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Foreign Capital Inflows-How to Make the Most of Them?

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FOREIGN CAPITAL INFLOWS-HOW TO MAKE THE MOST OF THEM?

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Objectives

- Evaluate the impact of FDI on the Egyptian economy.
- Investigate its determinants.
- What is required for Egypt to attract more FDI, ensure its stability, and maximize its benefits?

Outline

I. Introduction

II. Empirical Background

III. FDI inflows to Egypt: Trends and Determinants

IV. Absorptive Capacity of the Egyptian Economy.

V. Conclusion and Policy Recommendations

I. Introduction

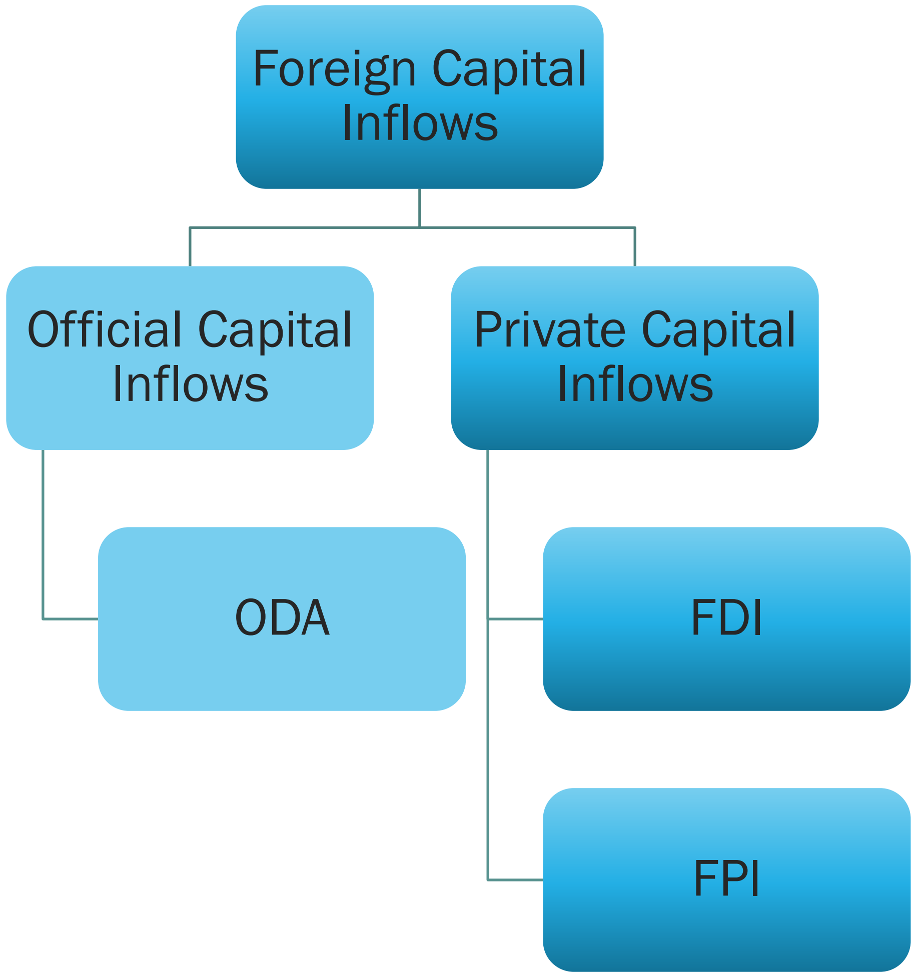
Unrestricted cross-border capital flow, aimed at better capital allocation and risk sharing.

Private capital inflows can boost recipient economies by providing investment resources that enhance employment and growth.

FDI contributes to physical capital accumulation, while FPI offers low-cost financial capital. Both types of investment can deepen financial sectors, spread new technologies, and improve efficiency and institutional quality

Neoclassical and *endogenous growth theories* suggest that foreign capital supports short-term growth and long-term spillovers.

The *two gaps model* highlights that developing countries with limited income sources benefit most, as foreign capital helps bridge savings and foreign exchange gaps, thus accelerating growth.

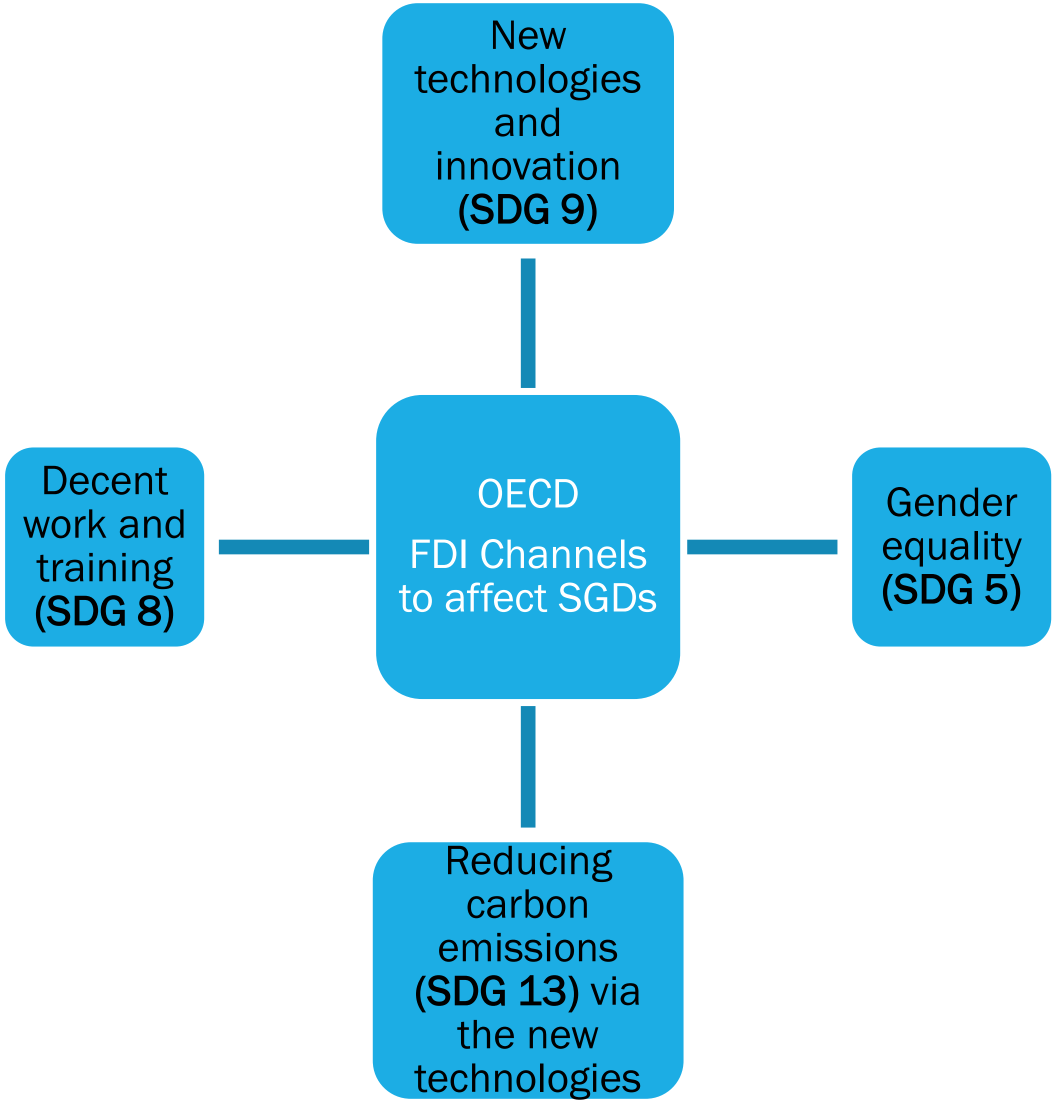


I. Introduction

- Foreign capital can also aid in achieving Sustainable Development Goals (SDGs).

- **FPI** benefiting sectors aligned with these goals. However, FPI's volatility can limit these benefits.

- The benefit of foreign capital depends on the host countries' legal and institutional framework and the flexibility of the domestic inputs in response to the new technologies.



I. Introduction

Total Egyptian investments (% of GDP) have decreased from 33 % in 1980 to 17% in 2022.

Gross savings (% of GDP) have averaged 13.6 % from 1980 to 2022.

This is largely below the levels of investments and savings for peer countries .

Recent severe foreign currency shortage.

Foreign capital inflows are *indispensable* as a source of finance for Egypt to achieve its economic targets.

Accordingly, this chapter reviews FDI inflows to Egypt, **aiming** to optimize their use.

II. Empirical Background

Growth models theoretically confirm the growth impact of private foreign capital, yet it is **empirically less straight forward,** especially for developing countries. **Empirical literature** investigating foreign capital's impact on recipient countries **is still inconclusive**.

- *Vita & Kyaw (2009), (Brambila-Macias & Massa, 2010),* Shaier & Abida (2013), Seyoum, Wu & Lin (2015) and Younsi, Bechini & Khemili (2021*)* studied the effect of FDI inflows on a group of developing countries and found **significant positive effect of FDI inflows** on economic growth, complementing domestic investments. Also, Shaier & Abida (2013*)* found that financial development is a significant absorptive capacity factor.

- Moreover, in a later study by Durham (2004*)* about the effect of equity portfolio investments and FDI on economic growth in 80 developing countries, he found **no direct effect of FDI or FPI on growth**. However, the indirect positive impact depended on the level of absorptive capacity of the host country, especially financial and institutional development.

II. Empirical Background

- ***For Egypt***, *Naguib and Xu (2016)* and *Alaa, Ashraf, and Marwa (2021)* examined FDI's short- and long-term effects, revealing a weak positive impact on growth only in the long run. Their findings showed FDI complemented domestic investments. Conversely, *Ingham, Read, and ElKomy (2020)* identified a significant negative effect of FDI on economic growth, while domestic investments had a significant positive impact, indicating these investments are substitutes.

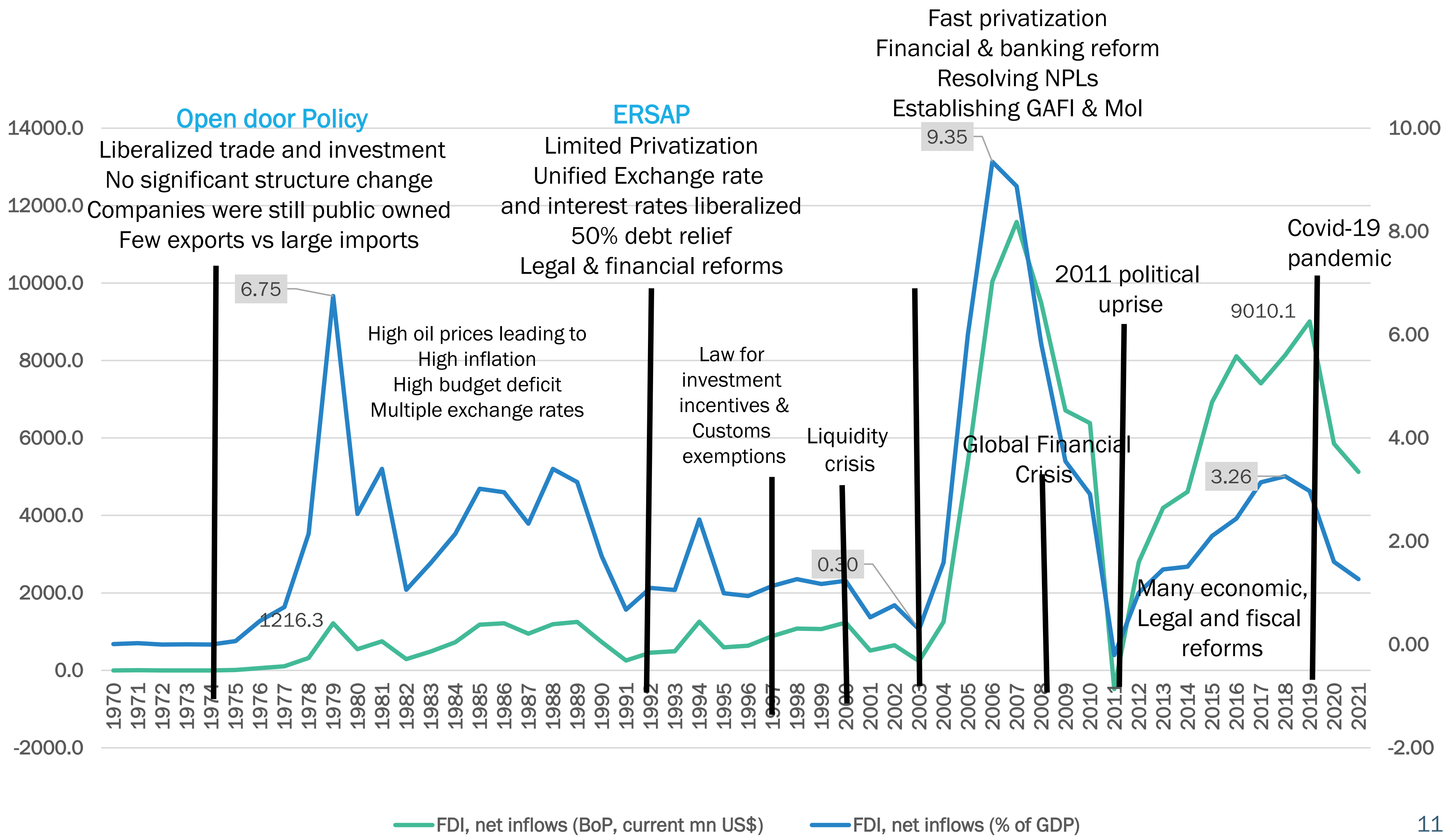
- Some studies suggested that FDI should not be studied as an aggregated variable. They believe that FDI has different effects according to its form, whether greenfield investments or mergers and acquisitions and according to the recipient sector.

- *Massoud (2008), Hanafy & Marktanner (2018), Ingham, Read and Elkomy (2020) and Abouelfarag and Abed (2020)* studied the sectoral effect of FDI employment and economic growth in Egypt. The source and sector of FDI tend to affect its impact on economic performance.

In Sum, empirical literature on Egypt concluded that

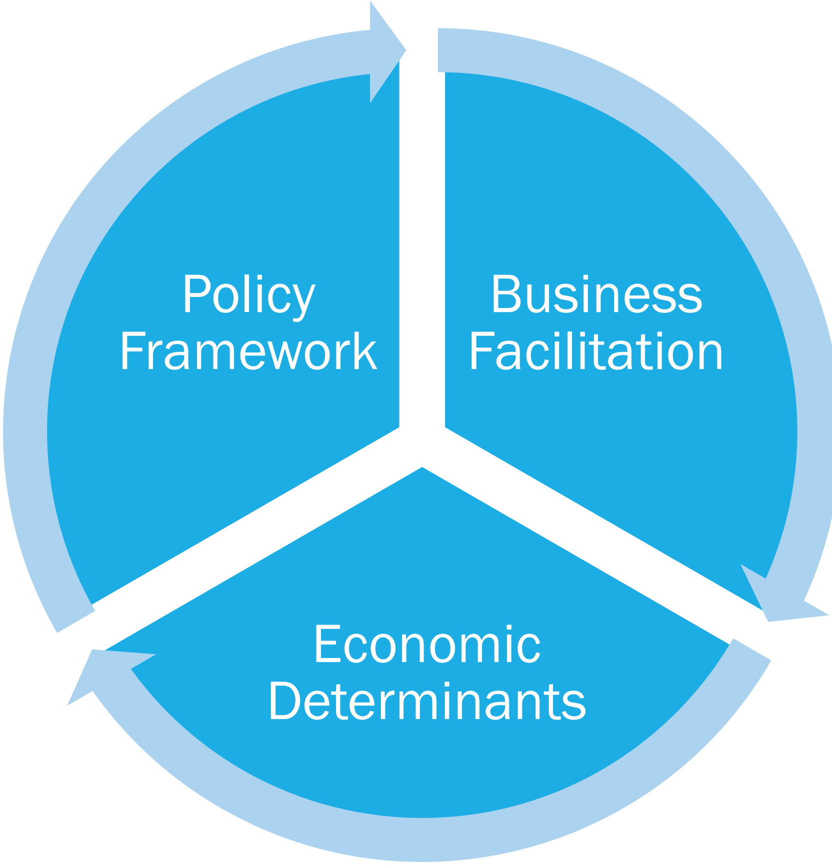
- Growth spillovers of foreign capital are still **not empirically assured**
- The benefits of FDI depend on its type (greenfield vs M&As), sectoral distribution, and <u>absorptive capacity </u>factors.

III. FDI Inflows to Egypt: Trends and Determinants



III. FDI inflows to Egypt: Trends and Determinants

Determinants of FDI



Determinants of FDI

3.1 Determinants of FDI: Policy Framework

The UNCTAD defined the policy framework to include *economic, and political stability of a country*, in addition to tax, trade and market *policies and regulations* that affect market structure and running business.

Policies and Regulations

- Egypt adopted several legal reforms concerning taxes, free zones, foreign ownerships, repatriation of profits, financial development and trade liberalization and tariffs reduction.
- As a result, Egypt FDI Regulatory Index improved (controversial).
- This index measures the discrimination in laws and regulations and not in real practices.

Political Stability

- *One of the main challenges*
- Refers to the ability of the government to maintain law and provide a predictable environment for business and investment.
- According to the **WDI,** Egypt's rank in political stability decreased from 29 out of 100 in 2008 to 7 in 2011, it recovered to reach 14 in 2022. The lowest rank goes to voice and participation.
- In Credendo Group's 2023 risk report (7 is the lowest rank), Egypt was ranked 6 for both short-term and long-term political risks, including political violence. Accordingly,

Economic Stability

- *Another challenge*
- Refers to a mix of external and internal balanced macroeconomic performance reflected in the form of stable macroeconomic indicators, such as: inflation, unemployment, public debt, exchange rate.
- The performance of the Egyptian has shown lack of economic stability which makes it vulnerable to shocks.

3.2 Determinants of FDI: **Business Facilitation**

Efforts were exerted overtime to facilitate business conducting in Egypt especially after the establishment of the **GAFI and ISC.**

Corruption is still a chronic problem hindering healthy investment environment.

Yet, there is some improvement in Egypt recent rank **CPI** and Ease of Doing Business.

Reports show unequal treatment for public and private enterprises, in terms of tax exemptions and subsidies on capital and assets although they are quarter as productive as private enterprises. **SOEs are outside market discipline.**

The private sector encounters restrictive administrative procedures throughout the business lifecycle. There is a need to streamline ongoing processes and required licenses, incorporating feedback from all stakeholders. The **Credendo Group's 2023 risk report ranked** Egypt 7 in business environment risk and 5 in expropriation risk.

3.3 Determinants of FDI: **Economic Determinants**

The economic determinants according to UNCTAD depend on the type of investors the government wants to attract, whether they are *market seekers, resources seekers or efficiency seekers*.

Market seekers

- Egypt is the world's 14th most populous country and the largest in North Africa.
- According to the global competitive report, Egypt is ranked 23rd out of 141 as per market size in 2019, up from 29th place in 2014

Resources seekers

- Oil sector in Egypt has long received the highest share of FDI since removing restrictions on foreign investments in the sector in 1997.
- Empirical studies showed the significant positive effect of indicators of resources abundance on FDI inflows to Egypt.

Efficiency seekers

Competitive infrastructure

- According to the Global Competitiveness index in the infrastructure pillar, Egypt's rank increased from 100 in 2014 to 52 in 2019.
- Logistics costs represent 20% of GDP in Egypt compared to 10%-12% world average.
- Empirically, the effect of infrastructure on FDI is controversial.

Trade openness

- Many free trade agreements, bilateral agreements, and free zones were established along time.
- Empirically, the degree of trade openness was found to be positively affecting FDI inflows in Egypt.
- **Financial development, higher institutional quality and human capital.**

To conclude

- Egypt has achieved several improvements that attracted FDI inflows, especially in the context of policies and regulations, business facilitation, openness, infrastructure, availability of resources and market size.

- Yet, Egypt still faces challenges in the context of ensuring political and economic stability, supporting the private sector, combating corruption and enhancing institutional quality.

IV. Absorptive Capacity of the Egyptian Economy

- Receiving foreign capital does not guarantee achieving the benefit of its spillovers, rather the recipient country must have the enabling conditions for that.

- Todaro (2001) defined absorptive capacity as the ability of a country to absorb foreign assistance and to use foreign funds in a wisely and productive manners (to make the best use of them).

- That is, absorptive capacity reflects the factors that enable the recipient country *to maximize the positive spillovers of foreign capital*.

- The factors counted among a country's absorptive capacity measures vary according to the type of capital inflow.

Human Capital Quality | **Financial Development** | **Trade Openness** | **Quality of institutions** | **Technology Gap**

IV. Absorptive Capacity of the Egyptian Economy
4.1. Human Capital Quality

Human capital quality guarantees the transfer of skills from foreign enterprises to domestic labor.

It can be *proxied* by:

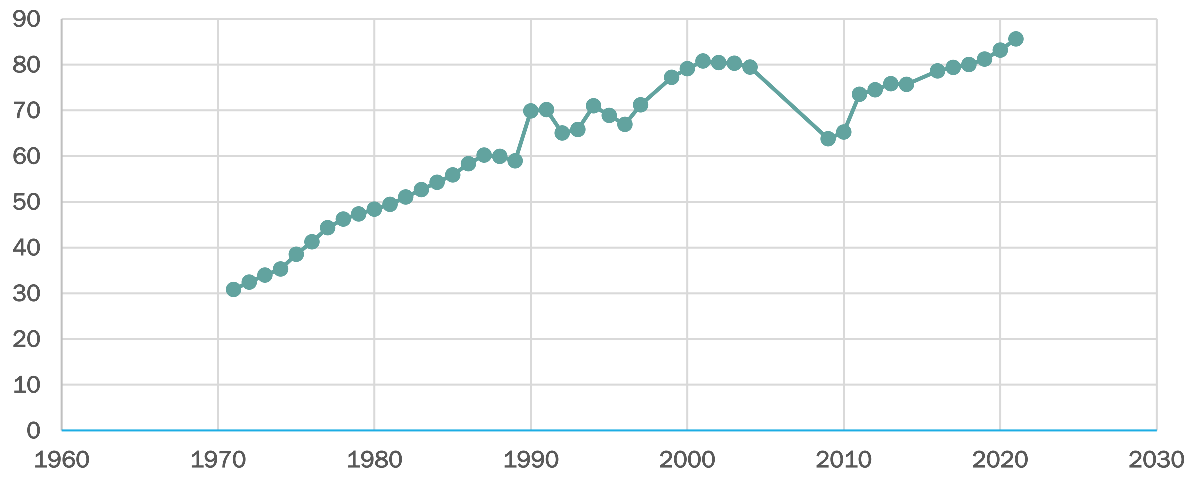
- Human Development Index (HDI)

- Educational attainment (the average years of secondary schooling completed by population over the age of 25)

According figures 4.1&4.2, Egypt has witnessed a constant improvement in the quality of human capital since 1990, thus enabling its economy to benefit from the potential macroeconomic spillovers of FDI.

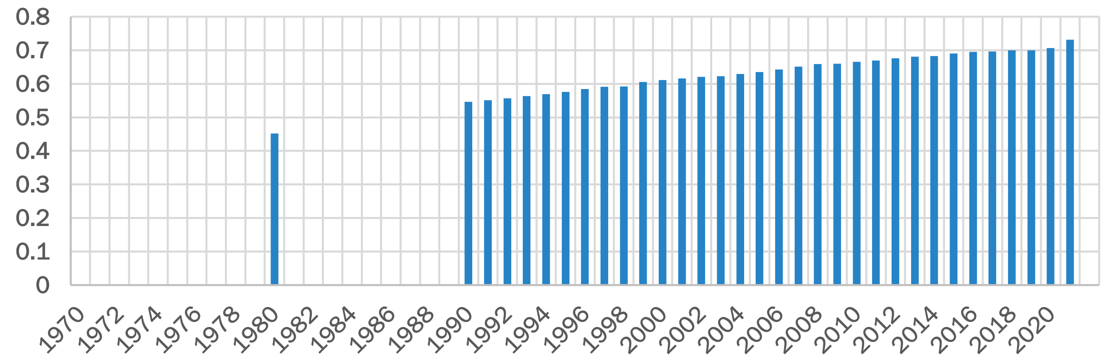
However, empirical studies on the absorptive role of human capital in Egypt were controversial.

Figure 4.1: Secondary school enrollment, percent of all eligible children



Source: Prepared by authored using the Global Economy Database https://www.theglobaleconomy.com/download-data.php

Figure 4.2: Human Development Index (0 - 1)

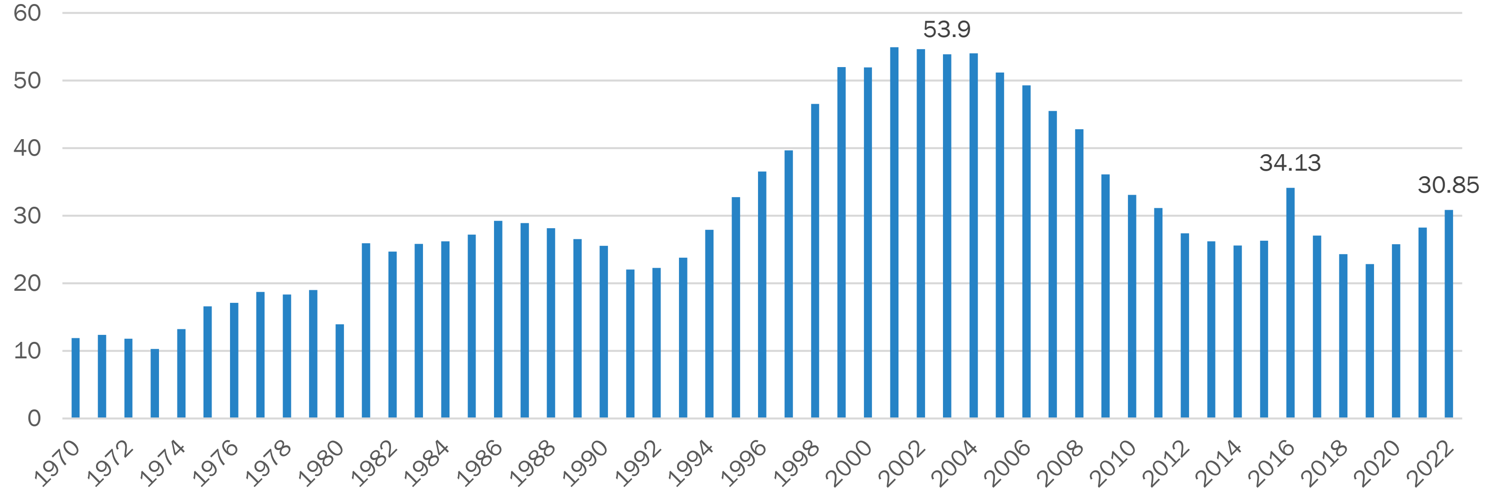


Source: Prepared by authors using data from The UNDP Human Capital reports https://hdr.undp.org/data-center/human-development-index#/indicies/HDI

IV. Absorptive Capacity of the Egyptian Economy
4.2 Financial Development

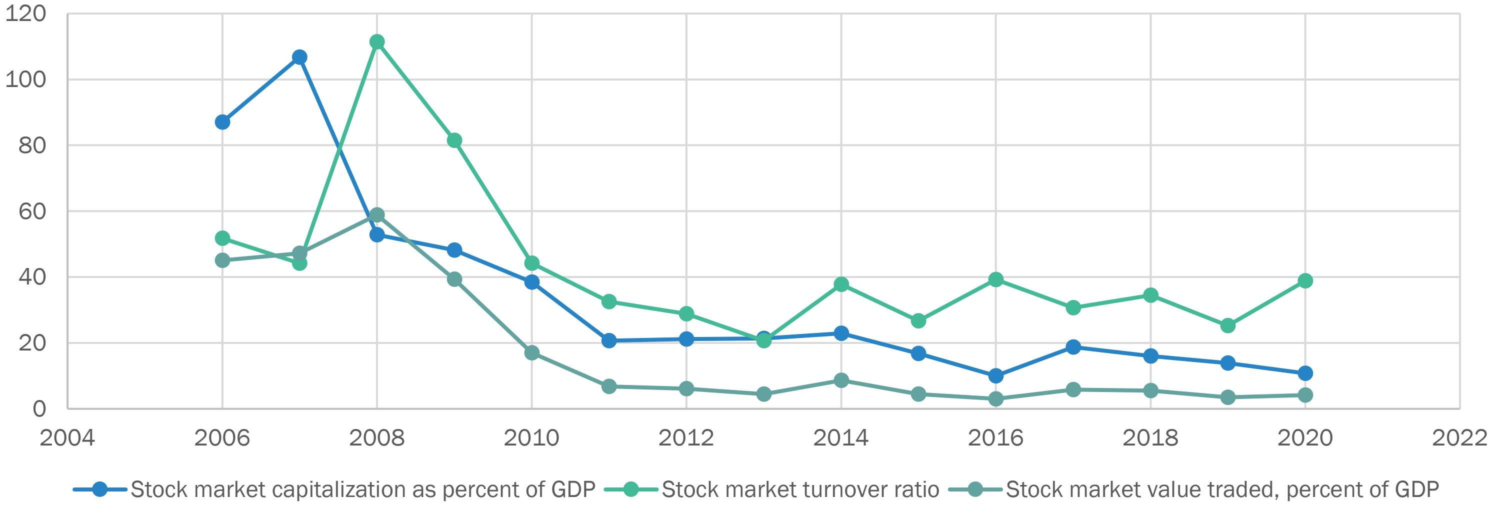
- Financial sector development has been previously highlighted as one of the determinants attracting foreign capital to the country.
- It has another role in enabling the foreign capital recipient country to reap the benefits of these inflows.
- Inadequate financial development can impede both foreign and domestic firms from obtaining the capital required for the desired technological upgrading.
- An effective allocation of investments for technology advancement is made possible by the existence of stable and well-functioning financial markets.
- Financial development of the banking sector is usually measured by the ratio of bank credit to the private sector to GDP, while the stock markets development can be measured by the ratio of market capitalization to GDP, the stock market turnover ratio and the ratio of market traded value to GDP.

Figure 4.3: Bank credit to the private sector as percent of GDP



Source: Prepared by authored using the Global Economy Database https://www.theglobaleconomy.com/download-data.php

Figure 4.4: Egyptian Stock Market Performance Indicators



Source: Prepared by authored using the Global Economy Database https://www.theglobaleconomy.com/download-data.php

IV. Absorptive Capacity of the Egyptian Economy
4.2 Financial Development

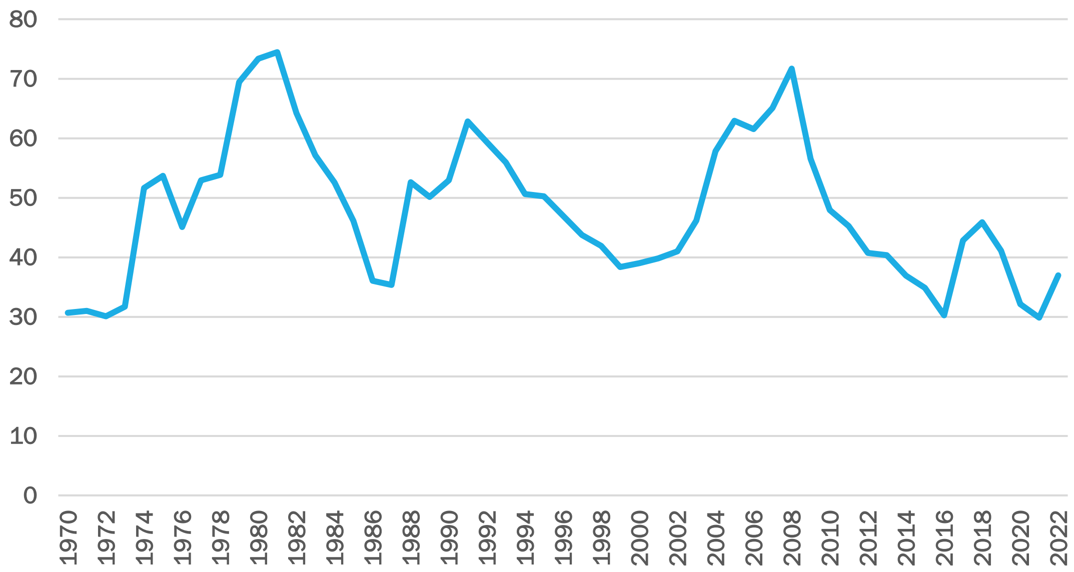
- Studies specified the bank credit to the private sector ratio as percentage of GDP thresholds above which FDI will start benefiting the recipient economy to be between 13% and 15%. *Figure 4.3* shows that this ratio has always been above this threshold, enabling it to absorb the positive effects of inward FDI. However, studies shows that most of the credit went to non-productive high return investments.

- *Figure 4.4* shows the unsustainability of the stock market indicators. The sensitivity of the stock market to the political changes, nationally and internationally, is reflected in this performance progress.

- *Empirical studies on the absorptive role of financial development in Egypt were controversial*

IV. Absorptive Capacity of the Egyptian Economy
4.3 Trade Openness

Figure 4.5: Trade openness: exports plus imports as percent of GDP



Source: Prepared by authors using World Bank Database
https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS?locations=EG

- It is suggested that an open trade policy entails the transfer of technology, thus its existence would also impact how FDI affects growth.

- Trade openness is usually measured by *the ratio of both exports and imports to GDP*.

- Yet, the high trade ratios in Egypt may not necessarily reflect high technological benefits. For instance, a large segment of Egyptian imports since the open-door policy of 1974 has been in the form of *consumption goods that have no technological spillovers*. Besides, the non-oil exports have been also witnessing frequent sluggishness resulting from lack of competitiveness.

- Accordingly, in addition to the inconclusive theoretical foundation supporting the absorptive role of trade openness, the progress of Egypt's trade openness indicator reflects a *low likelihood of significantly boosting* the growth spillovers of FDI.

IV. Absorptive Capacity of the Egyptian Economy
4.4. Quality of institutions

■ Quality of institutions in the recipient country provides an enabling environment in the country to attract foreign capital and it has a mediating role in boosting the foreign capital growth spillovers.

■ Institutional quality could be proxied by *governance and corruption*. Governance can be indexed by the World Bank *"Worldwide Governance Indicators"* (WGI). As for corruption, it can be indexed by the *"Corruption Perceptions Index"* (CPI).

■ *Figures 4.6 and 4.7* show historical trend for both indicators, reflecting a *low level of institutional* quality with almost no improvement over time.

■ Fernandez et al. (2020) studied determinants of FDI in Egypt and concluded that high political risk and corruption are among the factors that hinder inward FDI flows.

Figure 4.6: Egypt's Governance Indicators (1996-2022)

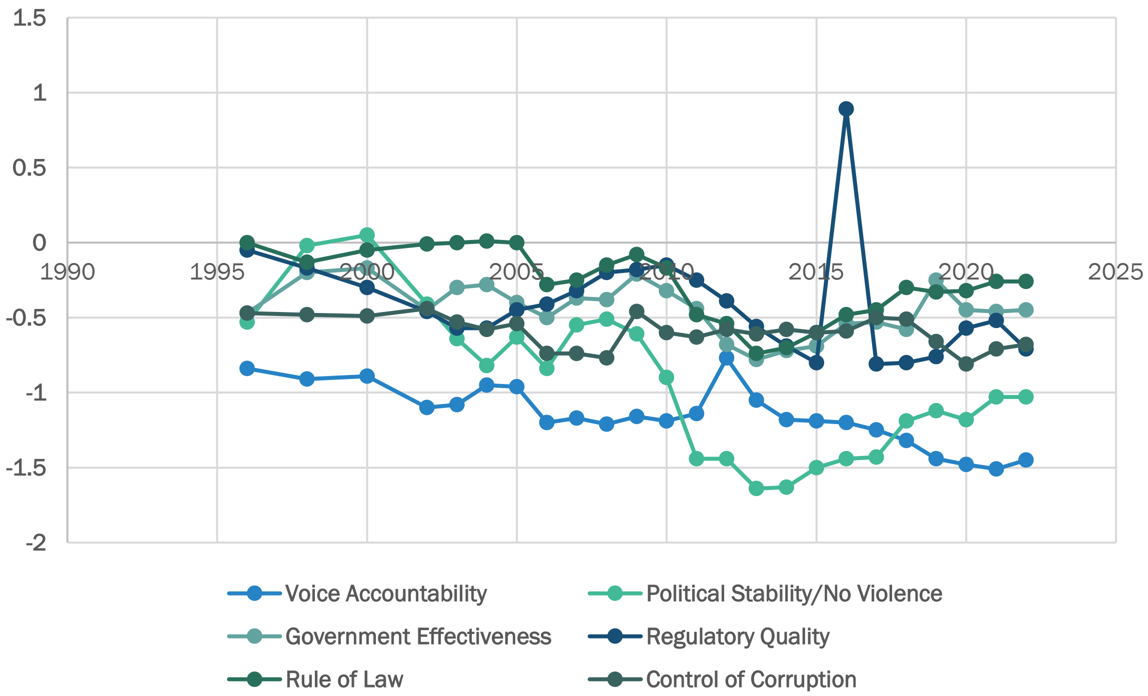
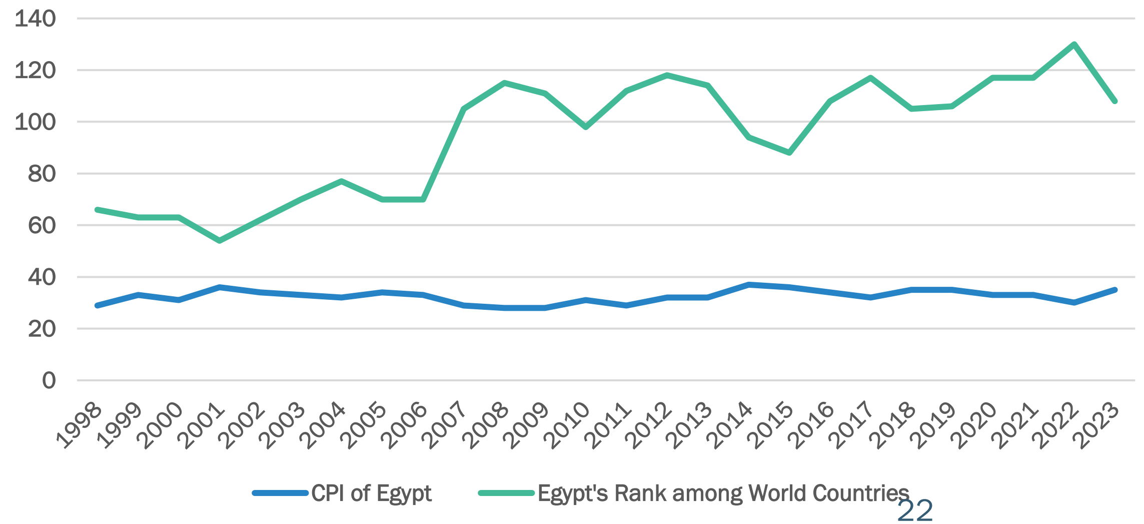


Figure 4.7: Egyptian CPI and World Rank 1998-2023



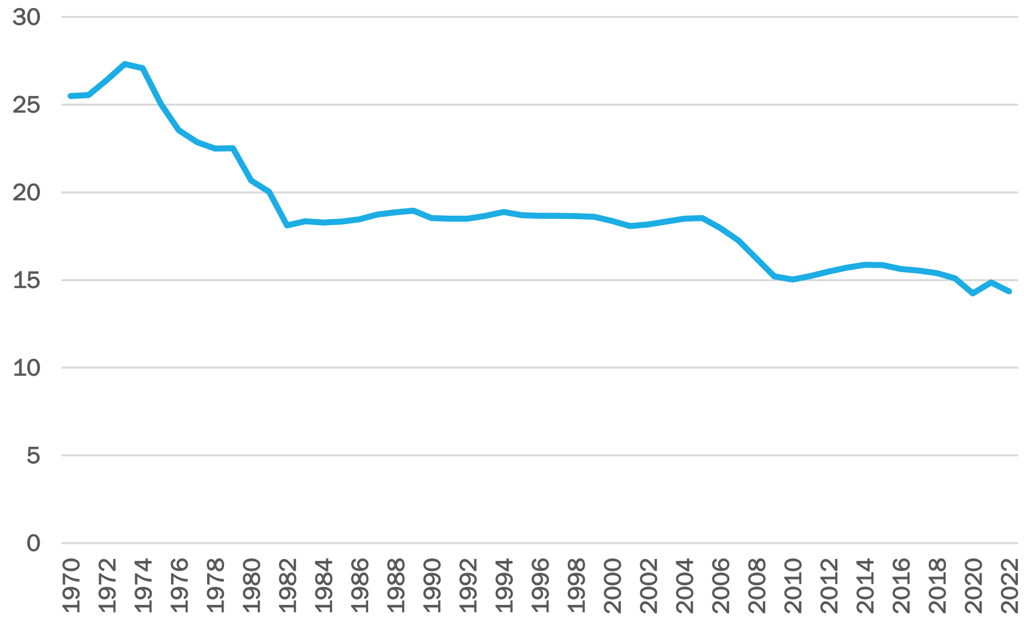
IV. Absorptive Capacity of the Egyptian Economy
4.5. Technology Gap

It's argued that a narrow technology gap between home and host countries enables local businesses in host countries to absorb FDI externalities

The technology gap can be measured by comparing the GDP per capita difference between the United States (the highest in technology) and the recipient country, relative to the recipient country's GDP per capita.

Figure 4.8 shows a general falling trend in Egypt's technology gap thus representing a potential positive impact regarding the ability of the Egyptian economy to benefit from the inward FDI flows.

Figure 4.8:
Egypt's Technology Gap



Source: Calculated by the authors using the World Bank data https://data.worldbank.org/indicator/NY.GDP.PCAP.KD

In Sum

- As per available data of absorptive capacity indicators (values of indices), Egypt has been well performing at the level of human capital quality, financial sector development, trade openness and technology gap

- However, empirical evidence did not confirm the absorptive role of these measures (so the quality of performance indices must be assessed).

- Still institutional quality requires more improvement

V. Conclusion and Policy Recommendations

Egypt's economic landscape has been significantly affected by FDI. Empirical studies concluded some positive spillovers of FDI, such as job creation, infrastructure development, and technological transfer. **However,**

FDI should not be treated as an aggregate phenomenon, rather, its sectoral impact should be assessed.

- Promotion policies should only target FDI in the **sectors** with high growth spillovers and those aligned with national development priorities (manufacturing, technology, renewable energy, export oriented).

- **Supporting Domestic investment.**

- Supporting greenfield investments, rather than mergers and acquisitions.

V. Conclusion and Policy Recommendation

Attracting FDI and increasing its stability

- Improving the investment climate to enhance the ease of doing business, BY regulatory reforms, improving institutional quality, enhancing transparency, and ensuring property rights.

- Foreign investors' confidence in the economy SHOULD be boosted via sound monetary and fiscal policies, export-oriented policies, and political stability.

v. Conclusion and Policy Recommendations

Conclusion	Implications
The Egyptian economy **is well performing in some absorptive capacity measures.** *But observed data must be cautiously considered.*	• **Quality of the education system** is questionable. • The value of **trade openness index** does not reflect the type or quality of exports and imports. • The improving **banking sector development index** does not guarantee an efficient utilization of the credit to the private sector. • THUS, well performing absorptive indices should not be taken for granted, rather this should be further enhanced via raising the quality of performance
Institutional quality forms a considerable **challenge** for Egypt for attracting and efficiently utilizing these inflows	• Improving transparency, accountability, and the rule of law to create a more conductive environment for investment. • Measures to streamline bureaucratic processes, enhance regulatory frameworks, accelerate dispute resolution, and combat corruption.

v. Conclusion and Policy Recommendations

Conclusion	Implications
Aligning investment policies with ***SDGs***	• Policies and incentives should give **priority** to investments and sectors which support SDGs. • Integrating sustainability criteria into investment decisions to attract socially responsible investors to benefit both current and future generations.

Thank you