisibles and financing related to trade deal with essential matters of importance to the developing world which are not dealt with by the GATT (R. E. Baldwin & Kay, 1975).

In the early years of its operation (1960s-1970s), UNCTAD gained fame for its role as an intergovernmental forum for negotiations and dialogue on issues affecting developing countries at the international trade platform. In the recent years (1990s - to date) however, UNCTAD has focused on analytical research dealing with the linkages between trade, investment, technology and enterprise development (UNCTAD, 2016). In other initiatives, the body has suggested a “positive agenda” for the developing world in international trade negotiations which helps developing countries to understand better the complexity of multilateral trade negotiations and craft their

positions in a beneficial manner. It has also expanded its scope to international investment issues as well as provision of diversified technical assistance to the developing countries on the international stage (UNCTAD, 2016).

### **1.2.3 Regional Trade Agreements**

Regional trading arrangements refer to agreements signed by two or more countries to encourage free movement of goods and services across the borders of its members. These agreements come with internal rules that member countries follow among themselves (CFI, 2017). Generally, these arrangements focus on the economic relations of a particular geographic or political area (R. E. Baldwin & Kay, 1975). There are various types of regional agreements. These types however will vary according to the level of commitment among the member countries. The common types include the following;

#### **1.2.3.1. Preferential Trade Area (PTA)**

This type of agreement requires the lowest level of obligation to reducing trade barriers, and in reality member countries do not actually remove the barriers among themselves. It can also be defined as a trade bloc where only selected products are given preferential access by the participating countries. Usually, preferential trade areas do not have any common external trade barriers (CFI, 2017). In the contemporary world, most of the trade arrangements have departed from this stage and moved to higher levels of integration. A few PTAs are however still in place, such as the North American Free Trade Agreement (NAFTA) which is an a trade arrangement between the US, Canada and Mexico (Anson et al., 2005).

#### **1.2.3.2. Customs Union (CU)**

A customs union is an arrangement in which there is zero duty between members on imports of goods and services and a common external tariff (Krueger, 1997). In other words, member countries of a customs union remove trade barriers among themselves and adopt common external trade barriers (CFI, 2017). The most famous example of a customs union is the European Union (OECD, 2013). In this union, trade among the member states flows tariff free and irrespective of which EU

country imports the good, the same tariff is paid. At the same time, the EU countries apply a common external tariff (CET) on all imported products outside of the Union.

#### **1.2.3.3. Common Market (CM)**

The common market is the next level in increasing order of integration. Here, not only the movement of goods and services, but also of factors of production is relatively free among member countries (Krueger, 1997). It is otherwise the form of transaction agreement in which members eliminate internal trade obstacles, embrace similar policies when it comes to working with non-members, and permit members to move resources among themselves freely (CFI, 2017). Some of the contemporary common markets arrangements in the world include; the European Single Market (European Economic Area), a trade bloc of 31 countries (by 2018), established in 1992 is the world's biggest single market (EU, 2019) and the Common Market for East and Southern Africa (COMESA) which was established in 1994 between 21 countries of Africa (COMESA, 2018)

#### **1.2.3.4. Economic Union (EU)**

This is a phase of regional integration where member countries enjoy all the benefits of early stages but also struggle to have common monetary and fiscal policies. Remarkably, every member country embraces similar tax rates (Cavusgil et al., 2017). It may also be defined as a trading agreement wherein members eliminate trade barriers among themselves, adopt common external barriers, allow free import and export of resources, adopt a set of economic policies, and use one currency (CFI, 2017). The European Union is arguably the planet's most avant-garde and enormous economic bloc with a total annual GDP of USD 18 trillion. The bloc has a single currency, the Euro and it is seeking to adopt a single fiscal and monetary policy in the long run (Cavusgil et al., 2017). The other economic unions in the world include, Eurasian economic union (EEU) established in 2014 and the Gulf Cooperation Council (GCC), a bloc of six Arab states established in 1981 (CFI, 2017).

### **1.3 THE ISSUE OF INTERNATIONAL INVESTMENT**

International investment is defined as the transfer of assets to another country or the acquisition of assets in that country i.e. the firm itself crosses borders to secure ownership of assets located abroad (Cavusgil et al., 2017). There are two types of cross-border investment, namely; Foreign Direct Investment (FDI) and International Portfolio Investment (IPI). This section describes each of these two types of investments.

#### **1.3.1 Foreign Direct Investment (FDI)**

The development of foreign direct investment (FDI) improved quickly from the 1980s and the 1990s in virtually all parts of the world on account of extensive development of Multinational enterprises (Blomström & Kokko, 1998). Multinational Companies (MNCs) are the firms that control assets and engage in the production of goods and services in more than one country. Their activities cover the entire value-chain of investment and production, ranging from raising capital, establishing new production facilities or acquiring productive assets, and engaging directly in the manufacture of goods and services, to developing new technologies (UNCTAD, 1999).

The global phenomenon of FDI comprises both inward FDI, which describes the volume of inflows into the domestic economies and outward FDI, which represents the amount of FDI that flows out of the domestic to the foreign economies. An overview of inward flows shows that worldwide inward Foreign Direct Investment (FDI) peaked in 2007, when aggregate inflows reached USD 1.976 trillion (UNCTAD, 2012). On account of the economic crisis which begun in 2008, global FDI flows plummeted to USD 777 billion in two years. By 2010, there was a global recovery of FDI flows, with the overall inward FDI having improved from USD 1.19 trillion in 2009, to USD 1.31trillion and USD 1.52 trillion in 2010 and 2011, respectively (UNCTAD, 2012).

On the other hand, outward FDI is also reported to have taken centre stage on the international business arena. For example, the UN in the 1998 World Investment report remarked that, in about a decade with effect from mid-1980s, the rate of growth of the ratio of outward FDI to global GDP became double the rate of growth of the

ratio of global trade to global GDP, suggesting that the interconnection of the worldwide economy rotate around this unequalled rise in global production (UNCTAD, 1998). By the year 2010, the aggregate output by all transnational enterprises (TNEs) was responsible for an international value-addition of close to USD 16 trillion, constituting over 10 percent of global GDP and no less than one-third of world-wide exports. This outstanding performance was realized despite the fact that the international outward FDI flows were about 15 percent short of their pre-crisis average level (UNCTAD, 2011).

### **1.3.1.1. Horizontal and Vertical Foreign Direct Investment**

Literature often categorizes Foreign Direct Investment into horizontal and vertical FDI. It is important to distinguish the two types of FDI in this discussion.

#### **1.3.1.1.1 Horizontal FDI**

Horizontal foreign direct investment is defined as the investor establishment of a similar business in a foreign country to the one operated by the firm in its home country. For example, a telephone company based in the United States establishing the same company in China (J. Chen, 2019). Many empirical studies have been carried out to examine the question of horizontal FDI with respect to its profitability and resilience. In one study, Aizenman and Marion (2004) compared the merits of horizontal and vertical FDI in a situation of uncertainty. They concluded that horizontal FDI is preferable because it turns to generate more income than vertical FDI and it would suffer less predatory actions. Other studies that have focused on horizontal FDI have recommended it to MNCs on account of its ability to substitute trade (Behrens & Picard, 2007). Therefore a country which is vulnerable to international sanctions for example, would benefit greatly from focusing on horizontal FDI than vertical FDI.

#### **1.3.1.1.2 Vertical FDI**

Vertical FDI is to the establishment of different but related production entities from the MNC's main business in foreign country. (J. Chen, 2019). This helps the investing MNC in the sense that every stage of production is located in a country where

the cost of its production is lowest (Behrens & Picard, 2007). Literature on FDI argues that via the knowledge-capital model, vertical FDI is preferred to horizontal FDI (Davies, 2008). Aizenman and Marion (2004) also found evidence supporting the view that vertical FDI flows more into emerging markets while in the mature markets receive more of horizontal FDI.

#### **1.4 THE FOUR RISKS OF INTERNATIONAL BUSINESS**

The concept of risk is crucial in the discussion of any business activity. It defines the likelihood that an event may happen, and it is usually associated with negative consequences (Dinu, 2012). Whereas there can be beneficial risks, the general connotation is that risk describes the potential for the occurrence of loss or damage. Literature generally summarizes the risks associated with international business activities into four types, namely; cross-cultural risk, country risk, commercial risk and currency risk (Cavusgil et al., 2017).

##### **1.4.1 Cross Cultural Risk**

Cross-cultural risk is can be defined as a condition in which a misunderstanding of a cultural nature may place some people's values at stake (Cavusgil et al., 2017). It is important to keenly focus on cultural differences with a view to avoid the occurrence of these misunderstandings or miscommunications because human beings love to maintain their values at all time. Yet, if such situations arise, they may obstruct an otherwise beneficial business transaction from taking place (Zigang, 2004). Some empirical literature suggests that culture impacts the decision making process in international business(Tse, Lee, Vertinsky, & Wehrung, 1988). This is even the more reason why the subject of cross cultural risk is essential.

##### **1.4.2 Country Risk**

Country risk, otherwise known as political risk refers to hypothetically unfreindly effects to a company operations and productivity caused by developments in the legal, political, and economic environment in a foreign country (Cavusgil et al., 2017). Alternatively, country risk may be defined as the unwanted government intervention in the business operations of international investments which may even

result into discontinuity of their businesses (Sottilotta, 2013). Empirical studies have generally come to the conclusion that a high level of country risk, will discourage international business and it is therefore suggested that governments should avoid unnecessary interference with the business operation of private firms (Quer, Claver, & Rienda, 2007).

### **1.4.3 Commercial Risk**

This type of risk implies that there is a possibility for making a loss with a trading partner and this can occur in any of the following ways; a) when your client cannot pay for the commodities you have supplied in accordance with the terms of transaction, b) when your trading partner fails to meet their obligations as stipulated in the agreement or c) when the other party to the trading agreement has a different interpretation of the agreement (Whitsett, 2018). It has been argued that commercial risk is severe in the case of international business entities than in domestic entities. Cavusgil et al. (2017) for example argue that while it is easier (and therefore cheaper) to terminate the services of a poor distributor through issuing an advance notice to this effect, such a decision would be more complicated (and thus more expensive) to be executed in foreign markets.

### **1.4.4 Currency Risk**

One of the most common risks in international business is the currency risk. It is also known as financial risk. This risk describes the undesirable effect of exchange rate volatility. It is recognized via statistical quantities which synopsise the likelihood that the actual purchasing power of either the home or foreign currency at a future date will fluctuate from its initially anticipated value (Adler & Dumas, 1984). There are many studies that have investigated how currency fluctuations affect international business. The most outstanding result is that currency fluctuations have a negative effect on international business (Cushman, 1983; Hayakawa & Kimura, 2009).

## **1.5 MULTINATIONAL ENTERPRISES AND THEIR IMPORTANCE**

A multinational enterprise (MNE), also known as a multinational corporation (MNC) is a company with facilities and other assets a country or countries other than

its home country (J. Chen, 2017). It operates offices or factories in foreign countries but it usually has a centralized head office which coordinates its global business. The role of MNEs in international business has been comprehensively discussed in literature. Early studies looked at MNEs and their growing influence in international trade, demonstrating that these corporations dominated export and import trade with over 60 percent by the 1970s (Helpman, 1984). Later studies have investigated how MNEs have contributed towards transfer of assets through Foreign Direct Investment (FDI), in the form of spillovers (Harrison, 1994). A cursory look through this literature helps us to illustrate the importance of Multinational Enterprises in the global economy.

### **1.5.1 Technology Transfer**

Multinational Enterprises have played a great role in facilitating the transfer of technology from the developed countries to the developing countries. This argument is straight forward because the greater number of MNEs originate from the developed countries. Usually, these big companies look for investment opportunities in the developing world, where it is cheaper to produce than in the developed countries (Batra, 1986). Empirical evidence shows that multinational corporations have successfully contributed to the growth of production technology in the developing world through spillovers (Palacios, 2018; Zhao & Zhang, 2006)

### **1.5.2 Creation of Jobs in the Developing World**

Multinational Enterprises are also credited for providing employment to the thousands of the jobless people. Statistics show that by 2011, MNEs associated companies around the world offered jobs to 69 million employees whose aggregated effort was able to realize revenues amounting to USD 28 trillion<sup>1</sup>. This contribution is phenomenal and serves to demonstrate the relevance of MNEs in the global economy.

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<sup>1</sup> This represented a 9 percent growth in value-added over the 2010 performance.



### **1.5.3 Non-debt Creating Capital flows**

Over the years, many developing countries have been heavily relying on external commercial borrowing (ECB) particularly to finance their capital expenditure budgets (Goode, 2010). The emergence of foreign direct investment (FDI) which involves Multinational Enterprises establishing production facilities into foreign countries was a useful relief in this regard. In Turner (2008) for example, it is reported that by 2007, the net capital inflows to the emerging market economies surpassed USD 400 billion. This was four times higher than what it was in the early 1990s. With this amount of non-debt capital inflows would help countries avoid the burden of meeting the usually huge debt-service payments.

### **1.5.4 Widening the Tax bases of host Economies**

Modern states use taxes to finance the provision of public goods and services. In explaining there is low tax revenue in the developing world, Besley and Persson (2014) demonstrate that developing countries largely depend on trade taxes than on income taxes. This is not surprising given the fact that the income per capita in developing countries is very low. If the greater amount of revenue from is obtained from trade taxes, it is therefore essential that the tax base be as wide as possible in order to realize the necessary amounts of government revenues. This is why the entry of multinational enterprises in the developing world is important. They help to broaden the tax base and hence higher government revenues (Carpentieri, Micossi, & Parascandolo, 2019).

## **1.6 SMALL AND MEDIUM SIZED ENTERPRISES AND BORN GLOBAL BUSINESSES IN INTERNATIONAL BUSINESS**

There is no universal definition for Small and medium-sized enterprises (SMEs). Every jurisdiction seems to have a customized definition of SMEs. According to the OECD, SMEs are non-subsidiary, independent firms characterized by the employment of a specified number of employees. The number differs across countries but it frequently lies between 200 and 500 employees (OECD, 2005). It is often observed in literature that SMEs are now the majority companies in the arena of

international business (Cavusgil et al., 2017). This dominance has been achieved by SMEs over time, following their proliferation across the world.

In Reynolds (1997), it has been argued that as early as the 1990s, SMEs were already participating in Foreign Direct Investment. An estimated 26 percent of all exports in the OECD countries were from SMEs while the percentage was higher in Asia standing at about 35 percent at that time. By the year 2017, SMEs were arguably the most important type of business enterprises in the OECD area accounting for 99 percent of all business enterprises. It is reported that these firms created approximately 70 percent of all the jobs and generated an estimated 50 percent to 60 percent of all value added in the OECD region (OECD, 2017).

A Born global business refers to a relatively new entrepreneurial company that starts international business very early in its development, moving swiftly into foreign markets (Cavusgil et al., 2017). Several companies today have gone global, but this alone does not mean that they are born global firms. The distinction between born global firms from other international organizations is simple, the born global firms originate internationally, while the others follow a stage by stage process of internationalization (AMD, 2018). The born global phenomenon epitomizes a fresh reality in international business (Cavusgil et al., 2017).

However, it is still a phenomenon in the developed world. In countries such as the United States, Denmark, Australia, and Ireland, these born global companies account for a considerable percentage of their national exports. This is because, these countries have developed enormous capacity in Internet and communications technologies which are crucial in facilitating early and effective international operations (Cavusgil et al., 2017)

## **1.7 REASONS FOR INTERNATIONALIZATION OF ENTERPRISES**

Literature is filled with a variety of explanations for the internationalization of businesses. The following are some of the key reasons driving the internationalization of business enterprises around the world.

### **1.7.1 Seeking Opportunities for Growth through Market Diversification**

A fundamental driver for internationalization of businesses is the desire for wider markets. Wadhwa and Reddy (2011) provide a comprehensive discussion on the role of marketing seeking FDI into the Asian countries. They argue that prominent market seeking factors such as market growth, market size and the structure of the domestic market, are at the fore front in influencing firms to penetrate the domestic markets of host economies. This argument is supported by empirical evidence. The market size hypothesis for example has been proven to be a significant factor in internationalization of investments by many researchers (Bandera & White, 1968; Culem, 1988; Lipsey, 1999; Shamsuddin, 1994; Wheeler & Mody, 1992).

### **1.7.2 The Resource Seeking Objective**

Business firms are usually driven by the desire to secure stable, high quality and particularly low cost supply of natural resources especially minerals, gas or agricultural products (Meyer, 2015). The natural resource factor has been a subject of inquiry in many foreign investment studies and it has been unambiguously established to have a significant effect on the internationalization of investments (Asiedu, 2002, 2006; Kinoshita & Campos, 2003; Morisset & Pirnia, 2000).

### **1.7.3 Earning Higher Margins and Profits**

Cavusgil et al. (2017) argue that for many commodities, there is a tendency for markets to become sluggish. Faced with stiff competition, the profit margins often shrink within the domestic markets. The pressure to keep a profitable business then forces the firms to seek for foreign markets which could either be growing markets or unserved markets where there could be less competition. An empirical study by Bhagwati, Dinopoulos, and Wong (1992) for example illustrates that a firm's decision to seek markets outside the domestic economy is a two-period scenario. In period one the firm makes a loss and is forced to seek a better opportunity in the second period.

### **1.7.4 Confronting International Competitors more Effectively**

It is argued that there is substantial international competition which keeps rising as multinationals enter markets everywhere (Cavusgil et al., 2017). While the

subject of international competition is an old one (C. Y. Baldwin, 1986), the strategy of confronting it through international markets is generally a recent one (Thompson, 2000). The strategy operates either proactively as a preemptive measure, or reactively in relation with the actions of multinational corporations (Cavusgil et al., 2017). Hence, a new dawn in international business can be said to have appeared with respect to managing international competition through entering international markets.

### **1.7.5 Developing Economies of Scale in Sourcing, Production and Research**

Economies of scale are the advantages of large scale production. When a firm enjoys economies of scale, they will help to reduce the per-unit cost of production through high volume of output (Cavusgil et al., 2017). In modern business, firms internationalize in search for bigger markets that can guarantee the presence of economies of large scale production. Katrishen and Scordis (1998) found that multinational insurers were able to achieve the targeted economies of scale.

## **1.8 INTERNATIONALIZATION PROCESS OF ENTERPRISES**

In the 1970s a model was developed to explain the stage by stage process of companies' expansion abroad. The model suggests that internationalization happens through incremental stages over a period of time. The stages include exporting, licensing, Franchising and then gradually advance to foreign direct investment (FDI), which is the most intricate entry strategy (Cavusgil et al., 2017). Below is a brief highlight of each of these stages.

### **1.8.1 Exporting**

To export is to sell commodities to customers located in a foreign country from a base in the domestic economy or from a third country (Cavusgil et al., 2017). In the modern world, countries have adopted export promotion strategies as a development approach based on internationalizing their domestically produced output (Hultman, Katsikeas, & Robson, 2011). The more a country exports in relation to its imports the better it is. This is in line with the Mercantilist theory which advocates for prosperity through greater volume of exports (Aizenman & Lee, 2007).

### **1.8.2 Licensing**

Licensing is an arrangement through which an intellectual property owner allows a firm the right of usufruct for a specified period of time in return for royalties or other form of compensation (Cavusgil et al., 2017). Industrial organization literature presents licensing as an important idea for among other reasons, the fact that it facilitates technological transfer among firms as well as being a key approach for gaining returns from internationalization (Anand & Khanna, 2000). Across the world, it has become standard practice for firms to adopt this method of reaching foreign markets.

### **1.8.3 Franchising**

This is an arrangement via which a firm allows a foreign company the right to use its entire business system in return for fees royalties, or other forms of compensation (Cavusgil et al., 2017). Under this arrangement, the foreign partner who is holding the franchise is an independent business operating abroad but is using the rights and system from the domestic firm. Modern day Franchise businesses include, McDonalds, KFC which are spread all over the world as fast food businesses. This arrangement also helps the focal (domestic) firm to benefit from the international market, without having to locate physically in the foreign market.

### **1.8.4 Foreign Direct Investment**

It can be defined as an internationalization strategy by which a firm establishes physical existence in a foreign country, either through acquisition of productive assets or by starting a Greenfield investment (Cavusgil et al., 2017). It is well known that globalization has presented enormous challenges to firms and economies. Foreign direct investment (FDI) has comes through as the most potent response, an integration tool to support these companies and economies (Jaklic & Svetlicic, 2017).

## **CHAPTER II**

### **THE THEORY AND ISSUE OF FOREIGN DIRECT INVESTMENT**

#### **2.1 THE ISSUE OF FDI THEORY**

Perhaps no one disagrees with the fact that FDI has made a phenomenal contribution in the arena of international business. However, literature seems to suggest that there is no single general theory that explains the concept of FDI entirely (Denisia, 2010). Rather, various scholars have come up with a variety of explanations intended to theorize FDI. According to Boddewyn (1983), there are competing theories of FDI with each providing a partial explanation of the phenomenon. These theories include; Dunning's eclectic paradigm (Dunning, 1973, 1993), the market size hypothesis by Scaperlanda and Mauer (1969) and theory of institutional variables as determinants of FDI (Asiedu, 2002; Gastanaga, Nugent, & Pashamova, 1998; Loree & Guisinger, 1995). A brief highlight of these theories is relevant here .

##### **2.1.1. The Eclectic Paradigm**

In Dunning's (1976) eclectic paradigm, three fundamental propositions are proposed to explain the degree and pattern of international production by MNCs. This theory opines that mostly, production sponsored by FDI depends on three forces which are; a) the existence of MNC's ownership or competitive advantages over domestic firms in the host economy, b) internalization advantages which are the benefits of MNC's own production as opposed to production through establishment of partnerships, licensing or direct exports and c) locational advantages which explains the existence of certain attractions like raw materials and low wages in host countries (Dunning, 2001).

### **2.1.2. The Market Size Hypothesis**

The market size hypothesis suggests that FDI will flow to a destination once the market at that destination is sufficient to enable MNC firms to exploit economies of scale (Scaperlanda & Mauer, 1969). Alternatively, it can be argued that once the size of the market reaches a certain critical point, it becomes a pull factor for inward FDI and reinforces its expansion (Chakrabarti, 2001).

Chakrabarti (2001) further observed that market size is the most extensively recognized determinant for inward FDI by most empirical studies. Studies carried out as early as the 1960s, and 1970s, such as Bandera and White (1968), Schmitz and Bieri (1972) included per capita GDP (as a measure of market size) in their respective studies and discovered a positive relationship with inward FDI.

### **2.1.3. The Institutional Variables Theory**

Interest in the policy and institutional variables as determinants of FDI became prominent in the 1980s following the enthusiastic liberalization trend in inward FDI policies in the developing world (Loree & Guisinger, 1995). Motivated by the desire to establish whether country reforms influence the flow of FDI, several authors have investigated the various effects of policy on FDI (Asiedu, 2006; Gastanaga et al., 1998; Obwona, 2001; Wei, 2000; Wei & Shleifer, 2000).

## **2.2 GLOBAL TRENDS IN FOREIGN DIRECT INVESTMENT**

Global inward Foreign Direct Investment (FDI) reached its highest point in 2007, when total inflows hit USD 1.976 trillion (UNCTAD, 2012). Due to the financial crisis which started in 2008, Worldwide FDI flows were affected, leading to a total decline equivalent to USD 777 billion in two years. By 2010, the world began to recover from this FDI slow down, with the overall inward FDI flows reported to have improved from USD 1.19 trillion in 2009, upwards to USD 1.31 trillion and USD 1.52 trillion in 2010 and 2011, respectively (UNCTAD, 2012). Thereafter, FDI has fluctuated up and down reaching USD 1.45 trillion in 2013 and USD 1.76 trillion in 2016 (UNCTAD, 2017).

Before 1990, worldwide annual inward FDI flows were less than USD 200 billion, constituting less than 1 percent of global GDP on average. But over the last

three decades, there occurred a phenomenal change in the international flows of FDI leading to an average growth rate of about 50 percent per annum. This has positioned FDI as one of the fastest growing drivers for worldwide economic growth and development. During the 1970s, international trade was the most significant global economic activity, but this has long been overtaken by FDI.

The United Nations in its 1998 World Investment report observed that, in a period of only ten years starting from mid-1980s, the growth rate of the ratio of FDI to global GDP doubled the growth rate of the ratio of international trade to global GDP, implying that the interdependence of the global economy revolved around this unprecedented rise in international production (UNCTAD, 1998). According to Mody (2004), FDI in its various forms represents the crucial underlying power that has brought about international economic integration. This is especially true because the majority of nations together with their formal productive units have been integrated into the transnational FDI web.

The significance of FDI in the world today is largely straight forward. In 2010 alone, the total output by all Multinational corporations (MNCs) brought forth a global value-addition of about USD 16 trillion, representing over 10 percent of worldwide GDP and at least one-third of global exports. This remarkable performance was possible notwithstanding the fact that the global FDI flows were apparently 15 percent less than their pre-crisis mean level (UNCTAD, 2011)

In 2015, MNC associated companies around the world offered jobs to 69 million employees, whose aggregated effort was able to realise revenues amounting to \$28 trillion<sup>2</sup>. Although by this time, the FDI global flows had significantly moved upwards to approximately \$ 1.746 trillion, they were still less than their 2007 maximum by about 11.7 percent (UNCTAD, 2012). This rising tendency serves to emphasise the fact that FDI has substantial relevance to the economic growth and development of the world. This is not only because of the way that it affects international production, employment and global trade, but also due to its influence on capital formation, widening of the tax bases of host economies and the global competition among firms.

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<sup>2</sup> This represented a 9 percent growth in value-added over the 2014 performance.



## **2.3 MOTIVE OF FOREIGN DIRECT INVESTMENT**

One of the most critical questions in international business is why businesses are engaged in FDI. For more than four decades now, the arguments for corporations to participate in international production have been discussed comprehensively by business scholars. The explanations for this phenomenon has been part and parcel of the numerous hypotheses and foreign development paradigms. According to Dunning (1993) and Dunning and Lundan (2008), FDI motivations are divided into four broad categories, namely; market seeking, resource seeking, efficiency seeking and strategic asset seeking motivations

### **2.3.1. Market-Seeking**

The goal is to achieve a direct international market presence in order to rapidly grow sales revenue and monitor the marketing mix strategy. It helps businesses to follow strategic goals such as shaking off competitors. Apart from market size, and the anticipated market growth, there exist four other reasons that explain why market-seeking companies may choose foreign investment, namely: (a) the principal suppliers or clients of a company may have spread internationally, and the company needs to pursue them in order to maintain its business; (b) a company may wish to adjust its product to local preferences and different consumer requirements that can only be done through the intervention of FDI in the industry; (c) the cost of supplying a domestic market from a nearby facility could be lower than supplying it from a distance and (d) a firm might find it important to have a physical presence in the leading markets served by its competitors as part of its international strategy. Unlike other types of foreign direct investors, market-companies prefer to view their international affiliates as self-contained business entities, rather than as part of an interconnected value-chain (Dunning 1993).

### **2.3.2. Resource-Seeking**

This type of investment aims at getting low-cost supplies of the factors of production in the host country. The most important of these are; raw materials, manpower, public benefits and the ability to reduce logistic costs. Dunning (1993) makes a distinction between three types of resource seekers: (a) those looking for

physical resources (such as agricultural products, raw materials and minerals), (b) those who are looking for cheap, high driven unskilled or semi-skilled labour and; (c) those pursuing technical potential, experience in management or marketing and organizational skills. Empirical evidence from Africa reveals that resource-seeking FDI has impacted African economies in various ways, and these impacts depend on a number of intervening factors such as the content in the investment contracts, the institutional framework in the host economy and the type of business model implemented by the foreign investor (Gerlach & Liu, 2010)

### **2.3.3. Efficiency-Seeking**

This is the FDI that comes into a country in search for an opportunity to enjoy the benefit of factors that may permit it to compete in international markets. The efficiency incentive for foreign direct investors is to rationalize their production, distribution, and marketing activities through joint governance and building synergies among geographically dispersed operations. Such rationalization basically stems from two sources: a) the advantages of factor endowment in host countries and b) the economies of scale and scope (Dunning 1993). According to the World Bank (2018), Efficiency-seeking FDI is not just export-oriented, but also essential to export diversification. Whereas it is more difficult to attract, efficiency-seeking FDI may turn out to be more than a mere source of capital, but a fundamental avenue for creating fresh jobs that are further diversified and with superior productivity and value to the host economy.

### **2.3.4. Strategic Asset-Seeking**

This is an undertaking that has led to increased self-competitiveness by acquiring strategic assets such as innovations that are not available on the home market, or even ties to global value chains.

According to Dunning (1993), such investment usually includes firms in emerging or developing countries and is often undertaken for variety of reasons, such as lower production costs or a desire to expand on overseas markets. The aim of this motive is to capitalize on the advantages of shared ownership of a network of activities and capabilities in different environments. The World Bank (2018) argues that this

type of FDI is motivated by investor's desire to acquire strategic assets (brands, human capital, distribution networks, etc.) that may empower a firm to compete in a specific market. It usually takes place in form of mergers and acquisitions

## **2.4 CHALLENGES OF FOREIGN DIRECT INVESTMENT**

Developing countries experience many challenges with FDI. Some of these are related with difficulties with attracting FDI inflows, while others are concerned with the way FDI impacts the host economies, after the Multinational companies have set up production facilities in the LDCs. In this section, we discuss the two types of challenges.

### **2.4.1. Challenges of Attracting FDI Inflows**

**Political risk.** Many developing countries are politically unstable. This is reflected in form of wars, authoritarian leaders, and lack of strong institutions (Mmieh & Owusu-Frimpong, 2004). Earlier studies by Lecraw (1991) and Nigh (1986) had revealed that the political risks associated with developing countries had a significant negative effect on FDI attraction to these economies.

**Administrative procedures.** Some developing countries are characterized by an unfriendly investment environment often complicated by the tedious bureaucratic procedures. According to Emery, Spence, Wells, and Buehrer (2000), administrative procedures were found to have a significant negative effect on the inflow of FDI in developing countries. In addition, Dutta and Sarma (2008) observed that approval procedures in India are time consuming and this has discouraged investors from locating in India, in preference to China which is more business friendly.

**High levels of corruption.** Developing countries are some of the most corrupt countries in the world. The corruption indexes are highest in the developing countries of Africa, Asia and South America (Olken & Pande, 2012). Studies have shown that perceived high levels of corruption obstruct the flow of foreign investment to LDCs (Wei, 1998).

**Poor infrastructure.** Developing countries are also characterized by high infrastructure deficit. Dutta and Sarma (2008) observed that transport, road, power and water availability are major considerations for foreign investors. If these critical basic

infrastructure are absent, foreign investors will most likely stay away from such a country.

Macroeconomic instability. Macroeconomic indicators speak about the health of an economy. Dupasquier and Osakwe (2006) argue that many African countries have unstable economies characterized by high incidences of currency crashes, excessive budget deficits, double digit inflation, all of which limit the continent's potential to attract FDI.

Protectionism. The high levels of barriers to trade punctuated by low integration into the global economy, has affected Africa's chances of attracting more FDI. Morisset (2000) presented empirical evidence showing a significant positive effect from openness to FDI inflows in Africa. The reverse implication of this finding is that, an economy that puts barriers to trade would be hostile to FDI inflows.

#### **2.4.2. Challenges Related with FDI Impact to the Host Economy**

Negative effect on economic growth. There are empirical findings suggesting that FDI's effects on economic growth are ambiguous and at worst negative to the host economy (Alfaro, 2003; Carkovic & Levine, 2002; Falki, 2009; Omoniyi & Omobitan, 2011). Besides, in Görg and Greenaway (2004) comprehensive literature survey, at least six empirical papers are sighted which reported negative effects from the presence of MNCs on domestic firms . Konings (2001), revealed the presence of a negative competition effect from foreign firms in Bulgaria, which over shadowed the positive technological effect to the domestic firms. Similarly, Herzer (2012) found a negative growth effect in a cross-country analysis on 44 developing countries.

FDI and wage spillovers. Lipsey (2004) provides a comprehensive analysis on how FDI dampened domestic firms' wages in Indonesia's manufacturing sector. Overall, the spillover effect from FDI firms manifested through the attraction of high skilled workers from domestic firms to Multinationals which were paying better. With only less skilled workers left in domestic companies, wages in local firms were significantly reduced to match the competencies of the less experienced workers. This dampening effect of wage spillovers in local firms could have led to the observed reduction in output from local firms.

Deterioration of the host countries' terms of trade. Empirical studies have been undertaken to investigate the paradox between the rise in FDI inflows and the decline in a host country's terms of trade. Theoretically, higher volumes of FDI should lead to better terms of trade. However, China, the world's topmost FDI recipient has had its terms of trade worsening over the years. H. Li, Huang, and Li (2007) found that China, in pursuit of export promotion strategy has had most of her FDI flowing in the labour-intensive export sectors. Consequently, the capital-intensive sectors facing import substitution have ended up suffering a contraction.

## **2.5 LEADING DESTINATIONS FOR FDI**

### **2.5.1. Global Overview**

FDI flows to emerging economies have declined since 2004, dropping by 27%, while flows to Europe have risen more than massively increased to \$172 billion. In North America, flows have become more responsive after shrinking to \$291 billion by 4 per cent in the year 2016. While the establishment of cross-border mergers and acquisitions deals held steady, growing over 21% in magnitude, it was not enough to accommodate both the significant adverse US FDI generated by policy changes

Foreign investment in the United States reached \$ 252 billion, in recent years, representing a slight improvement over the last three years (UNCTAD, 2017). Australia's FDI inflows hit \$60 billion in a historic-level as international investors invested wisely this country's previous \$25 billion in inflows (UNCTAD, 2018). FDI flows to emerging economies remained unchanged, increasing by only 2 per cent to \$706 billion, with major regional variations (UNCTAD, 2017). Asia and Africa observed increased inflow of FDI in 2018, but FDI in Latin America and the Caribbean stayed unchanged at about \$ 517 billion by 2018 (UNCTAD, 2019).

Developing Asia maintained their professional zone of FDI inflows and reported an increase in FDI by close to 4 per cent to \$512 billion in 2018, including strong outlook in all sub-regions. China, the largest beneficiary of FDI in the growing economy, received \$139 billion, up by 4 per cent (UNCTAD, 2019). Flows towards South-East Asia increased by 3 percent to a new historic level (\$149 billion) for the second straight year (World Bank, 2019).

FDI flows to Africa increased by 11 per cent to \$46 billion in 2017, although this was still below the average annual flow of \$ 50 billion during the preceding 2 decades. The increase in flows seems to have been primarily due to the continued of resource-seeking investment from Europe and Asia, the slow growth of the developed countries and significant economic improvements in many African economies (UNCTAD, 2018). Overall, China is topmost FDI destination, having reached \$ 139 billion in 2018. Emerging economies of Asia, Latin America and Africa together received \$ 706 billion inflows, while North America was the second largest block with inflows equal to \$ 291 billion (UNCTAD 2019).

### 2.5.1. Leading Destinations in Africa

According to UNCTAD report of 2019, the five leading FDI destinations in 2017 and 2018 were; Egypt, South Africa, Congo, Morocco and Ethiopia. The five countries commanded a combined inflow amounting to \$ 20.5 billion and \$ 23.3 billion in 2017 and 2018 respectively (UNCTAD, 2019). Figure 3, illustrates the distribution of these inflows in the five countries.

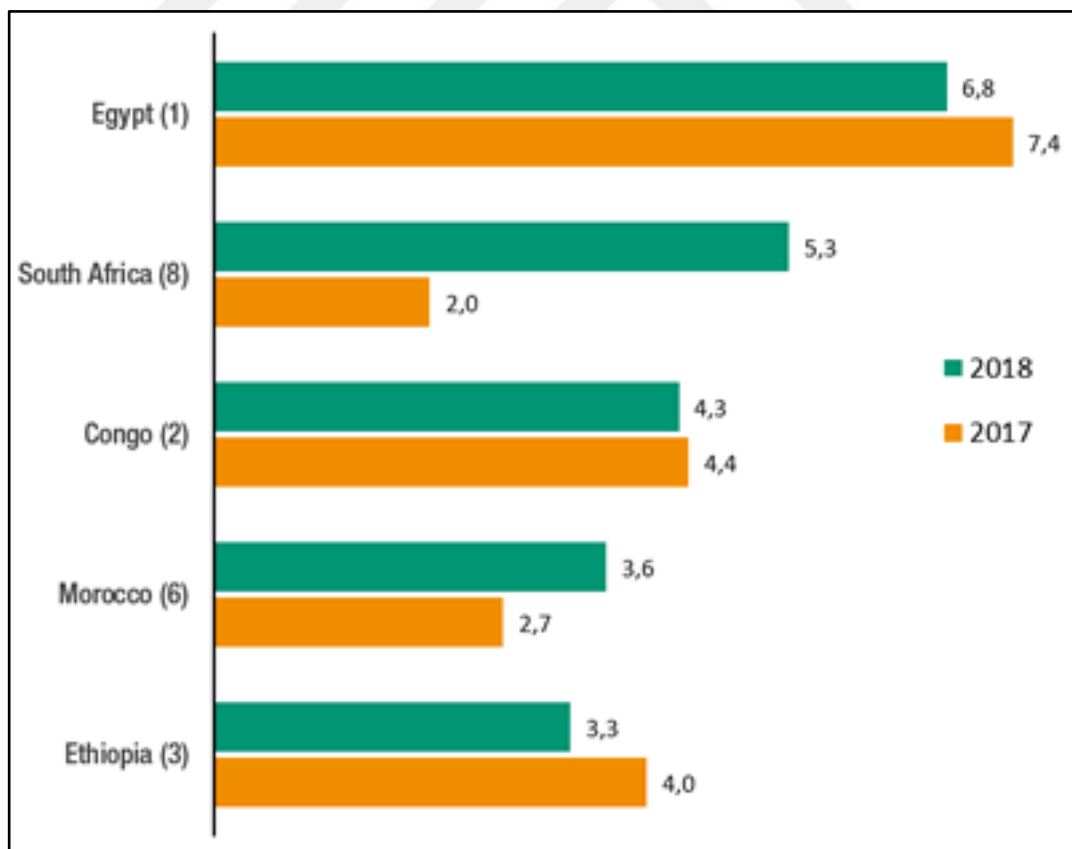


Figure 2. African FDI inflows: top 5 recipients (billions of USD) UNCTAD, 2019

In general North African countries, particularly those which are part of the MENA region are more attractive to FDI, than sub Saharan Africa. This is because these countries have mineral resources, particularly oil which attracts investors from Europe, North America and China (Hisarciklilar, Kayam, & Kayalica, 2006).

### 2.5.2. Leading FDI Investors in Africa

The latest trends in the inflow of FDI indicates that the major sources are the advanced countries. The vast majority Africa’s FDI comes from Europe, United States of America, China and South Africa (UNCTAD, 2015). There is little outflows from Africa to other parts Africa, except in the case of South Africa and Nigeria. South Africa tops other African countries in terms of investing in fellow African countries. In recent decades, the outflow of FDI from South Africa has been on the rise. By 2017, South Africa’s outward FDI in the rest of Africa reached \$ 7.4 billion, while Nigerian firms invested \$ 1.3 billion in fellow African countries (UNCTAD, 2018). Figure 4 below, shows the top five sources of FDI to Africa

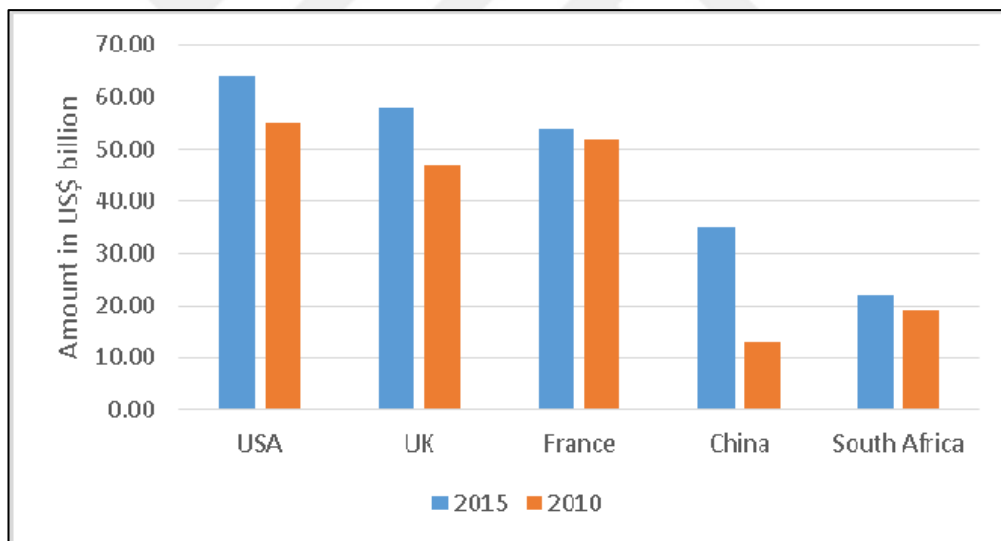


Figure 3. Top 5 investor economies by FDI stock in Africa, 2010 and 2015 (UNCTAD, 2017)

In general, the USA was the single largest investor on the African continent with a total FDI stock greater than \$ 60 billion. This is followed closely by the United Kingdom and France. However, despite being in the 4<sup>th</sup> position, China is the most aggressive investor on the African continent (UNCTAD, 2019). The rate at which

China is investing in Africa is more than double that of the leading three investors on the African continent.

## **2.6 FACTORS TO CONSIDER IN CHOOSING FDI DESTINATIONS**

There are several factors that are considered by Multinationals in choosing FDI destinations. These include; market size, trade factors, economic factors, human resource factors, institutional factors, and profit retention factors (Cavusgil et al., 2017; Morisset & Pirnia, 2000). Empirical literature also shows some of the most commonly applied factors Chakrabarti (2001). Below, we explain some of these factors.

### **2.6.1. Market Factors**

The market size hypothesis suggests that FDI is attracted to countries with large markets. Consequently, once the market size of a country has reached a level meriting the tapping of economies of scale, it becomes a viable candidate for inward FDI (Moosa, 2002; Scaperlanda & Mauer, 1969). In addition, Chakrabarti (2001) observed that market size is the most extensively recognized determinant for inward FDI by most empirical studies .

### **2.6.2. Institutional Factors**

Literature on the relationship between institutional factors and economic performance is growing fast. In general, the current literature points to the fact that poor public institutions exhibit great explanatory power for poor economic results including slow economic growth, reduced domestic entrepreneurship and foreign direct investment (Wei & Shleifer, 2000). More specifically, the quality of institutions is a vital factor for inward FDI with countries having good quality institutions being more attractive (Tun, Azman-Saini, & Law, 2012). When important institutions that are relevant for the proper functioning of markets are deprived, the cost of doing business rises (Blonigen, 2005) . Besides, poor institutions might result into inadequate infrastructure in the form of public goods, altogether resulting into diminished FDI to the country.



### **2.6.3. Economic Factors**

Modern FDI literature recognizes economic policy variables among the key considerations for destination choice of inward FDI. This is based on the argument that the investment decision process is affected by government actions and policies at different stages (Faeth, 2009). Inward FDI is attracted to a country with a stable macroeconomic environment and vice versa (Mlambo, 2005). Several empirical studies have tested the effects of a variety of economic factors on FDI and almost overwhelmingly, they have found that macroeconomic stability is relevant and significant to the flow of FDI (Blonigen, 1997; Chakrabarti, 2001; Kinoshita & Campos, 2003; Lo, Lin, Chi, & Joseph, 2013). Factors commonly tested in studies include, inflation, exchange rates, public debts and budget deficits (Chakrabarti, 2001; de Angelo, Eunni, & Fouto, 2010; Kinoshita & Campos, 2003; X. Li & Liu, 2005; Mlambo, 2005)

### **2.6.4. Human Resource Factors**

The human resource question usually revolves around the availability of skilled labour and the labour cost in a potential destination. The labour cost hypothesis arising from the locational advantages theory is one of the classical drivers of inward FDI in the developing world. It is argued that resource or asset seeking FDI moves to locate in resource rich countries as a strategy of acquiring resources absent in their own economies such as natural resources and low cost labour (Asiedu, 2006; Kinoshita & Campos, 2003). LDCs are usually characterized by low cost of labour due to both the existence of large numbers of unemployed people and the fact that most people lack technical skills leading to low wages, which in turn encourage inward FDI (Zhang, 2001).

### **2.6.5. Trade Openness Factors**

Openness measures the extent to which countries interact with each other through trade. Theoretically, since the majority of investment establishments are engaged with production for the trade sector, the magnitude of a country's openness to transnational trade is germane to the FDI location decision (Chakrabarti, 2001). It is assumed that openness has a positive relationship with FDI as it creates a stimulus

for the entry of MNCs (Lo et al., 2013; Morisset & Pirnia, 2000). In addition, Choong and Lam (2010) argue that for some economies, openness could be an indicator for economic reforms, which form part of the global policy requirements for international capital movements .

## **2.7 TYPES OF FDI**

In general, five types of FDI are mentioned in literature namely; Greenfield investments, Mergers, Acquisitions, Joint ventures and Consortium (Beugelsdijk, Smeets, & Zwinkels, 2008; Calderón, Loayza, & Servén, 2004). Briefly, we describe the different types below:

### **2.7.1. Greenfield FDI**

This is a type of FDI in which the parent company creates a subsidiary in another country, building its operations from the ground up. Besides the construction of new production facilities, these projects can also include the building of new distribution hubs, offices, and living quarters (Investopedia, 2019). The value of reported global Greenfield investments rose from 771.8 billion dollars in 2013 to 980.7 billion dollars in 2018 representing an average annual increase of 4.91 percent (UNCTAD, 2019). Studies have been carried out concerning the choice of entry mode by MNCs, between Greenfield, Mergers and acquisitions and joint ventures. It has been found that mostly, profitability of Greenfield investments influences this choice, not only directly but also indirectly (Klimek, 2011; Raff, Ryan, & Stähler, 2009).

### **2.7.2. Acquisitions**

This refers to the purchase or sale of existing shares by the direct investor or direct investment enterprise as opposed to purchase or sale of newly issued shares. Alternatively, it is the *equity* component of FDI inflows and outflows (but not to *reinvestment of earnings* and debt instruments (OECD, 2009). FDI literature reveals that during the 1990s, FDI in the form of acquisitions grew much more rapidly in the developing world than Greenfield investments. This was primarily due to the extensive privatization policies in the developing world at that time (Calderón et al., 2004). The value of global net acquisitions by seller is reported to have increased from 98.05

billion dollars in 1990 to 815.7 billion dollars in 2018, representing an average annual increase of 7.86 percent (UNCTAD, 2019).

### **2.7.3. Mergers**

A merger is the combination of two firms, which subsequently form a new legal entity under the banner of one corporate name (Investopedia.com, 2020). Literature shows that mergers can generate many positive outcomes, including inter-partner learning and resource sharing, increased scale economies, cost savings from eliminating duplicative activities, a broader range of products and services for sale, and greater market power (Cavusgil et al., 2017). Mergers form a significant activity in FDI. The largest international merger in recent years include the Kraft Foods of the United States and Cadbury of the United Kingdom (Cavusgil et al., 2017).

### **2.7.4. Joint Ventures**

Joint ventures are normally formed when no one party possesses all the assets needed to exploit an available opportunity (Cavusgil et. al., 2017). In a typical joint venture FDI deal, a foreign partner would bring capital, technology, managerial experience, training, or a unique product. The local partner would then contribute the use of its factory or other facilities, Knowledge of the local language and culture, market navigation know-how, useful connections to the host-country government, or lower-cost production (Cavusgil et. al., 2017).

### **2.7.5. Consortium**

A consortium is a project-based, frequently non-equity venture originated by multiple partners to accomplish a large-scale project. It is characteristically designed with a contract that defines the rights and obligations of each member (Cavusgil et al., 2017). Work is assigned to the members on a similar basis as profits. For example, in a three-partner consortium, if each partner performs one-third of the work, then each earns one-third of the profits. In the area of FDI, Multinational companies can form Consortia to invest in multi-dollar investments. In 1999, UNCTAD reported that Telecom Malaysia had formed a consortium with SBC International of the United States to invest \$ 1.2 billion in a privatized South African Telecom. In other global

examples, Boeing, Fuji, Kawasaki, and Mitsubishi joined forces to design and manufacture major components of the Boeing 767 aircraft (Cavusgil et al., 2017) |



## CHAPTER III

### FDI IN SOMALIA: AN EMPIRICAL RESEARCH

#### 3.1 THE STATE OF THE SOMALIAN ECONOMY

Somalia is a country with about 15 million people, with a land area of 627 340 square kilometers.<sup>3</sup> Until 1991, Somalia was governed by the Somali Revolutionary Socialist Party (SRSP) under a military regime led by General Siad Barre. During this period, Somalia's economy and financial infrastructure operated according to the socialist ideology. In 1991, the unified government of Somalia collapsed together with the whole economic and financial system (Bekkin, 2007). The period that followed the fall of the Siad Barre government has been characterized by civil wars becoming a failed state and a humanitarian disaster that led to the displacement of millions of Somali nationals within and outside of Somalia (Marchal, 2013).

The Somali economy literally collapsed with the fall of the unified government in 1991. The unending clan based conflicts in Somalia have since then prevented the reconstruction of a robust economy for several decades. Consequently, the state of the country's economy became unconventional. Jamal (1988) in a comprehensive paper discusses how Somali's survive in such an economy and casts some doubt on the validity of the alarming statistics which attempt to show a very bad situation. Besides, there is complementary literature that describes the survival, resilience and state of the society following the collapse of the nation state of Somalia in 1991.

Reno (2003) for example argued that some of the global economic changes that have taken place since the 1970s have given the Somali social network chances to reconfigure economic ties with the rest of the world. Mubarak (1997) on his part observed that the informal markets that sustained private sector activities under the repressive policies of Siad Barre's government have given Somalia a functioning

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<sup>3</sup> Source: <https://unctadstat.unctad.org/CountryProfile/GeneralProfile/en-GB/706/index.html>

system to the economy, despite the absence of a proper government. In the words of Webersik (2006), “today there is a thriving economy, largely based on trade and arbitrage, rather than on production without a functioning state in Somalia”. The total sum of the above literature suggests that despite the ongoing conflict, Somalia has a working economy although eccentric, which is supporting the survival of millions of Somali citizens.

Some of its economic indicators in Somalia are summarized in the table below

Table 1 Somali economic indicators

Indicator (millions of USD)	2005	2010	2015	2018
GDP, current	2,316	1,093	1,455	1,615
GDP per capita, current	22	91	105	108
Real GDP growth (Annual)	3.00	2.60	2.70	3.26
Exchange rate (/US\$)	15,251.25	31,269.66	22,254.24	-
Merchandise exports, current	250	450	440	340
Merchandise imports, current	626	840	1, 100	1, 240
Merchandise Trade balance	-376	-390	-660	-900

Source UNCTAD (2019)

### 3.2 HISTORICAL BACKGROUND OF FDI IN SOMALIA

FDI has only recently become a global phenomenon. Before 1990, the worldwide annual inward FDI flows were less than USD 200 billion, constituting less than 1 percent of global GDP on average. It was only after 1990 that there occurred a remarkable change in the international flows of FDI leading to an average growth rate of about 50 percent per annum. According to the 1998 World Investment report, the growth rate of the ratio of FDI to global GDP doubled the growth rate of the ratio of international trade to global GDP, implying that the interdependence of the global economy revolved around this unprecedented rise in international production (UNCTAD, 1998) .

Somalia which has been at war since the early 1990s does not have a very impressive FDI history. This is because, the country went into civil war at the most crucial time, when FDI inflow worldwide were just beginning to rise up. It is a well-

known fact that peace and political stability is one of the key factors that facilitate the inflow of FDI (Asiedu, 2002). Therefore, in the absence of peace and stability, Somalia has not been an attractive FDI destination over the last three decades.

Nevertheless, even with her bumpy journey in the race for foreign direct investment (FDI). Some amount of FDI has been flowing in and out of the country at different times. Statistics from the world development indicators (WDI) show that for the period 1990 to 2004, FDI in Somalia was very close to zero and sometimes negative. This performance is expected because this was the period when Somalia was under a very severe civil war. From 2005, Somalia having obtained some relative peace, started to attract FDI inflows and the volume entering the economy started to rise. Figure 3.1 below illustrates the FDI inflows for a period of 27 years from 1990 to 2017.

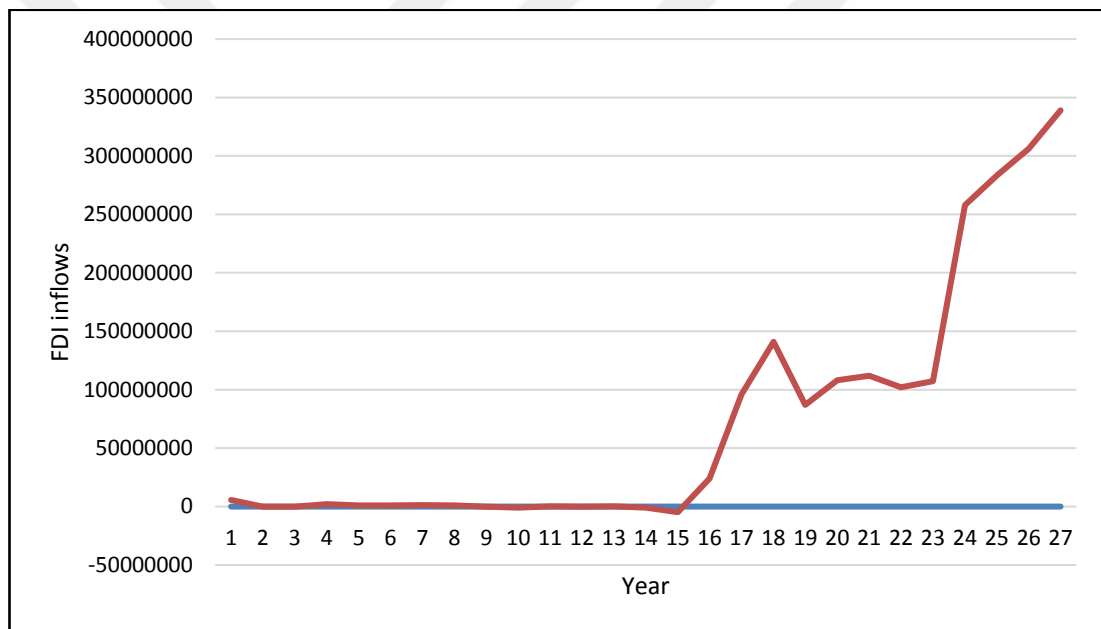


Figure 4: FDI inflows in Somalia World Development Indicators (WDI)

### 3.3 SCOPE OF THE STUDY

The few studies on FDI in Somalia have largely focused on establishing its determinants (Ibrahim, Omar, & Ali, 2017), effect of exchange rate volatility on FDI inflows (Ali, Ibrahim, & Omar), and the impact of FDI on environmental pollution (Bildirici & Gokmenoglu, 2020). Very little is known about the effect of FDI on economic growth, from the work of Mohamed and Isak (2017). This study sets out to contribute on this topic. The study applies time series data covering the period 22 years

from 1998 to 2019. A linear regression model is used, but due to endogeneity and small sample concerns, econometric analysis is implemented using the autoregressive distributed lag (ARDL) approach.

### **3.4 OBJECTIVE AND SIGNIFICANCE OF THE STUDY**

This study set out to achieve the following objective;

1. To estimate the effect of inward FDI on economic growth in Somalia.

The study is significant in three major areas namely; contribution to knowledge, guiding policy formulation and helping the researcher complete a Master's degree. As already observed in section 3.2 above, very little effort has been done so far to establish empirical evidence on the extent to which FDI is influencing economic growth in Somalia. This question has not been conclusively addressed. Therefore, this study is an addition to the existing effort. In addition, the making of policies on FDI in Somalia today is not based on any empirical evidence. Rather the government is simply giving incentives and accepting the conditions of investors. There is an urgent need to provide empirical evidence that can guide the government on the type of policies they institute. Lastly, this study will help the current researcher to fulfill the requirements for the award of a Master's degree of Cankaya University.

### **3.5 LITERATURE REVIEW**

Over the last one half of a century, the phenomenon of economic growth has been a fundamental problem for both academicians and policy makers. The questions that lie at the heart of this puzzle include among others; a) why do some countries grow faster than others? b) Why does it arise that at any point in time, certain countries are considerably wealthier than others? In seeking to answer these and other questions concerning growth, economists have proposed several theories. However until this far, there is no single theory that provides a unifying description of growth (Petraikos & Arvanitidis, 2008). The existing theories, such as the Solow model, endogenous models, the new economic geography etc., can only partially describe the role of the different factors in determining economic growth .



Klenow and Rodriguez-Clare (1997) categorized the various theories into three: the first category comprises the theories which have endeavored to explain world growth over the last two centuries. These are mainly the endogenous models of growth, prominent among them being the models of Lucas (1988); Romer (1990) and Grossman (1991). The second category includes theories of country growth inspired by the fabulous differences in the growth rates of different countries. The traditional Solow model (1956) and Lucas (1993) paper on the economic wonders of the Asian tigers falls in this category. The last category includes models that explain the existence of richer countries than others and these include the human-capital augmented Solow model by Mankiw, Romer and Weil (1992) among others .

There is sizable evidence that most country studies are based on the standard growth model (Solow, 1956) which places emphasis on capital accumulation, the size of employed labour and exogenously determined technology in the growth of initially poor countries (Anwar & Nguyen, 2010; Owusu & Odhiambo, 2014; Rao & Hassan, 2012; Yao, 2006). In addition, Mankiw, Phelps, and Romer (1995) observed that notwithstanding its simplicity, the Solow model has a multiplicity of predictions, which are widely consistent with experience .

In Somalia, the only study that has investigated this question so far is the one by Mohamed and Isak (2017). Theoretically, their study is based on the Solow model (1956), implemented through a production function with the traditional factors of capital and labour. Their analysis is however only a short run analysis, since their cointegration test reveals the absence of a long run relationship. The present study extends this Solow model (1956) based study, but with the addition of several other factors to the production function, which enter the model as part of the total factor productivity component of the traditional production function.

### **3.5.1. Determinants of Economic Growth**

Based on both theoretical and empirical literature, the variables explained below have been frequently mentioned as some of the key factors driving the growth of countries. This study has illustrated the importance of these determinants and the rationale for their inclusion in the economic growth model of Somalia. In addition,

various studies which have applied the same variables have been cited. Finally, the tested hypotheses for the various factors have been mentioned.

### **3.5.1.1 Capital**

In the standard neoclassical theory, capital intensity is one of the fundamental factors determining the prosperity and growth of an economy. It is commonly described as the physical capital consisting of a combination of various capital goods (e.g. machines, equipment, buildings etc.), which the average worker has at his disposal. It is hypothesized that the larger the amount of capital, the more prosperous that economy will be. But physical capital in an economy maybe domestically owned (domestic investment, DI) or foreign owned (such as FDI) . De Mello (1999) argued that FDI has a direct effect on the economic growth of a country through its contribution to the economy's physical capital.

In empirical growth studies, the capital variable has been either represented by total investment (Piazolo, 1995) or with investment disaggregated into its foreign investment (FDI) and domestic investment (DI) categories (Akram, Manzoor, Hassan, Farhan, & Alam, 2011; Balasubramanyam, Salisu, & Sapsford, 1996; Borensztein, De Gregorio, & Lee, 1998; Mehic, Silajdzic, & Babic-Hodovic, 2013) . In the latter case, the separation of the two types of investment and their parallel inclusion in the model permits an investigation into the exogenous effect of FDI, while controlling for the influence of domestic investment on economic growth. Since the objective of this study was to measure the effect of FDI on growth, both domestic investment (DI) and foreign investment (FDI) were specified as explanatory variables, in order to be able to estimate the specific effect of FDI on Somalia's growth. We tested the hypothesis that both FDI and domestic investment (DI) are positively related with growth .

### **3.5.1.2 Labour**

Labour is another classical determinant of economic growth. Under the standard neoclassical hypothesis, growth is a function of labour (L) and physical capital (K). In the growth model equilibrium analysis, it is often shown that steady state implies that the growth rate of the labour force is associated with a proportionate rise in economic growth (Kormendi & Meguire, 1985) . Empirical studies have

applied various proxies to measure the impact of labour on growth including among others; total population (Piazolo, 1995), the mean population growth rate (Kormendi & Meguire, 1985), the growth rate of the labour force (Bhalla, 1997) and the number of workers in an economy (Hall & Jones, 1999) .

Empirical findings differ only in their respective levels of significance, but overall the measures of labour turn out to be positively related to economic growth. The labour factor is very important for economic growth in Somalia, because labour is the abundant and cheaper productive resource available in the country when compared with capital. Following Hall and Jones (1999) and on account of data availability, this study applied the total labour force to measure the effect of the labour factor on economic growth . The study therefore tested the hypothesis that labour is positively and significantly related with economic growth in Somalia.

### **3.5.1.3 Macroeconomic Stability**

Economic theory nowadays broadly acknowledges that a stable macroeconomic framework is necessary for sustainable economic growth (Fischer, 1993). The macroeconomic framework comprises monetary, fiscal and exchange rate policies which produce measurable indicators such as the inflation rate, the budget deficit and the balance of payments. Hypothetically, variables such as inflation and budget deficits produce negative effects on economic growth. When a government through its monetary and fiscal policies fails to control inflation and budget deficits, such a government will have lost the stability of its macroeconomic framework, which would negatively affect economic efficiency and reduce growth (Leitão & Rasekhi, 2013) . Several empirical studies have included these variables to measure the influence of macroeconomic stability on economic growth and proven that they have a significant impact (Feeny, Mitchell, Tran, & Clarke, 2013; Fischer, 1993; Kormendi & Meguire, 1985; Piazolo, 1995).

In Somalia, macroeconomic stability is one of the key goals of the present government . This study used inflation because the government is strongly focusing its effort on it and yet it is the best single indicator of macroeconomic stability (Fischer, 1993). The distortionary effects of inflation not only lower the real income in the economy, but also affect the growth rate by decreasing the productivity of

investment (Corden, 1990). The study tested the hypothesis that inflation is negatively related with economic growth in Somalia .

#### **3.5.1.4 Exports**

The relationship between exports and economic growth has been studied extensively by development economists, particularly during the post second world war era. There are several benefits of exports to an economy as discussed in Feder (1983). But theoretically, the endogenous growth literature provides a basis for expecting a positive relationship between exports and economic growth (Greenaway & Sapsford, 1994). Several empirical studies have investigated the connection between exports and growth (Amadou, 2013; B. Chen & Feng, 2000; Ledyeva & Linden, 2008; Piazzolo, 1995; Ram, 1985) .

The empirical approach involves the inclusion of the export variable in the growth model along with other factors which help to control the other influences on growth (Greenaway & Sapsford, 1994). This study therefore tested the effect of exports to economic growth in Somalia using the hypothesis that exports are positively related to the country's growth .

### **3.6 METHODOLOGY**

The methodology section deals with both the theoretical framework and the empirical estimation methods. Under the framework, we introduce the Solow model (1956) and explain the development of the study's economic growth equation based on this neoclassical growth model. The hypotheses for the specified variables are also explained.

#### **3.6.1. Theoretical Framework**

This study was routed in the neoclassical Solow (1956) model which suggests that output is a function of capital, labour and constant technology. The model is expressed in its simplest form with Hicks-neutral technology as follows;

$$Y_t = A_t f(K_t, L_t) \tag{1}$$

Where  $Y_t$  is the level of output,  $K_t$  is the amount of domestic and foreign capital,  $L_t$  is the employed labour and  $A_t$  represents ideas measuring the level of technology at a

given time  $t$ . Equation (1) provides a basis for constituting an aggregate production function (APF) framework which has been applied widely in economic growth studies in the developing world (Fosu & Magnus, 2006) .

The standard aggregate production function (APF) approach assumes that the “unconventional inputs” such as inflation, exports, etc., can be augmented within the production function in order to measure their effect on economic growth. The APF model was hence used by this study due to its flexibility and following empirical studies that have applied it in similar studies (Feder, 1983; Fosu & Magnus, 2006; Kohpaiboon, 2003; Siliverstovs & Herzer, 2006). The production function was specified using the Cobb Douglas function as follows;

$$Y_t = A_t K_t^\alpha L_t^\beta \quad (2)$$

Where  $Y_t$  denotes aggregate output at time  $t$  (real GDP $_t$ );  $A_t$ , stand for total factor productivity;  $K_t$  represents both domestic capital ( $DI_t$ ) and foreign capital ( $FDI_t$ ) and  $L_t$  is the labour stock ( $LBR_t$ ) .

The total factor productivity (TFP) in this model captures the effect of the unconventional factors on economic growth. Hence,  $A_t$  is expressed as a function of these unconventional factors which include; inflation ( $INF$ ), and exports ( $EXPT$ ), as shown in equation (3).  $Z_t$  stands for the other exogenous factors (Siliverstovs & Herzer, 2006) .

$$A_t = f(EXPT_t, INF_t, Z_t) = EXPT_t^\gamma INF_t^\phi Z_t \quad (3)$$

Combining equations (2) and (3) and representing the  $Y_t$  as  $GDP_t$ ;  $K_t$  as  $DI_t$  and  $FDI_t$ ; and  $L_t$  as  $LBR_t$ , gives us the aggregate production function equation as follows;

$$GDP_t = Z_t DI_t^\alpha FDI_t^\delta LBR_t^\beta EXPT_t^\gamma INF_t^\phi \quad (4)$$

Where  $\alpha$ ,  $\delta$ ,  $\beta$ ,  $\gamma$  and  $\phi$  are the output elasticities with respect to  $DI_t$ ,  $FDI_t$ ,  $LBR_t$ ,  $EXPT_t$ , and  $INF_t$ , respectively. The natural logarithms (L) transformation on equation (4), gives the following linear growth function

$$LGDP_t = c + \alpha LDI_t + \delta LFDI_t + \beta LLBR_t + \gamma LEXPT_t + \phi LINF_t + \varepsilon_t \quad (5)$$

In the above equation,  $c$  is a constant term,  $\varepsilon_t$  is the error term and all coefficients are constant elasticities. Equation (5) is the final economic growth model which was estimated to analyze the effect of FDI and other determinants on economic

growth in this study. The model says that a change in real GDP depends on the individual changes in each of the independent variables .

### 3.6.2. Explanation of Variables

Table 2 presents the variable definitions and expected effects on each of the variables in the empirical model. The expected effects indicated in the table define the tested hypotheses between the dependent variable and the explanatory variables.

Table 2 The growth equation variables: definitions and expected effects

Variables	Definition	Expected effects on the dependent variable
		Dependent variable
LGDP	Log of Real GDP measured at 2005 prices	
LFDI	Log of foreign direct investment (2005 prices)	+
LEXPT	Log of real exports (2005 prices)	+
LLBR	Log of total labor force in the economy	+
INF	Inflation, consumer prices (annual percent)	-
LDI	Log of domestic investment (2005 prices)	+

The log of real GDP in this model is the dependent variable. The volume of real GDP measures the size of the economy. When expressed in logarithms it is interpreted in terms of elasticities which represents economic growth (de Angelo et al., 2010). Several empirical studies have used this measure in economic growth studies (Guru-Gharana, 2012; Kohpaiboon, 2003; Siliverstovs & Herzer, 2006; Tang & Abosedra, 2014). Changes in the explanatory variables, lead to changes in real GDP which provides the measure of economic growth .

Foreign direct investment (FDI) was the central variable of interest in this study. It was hence modelled as an explanatory variable, entering as a component of the capital variable. The role of FDI in the economic growth of countries has been broadly examined in literature. Some studies have examined FDI's contribution through technological transmission and innovativeness to domestic firms (Berthélemy & Demurger, 2000; Borensztein et al., 1998; Bwalya, 2006; García, Jin, & Salomon, 2013). Others have investigated the specific growth effect of FDI while controlling

for other factors affecting growth (Anwar & Nguyen, 2010; Balasubramanyam et al., 1996; Carkovic & Levine, 2002), while another strand of literature has attempted to find out whether FDI has a complementary effect on domestic investment (Borensztein et al., 1998; De Mello, 1999). This study investigated the distinct effect of FDI on growth, while controlling for domestic investment and other factors. The study tested the hypothesis that inward FDI positively affects economic growth in Somalia .

Exports entered the aggregate production function (APF) as one of the unconventional factors of production, via total factor productivity (TPF). The specific relevance of this factor in this analysis was to assess Somalia's export promotion strategy, which is one of the modern policies followed by the Somali government. This is in line with a broad range of empirical growth studies which have included this variable in order to test the export-led growth theory (Balasubramanyam et al., 1996; Feder, 1983; Greenaway & Sapsford, 1994; Ram, 1985). It was hypothesized that there is a positive relationship between exports and economic growth .

Labour stock and Capital stock are the two classical variables in the Solow growth model which are primarily responsible for growth in real output. These two variables were automatically modelled in the production function of this study on that theoretical basis. It is a standard practice for empirical growth studies to include these two variables in their analyses (Barro, 1991; Chow, 1993; Fosu & Magnus, 2006; Tiwari, 2011). Following Fosu and Magnus (2006) and on account of data availability, this study measured the labour stock variable by the total labour force comprising of all people aged 15 years and above who are economically active. The tested hypothesis was that labour stock is positively related with economic growth in Somalia .

Domestic capital is one of the two components of total capital stock in the economy, the other being foreign owned capital (De Mello, 1999). In empirical studies, domestic capital is measured in different ways such as; the ratio of gross domestic fixed investment to GDP (Kohpaiboon, 2003), real capital stock computed as accumulated capital expenditure (Siliverstovs & Herzer, 2006), or gross fixed capital formation (Fosu & Magnus, 2006; Piazolo, 1995). In this study, domestic investment was proxied by licenced domestic investment data at Somalia's Ministry of Finance

archives. The study estimated the hypothesis that domestic investment is positively related with economic growth in Somalia .

The inflation variable entered the analysis through TFP as a measure of the macroeconomic stability in the economy. Several growth studies include inflation variable as in order to capture the effect of the macroeconomic stability. There are mainly two measures of inflation which are used in empirical studies; either the annual inflation rate based on the GDP deflator (B. Chen & Feng, 2000; Piazzolo, 1995), or the annual inflation rate based on the consumer price index (Carkovic & Levine, 2002; Shahbaz & Rahman, 2010). This study applied the annual inflation rate based on the consumer price index (CPI). It tested the hypothesis that inflation is negatively related with economic growth, due to the distortionary effects of inflation on the production process .

### **3.6.3. Empirical Approach**

To estimate the economic growth model, the study applied the autoregressive distributed lag (ARDL) method. Choice of this estimation approach was based on its flexibility. Literature is robust on the suitability of using ARDL method whether the variables are stationary I (0), non-stationary I (1) or a mixture of both (Duasa, 2007; Narayan, 2005; Odhiambo, 2010). In addition, with Monte Carlo experiments, the ARDL model was confirmed to have exceptional small sample properties as well as robust estimates (Kargbo & Adamu, 2009; Narayan & Narayan, 2006). Hence, this method was deemed appropriate and study applied for the empirical analysis.

#### **3.6.3.1 Data**

Data applied for analysis in this study covered a period of 22 years (from 1998 to 2019). This is because Somalia has suffered many years of war and there is a problem of data availability. These Data were largely obtained from the World development indicators (WDI) database and additional sources such Somali ministries of labor and finance as well as the central bank. It was recorded as follows; 1) data on annual exports of goods and services recorded at current US dollars and 2) labour stock measured by the total labour force, constituted by all people aged 15 years and above, who are economically active . Data were obtained from WDI and



complemented with that from Ministry of Labor in Somalia. Planned domestic investment (DI) data were obtained from Ministry of finance archives. It was recorded at current US dollars.

Following Sun, Tong, and Yu (2002), all monetary data denominated in US dollars was converted into 2005 prices using Somalia's GDP deflator. Natural logarithms were then applied to the variables. This was necessitated by the need to linearize the Cobb Douglas production function and facilitate easy interpretation of results. Exception on logarithm transformation was made for the inflation due to the fact that inflation is recorded as an index.

### 3.7 RESULTS AND ANALYSIS

This section presents the findings from of the study. Results are presented as summaries in tables, followed by discussions. In addition, findings are compared with other empirical studies, both in Somalia and elsewhere. The reported results include descriptives, correlations, diagnostic tests and error correction model (ECM) results from the ARDL method.

#### 3.7.1. Descriptive Statistics

Table 3 presents the descriptive summary statistics for the growth equation. The highest variability appears in inflation with a standard deviation of 8.12. This is perhaps explained by the wide range in inflation data. As can be seen from the table, the minimum value of inflation is 0.07 percent, while the maximum inflation rate experienced over the study period was 30.82 percent. The rest of the data shows limited spread with standard deviations in all cases is less than 2.0. This implies that overall, most of the data observations are located near the mean value which represents the center of the data.

Table 3 Descriptive statistics for the growth variables (1998 - 2019)

	LGDP	LFDI	LLBR	LEXPT	INF	LDI
Mean	22.72	18.95	16.17	20.64	9.02	21.19
Med	22.69	19.16	16.17	20.51	7.25	21.06
Max	23.41	20.94	16.46	22.17	30.82	22.06
Min	22.02	13.99	15.86	19.22	0.07	20.34
SDV.	0.44	1.65	0.19	0.92	8.12	0.54
Obs.	22	22	22	22	22	22

### 3.7.2. The Correlation Matrix

Table 4 shows a pairwise correlation matrix for the growth model variables. Correlation measures the relationship between variables in such a way that when two variables are positively correlated, it implies that they move in the same direction and vice versa for the negative relation.

Table 4 Correlation between variables in the Growth model

Correlation	LGDP	LFDI	LLBR	LEXPT	INF	LDI
LGDP	1.00					
LFDI	0.84 (0.01)	1.00				
LLBR	0.79 (0.03)	0.22 (0.04)	1.00			
LEXPT	0.81 (0.01)	0.47 (0.06)	0.58 (0.23)	1.00		
INF	-0.43 (0.05)	-0.56 (0.01)	-0.14 (0.17)	0.07 (0.04)	1.00	
LDI	0.78 (0.07)	0.61 (0.11)	0.27 (0.06)	0.38 (0.02)	-0.12 (0.04)	1.00

From the correlation table, we can see that real GDP is positively correlated with most of the specified predictor variables, such as FDI, labour, exports, and domestic investment. The p-values are all significant, meaning that the null hypothesis of “no relationship” can be rejected. Inflation however moves in the opposite directions with real GDP, which also makes sense theoretically. Practically, all correlation coefficients in table 3.3 are consistent with the study hypotheses between the dependent and independent variables. There are also notable linear relationships between independent variables, however the coefficient values are small.

### 3.7.3. Diagnostic Tests

Standard procedures for estimating time series data require conducting diagnostic tests before running the regression analysis. Among these tests are; the unit root and cointegration tests. The purpose of conducting unit root and cointegration tests is to avoid performing spurious regressions, which occurs whenever the analysed data are not stationary or not cointegrated (Ruxanda & Botezatu, 2008). The real problem with non-stationary data regressions is that statistical tests often confirm the regression coefficients as long as there are trends in the data. But in the presence of

unit roots these tests are known to overestimate the dependency relationship among variables leading to the rejection of the “no relationship null hypothesis”, even when such a relationship does not actually exist (Ruxanda & Botezatu, 2008).

### 3.7.3.1 Unit Root Test

The unit root tests were performed using both the Augmented Dickey Fuller (ADF) and the Phillips-Perron (PP) tests. The results reported in table 5 show that the variables are mutually integrated, i.e. there are variables which are I (0) while others are I (1). Further, the test reveals that all variables are stationary at first difference. The purpose of conducting the first difference test was rule out the existence of variables that are I (2), before running regression with the ARDL method. This is important because the ARDL method is known to collapse in the presence of I (2) variables (Odhiambo, 2010).

Two tests ADF and PP were jointly applied because each has its own strength over the other. The PP tests for example are known to be robust to general forms of heteroskedasticity in the error term as well as being more powerful than ADF in finite samples for aggregate data (Choi, 1992). On the other hand, due to the inclusion of lags of order p, the augmented dickey fuller (ADF) test procedures accept higher order autoregressive processes (Elder & Kennedy, 2001). Overall, the results from both tests are generally similar for most of the variables which is helpful in in terms of our conclusion about the stationarity status of the variables.

Table 5 Unit Root Test Results

<u>Levels</u>	Augmented Dickey Fuller		Phillips-Perron	
	Constant without trend	Constant with trend	Constant without trend	Constant with trend
LGDP	-0.22	-2.59	-0.22	-2.11
LFDI	-4.27***	-4.57***	-4.69***	-10.97***
LLBR	-0.79	-4.06**	-0.79	-3.28*
LEXPT	-0.18	-2.26	-0.09	-2.25
INF	-4.86***	-5.09***	-4.87***	-5.26***
LDI	-0.11	-2.74	-0.03	-2.26
<u>First difference</u>				
LGDP	-4.02***	-3.85**	-4.02***	-3.85**
LFDI	-3.58**	-3.76**	-3.52**	-3.72**
LLBR	-3.51**	-4.72***	-2.71*	-3.93**
LEXPT	-5.39***	-5.26***	-5.38***	-5.28***
INF	-6.30***	-6.87***	-7.19***	-9.12***
LDI	-3.99***	-3.88**	-3.99***	-3.87**

Note: \*\*\*, \*\*, \* denote rejection of the null hypothesis at 1%, 5% and 10%.

### 3.7.3.2 ARDL Cointegration Specification and Testing

To establish the existence of a long run relationship between variables, the ARDL method provides for computation of a significant Wald statistic based on the lagged levels of variables from the relevant equation in a conditional equilibrium correction model (ECM). Following Narayan (2005) and Shahbaz (2012) our formulation of the empirical ARDL bounds testing for cointegration model was specified as follows:

$$\begin{aligned}
 \Delta LGDP_t = & \delta_0 + \delta_1 LGDP_{t-1} + \delta_2 LFDI_{t-1} + \delta_3 INF_{t-1} + \delta_4 LLBR_{t-1} + \delta_5 LEXPT_{t-1} \\
 & + \delta_6 LDI_{t-1} + \sum_{i=1}^p \delta_i \Delta LGDP_{t-i} + \sum_{j=0}^q \delta_j \Delta LFDI_{t-j} + \sum_{k=0}^r \delta_k \Delta INF_{t-k} \\
 & + \sum_{l=0}^s \delta_l \Delta LLBR_{t-l} + \sum_{m=0}^t \delta_m \Delta LEXPT_{t-m} + \sum_{n=0}^u \delta_n \Delta LDI_{t-n} \\
 & + v_t
 \end{aligned} \tag{6}$$

To establish Cointegration, we computed the F-statistic by regressing equation (6) using OLS method. The F-statistic was computed using the Wald test for coefficient restrictions. The bounds testing procedure was then applied to establish whether the parameter coefficients of the lagged levels of variables were jointly significant. We tested the hypothesis that  $H_0: \delta_1 = \delta_2 = \dots = \delta_7 = 0$  against the alternative  $H_A: \delta_1 \neq \delta_2 \neq \dots \neq \delta_7 \neq 0$ . Table 6 summarises the results of the bounds test. Given the small size of our sample, we applied Turner's (2006) response surface method to adjust the asymptotic critical values to fit the actual size of the sample.

The results show that the F- statistic is significant at 10 percent, if we use the unrestricted intercept with a trend. However, when we apply the unrestricted intercept and no trend, the F- statistic becomes significant at 5 percent. Overall, we reject the null hypothesis of no cointegration

Table 6 Bounds Test for Cointegration Results

Model	F-statistic	Outcome
$F_Y(Y/F,P,L,D,E)$	6.345*	Cointegration
Adjusted critical values for small sample (T=22) <sup>a</sup>		
	Lower bound I (0)	Upper bound I (1)
Unrestricted intercept and no trend	1%	6.371
	5%	4.059
	10%	3.191
Unrestricted intercept and unrestricted trend	1%	7.991
	5%	5.139
	10%	4.074

$F=LFDI, Y=LGDP, P=INF, L=LLBR, D=LDI, E=LEXPT.$

Note: \* represent 10% significant level.

<sup>a</sup> Adjusted critical value bounds for the our sample were computed using the response surface method found in Turner (2006).

### 3.7.4. Granger Causality

With evidence of a cointegration relationship the next step involved investigating the long run and short run granger causality for the growth model. The long run regression was based on the conditional ARDL ( $r_1, s_1, s_2, s_3, s_4, s_5$ ) for the economic growth model, where  $s_i$  represent the lag orders of the independent regressors, while  $r_1$  is the lag order for the dependent variable. Selection of the lag orders was based on Schwarz Bayesian Criterion (SBC), following Narayan (2005). In developing the long run granger causality model in equation (7), we followed Narayan (2004), while for the short run dynamics, our formulation in equation (8) follows Duasa (2007) and Odhiambo (2010).

$$\begin{aligned}
 LGDP_t = & \pi_1 + \sum_{j=1}^r \gamma_{1j} LGDP_{t-j} + \sum_{j=0}^{s1} \beta_{1j} LFDI_{t-j} + \sum_{j=0}^{s2} \theta_{1j} LLBR_{t-j} \\
 & + \sum_{j=0}^{s3} \omega_{1j} LEXPT_{t-j} + \sum_{j=0}^{s4} \delta_{1j} INF_{t-j} + \sum_{j=0}^{s5} \vartheta_{1j} LDI_{t-j} + v_t \quad (7)
 \end{aligned}$$

$$\begin{aligned}
\Delta LGDP_t = & \pi_2 + \sum_{j=1}^r \gamma_{2j} \Delta LGDP_{t-j} + \sum_{j=0}^{s1} \beta_{2j} \Delta LFDI_{t-j} + \sum_{j=0}^{s2} \theta_{2j} \Delta LLBR_{t-j} \\
& + \sum_{j=0}^{s3} \omega_{2j} \Delta LEXPT_{t-j} + \sum_{j=0}^{s4} \delta_{2j} \Delta INF_{t-j} + \sum_{j=0}^{s5} \vartheta_{2j} \Delta LDI_{t-j} \\
& + \mu ECM_{t-1} + \epsilon_t
\end{aligned} \tag{8}$$

All variables are as earlier defined, while the term  $ECM_{t-1}$  in equation (8) represents the lagged error correction term derived from the long run model in equation (7). The lagged ECM term tells us about the reliability of the long run causality. A negative and significant coefficient of the lagged ECM term implies that the variables converge to the long run equilibrium (Narayan, 2005). The coefficient of the ECM term ( $\mu$ ), measures the speed of convergence to the initial equilibrium position in case of a shock (Fosu & Magnus, 2006).

#### 3.7.4.1 Regression and Stability Tests

In order to estimate granger causality for the growth model, it was necessary to conduct diagnostic tests for the regression and model stability respectively. The regression diagnostics were conducted to test the goodness of fit of the ARDL model while the cumulative sum (CUSUM) and the cumulative sum of squares (CUSUMSQ) tests were done to ascertain model stability.

#### 3.7.4.2 Regression Diagnostics

The regression and diagnostic tests are given in table 7, obtained from equation (7). The model passes all the tests including serial correlation, normality, functional form and the test for heteroskedasticity. In addition, the goodness of fit measures;  $R^2$  and the F-statistic are exhibit very good results, implying that the model is very good.

Table 7 Regression Diagnostic Results

$R^2$	0.931
Durbin-Watson statistic	2.831
F (8, 12)	13.49 [0.000]
A: Serial correlation F (1, 7)	4.332 [0.076]
B: Functional form F (1, 7)	4.931 [0.077]
C: Normality $\chi^2$ (2)	1.242 [0.537]
D: Heteroskedasticity F (1, 19)	1.112 [0.305]

- A: Lagrange multiplier test of residual serial correlation
- B: Ramsey's RESET test using the square of the fitted values
- C: Based on a test of skewness and kurtosis of residuals
- D: Based on the regression of squared residuals on squared fitted values

### 3.7.4.3 The CUSUM and CUSUMSQ Stability Test

To investigate the stability of the specified ARDL equations above, we used the recursive residuals methods proposed by Brown et al. (1974). The cumulative sum (CUSUM) and cumulative sum of squares (CUSUMSQ) illustrate structural stability using charts plotted at 5 percent significance level. The respective charts show that our data is structurally stable.

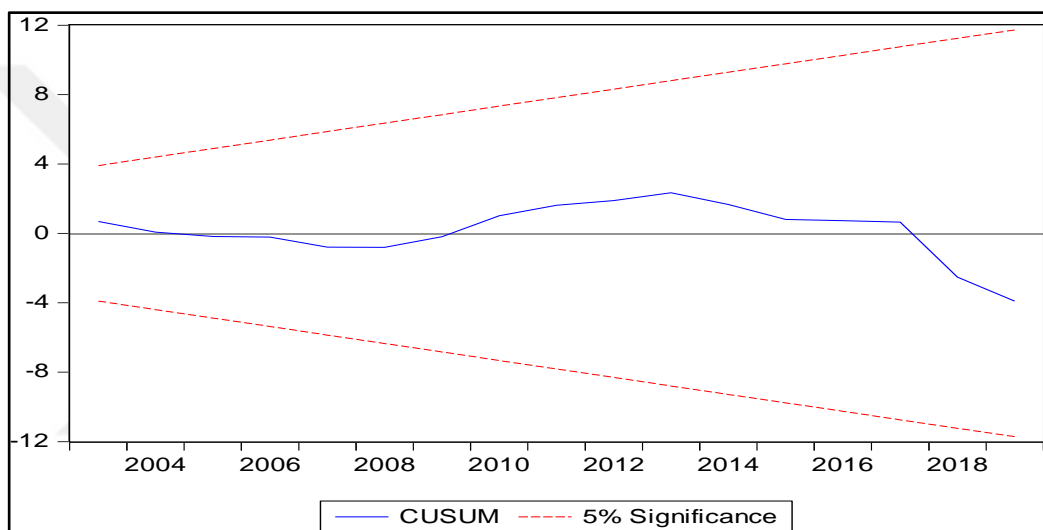


Figure 5 Plot of CUSUM for coefficients stability of the ECM model

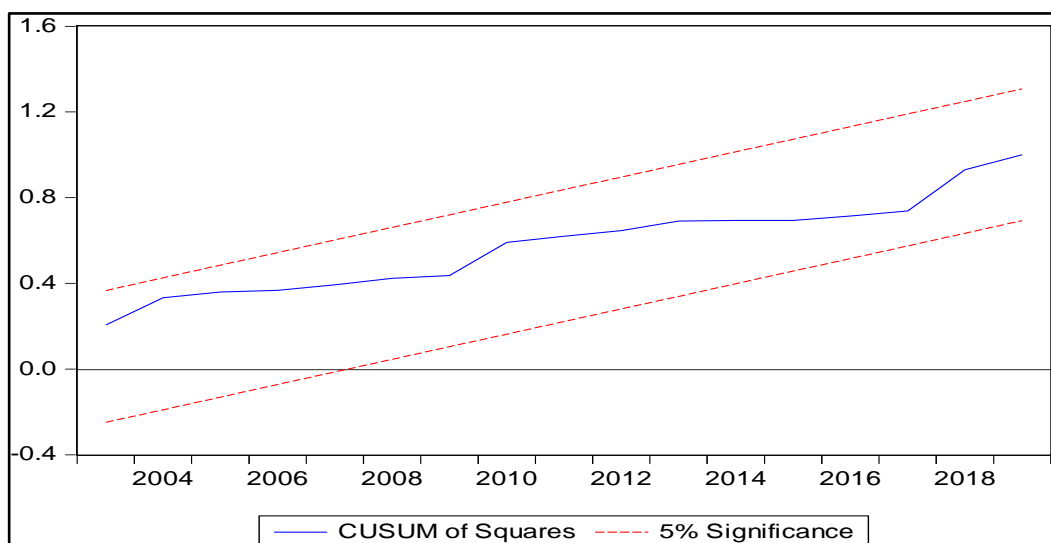


Figure 6 Plot of CUSUMSQ for coefficients stability of the ECM model

The two tests illustrated that no systematic changes occurred in the data generation process over time and no haphazard departures existed in the data generation process. Given the satisfactory diagnostic tests for both goodness and stability, the ARDL equation for economic growth was regressed using the OLS method to generate the required results.

### 3.7.5. Discussion of the Causality Results

The granger causality and error correction results for the factors influencing economic growth in Somalia are presented in the Tables 8 and 9. In this section, the results are interpreted, discussed and comparisons made with earlier studies.

Table 8 The estimated long run coefficients

Equation (7): ARDL (0,1,1,1,1,1) selected based on SBC. Dependent variable is LGDP<sub>t</sub>

Regressor	Coefficient	Standard error	T-ratio	P-Value
LFDI	2.9138**	0.9422	3.0927	0.027
LLBR	1.9206**	0.8476	2.2659	0.052
LEXPT	3.5981**	1.2936	2.7814	0.038
INF	-0.8048	0.5652	-1.4239	0.236
LDI	3.7074***	0.8823	4.2019	0.002
C	-54.236*	28.079	-1.9316	0.090
TREND	-0.9121**	0.3107	-2.9353	0.032

Note: \*\*\*, \*\* & \* denote 1%, 5% & 10% significant levels respectively

Table 9 Error correction representation for the selected ARDL Model

ARDL (0,1,1,1,1,1) selected based on SBC. Dependent variable is dLGDP<sub>t</sub>

Regressor	Coefficient	Standard error	T-ratio	P-Value
dLFDI <sub>t-1</sub>	4.2163***	1.0825	3.8950	0.003
dLLBR <sub>t-1</sub>	3.7534***	1.1001	3.4119	0.006
dLEXPT <sub>t-1</sub>	0.4928	0.3374	1.4606	0.182
dINF <sub>t-1</sub>	-1.2117	0.7409	-1.6355	0.163
dLDI <sub>t-1</sub>	5.4019**	1.8025	2.9969	0.013
C	-86.419**	37.179	-2.3244	0.045
TREND	-12.850*	6.4016	-2.0073	0.068
ecm(-1)	-0.3974***	0.0957	-4.1529	0.002

Note: \*\*\*, \*\* & \* denote 1%, 5% & 10% significant levels respectively

The lagged error correction model (ECM<sub>t-1</sub>) has the expected sign and it is significant at 1 percent, implying that our long run model correctly represents the causal relationship between economic growth (LGDP) and its determinants. In the long run, foreign direct investment (LFDI), labour (LLBR), exports (LEXPT) and



domestic investment (LDI) are the only variables in this regression that granger cause economic growth in Somalia. Inflation (INF) is statistically insignificant and hence does not influence economic growth in the long run. During the short run the factors which granger economic growth include, FDI (LFDI), labor (LLBR), and domestic investment (LDI). Inflation (INF) and exports (LEXPT) are insignificant in the short run.

The most important question of this study regarding the effect of inward FDI on economic growth in Somalia has been answered in the affirmative. Inward FDI granger causes economic growth both in the short run and in the long run. It has been established empirically that in the long run, for every 1 percent increase in inward FDI there is a 2.91 percent increase in real GDP while in the short run, a 1 percent change in FDI brings about a 4.22 percent growth in real GDP. These positive and significant findings have confirmed the hypothesis of this study and the several FDI theories which suggest a positive relationship between FDI and host country economic growth. These new results also complement the earlier findings on Somalia by Mohamed, M. M., & Isak, I. (2017).

The labour variable, measured by the number of economically active people in the economy, turned out with a positive effect on economic growth in Somalia, both in the short run and in the long run. This implies that labour explains not only the cyclical (short run) changes in economic growth, but also determines the long run trend of output (Medina-Smith & Pangestu, 2001). Results reveal that a 1 percent increase in the labour stock brings about a 1.92 percent increase in real GDP in the long run, while in the short run a 1 percent change in labour leads to only 3.75 percent change in real GDP. The increase in economically active people could be explained by an increase in women participation in productive activities. In Somalia, women are highly involved in production especially through the informal sector. These findings are consistent with the theoretical expectations and are in harmony with several empirical studies which came to a similar conclusions (Hall & Jones, 1999; Kormendi & Meguire, 1985; Tiwari, 2011; Zelleke & Sraiheen, 2012). The rise in labour stock in Somalia is therefore significantly instrumental for economic growth.

Domestic investment (LDI) has also been found to have a positive and significant effect on economic growth during both time periods and it exerts the largest

impact on growth in the short run. The findings show that other things being equal, a 1 percent change in domestic investment leads to a 5.41 percent growth in real GDP in the short run while in the long run, a 1 percent increase in domestic investment corresponds to a 3.71 percent increase in real GDP. Without diminishing the role of inward FDI, these results reveal that domestic investment exerts a greater effect on Somalia's economic growth than FDI does. In the augmented Solow growth model, the two forms of investment namely; inward FDI and domestic investment (DI) entered the model as measures for foreign owned capital and domestic capital respectively, both theoretically expected to have a significant positive effect on output. The findings of this study, agree with this Solow growth hypothesis on the role of capital in generating growth. From this study, we have obtained empirical evidence that Somalia, which is still an underdeveloped country, positively responds to every unit increase in physical capital in the form of investments. Capital is necessary to be combined with the country's abundant labour to speed up the growth and development of the economy.

Exports to the rest of the world also bear a significant positive effect on real GDP in the long run, but not in the short run. This result is in line with the theory which suggests that a country's exports are positively related with economic growth (Piazolo, 1995). Empirical literature is also dominated with findings showing that there exist a positive relationship between exports and economic growth (Anwar & Nguyen, 2010; Kormendi & Meguire, 1985; Ram, 1985; Shahbaz, 2012). From this study, it has been established that *ceteris paribus*, a 1 percent increase in real exports increases real GDP by 3.59 percent in the long run. This evidence supports Somalia's export-led growth strategy which the country has been following for the last 10 years.

Inflation, a measure of the macroeconomic stability in the economy had neither short run nor long run causality to economic growth. Results indicate that the inflation variable is not significantly different from zero during the two time periods. Hence it is concluded that the macroeconomic indicator does not have a causal effect on economic growth in Somalia. In the analytical model, we hypothesized that inflation is negatively related to economic growth due to the distortionary effects it exerts on the production process. The expected negative relationship has been

observed, but the effect is insignificant. Hence we cannot use these results for policy purposes |



## CONCLUSION

This study set out to investigate the effect of FDI on Somalia's economic growth. Evidence shows that the significant drivers of economic expansion in the long run include inward FDI, labour stock (LLBR), domestic investment (LDI) and exports (LEXPT). During the short run period, it is the labour stock (LLBR), domestic investment (LDI), and the existing stock of FDI that explain economic growth. It has been established that inflation (INF), the measure of macroeconomic stability has no significant effect on economic growth in Somalia, despite being correctly signed. These findings have several policy implications for the country's economic growth.

First, the finding that inward FDI is positive and significantly related to Somalia's economic growth has multidimensional relevance; a) it has extended the literature on how FDI impacts Somalia's growth. Prior to this investigation, there has been only one empirical study conducted by Mohamed, M. M., & Isak, I. (2017). The current result is consistent with their findings with a useful addition that the effect of FDI on Somalia's growth is statistically significant; b) this evidence justifies Somalia's continuous efforts to attract more FDI given that FDI has growth and development value for the country.

In addition, since long run growth in Somalia is positively influenced by the traditional inputs to the production function including an increase in domestic capital (LDI), there should be no loss of sight of the importance of these two factors. Government should equally encourage domestic entrepreneurship with identical enthusiasm as that applied for attracting foreign investors. This should be achieved through providing incentives to domestic investors, bearing in mind that these domestic investors will be more permanent in the economy, compared with their foreign counterparts

The Labor factor (LLBR) has also been found to be positive and significant both in the short run and in the long run. This implies that Labor is extremely important for economic growth in Somalia. It is hence forth recommended that

government makes effort to increase labor both in terms of quantity and quality. Efforts could be made for example to stop the big number of labor movement away from Somalia, by giving incentives to those who stay and work in Somalia, especially after acquiring high education qualifications.

The study has also established that an increase in exports (LEXPT) increases the country's growth. The export-led growth strategy which is in force for over a decade should be strengthened and promoted throughout the country. As this study has shown, exports are in the second position in terms of the magnitude by which they increase long run economic growth. However, Somalia has unfortunately continued to export unprocessed commodities in the form of camels, goats and sheep and other agro products. The policy for improving export income should focus on value addition to the country's exports to increase the revenue generated from exports

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