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How effectively do Germany's foreign trade and investment promotion schemes support investment in Africa?

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The Africa Policy Guidelines developed by the German Federal Government emphasise the need to promote economic development on the African continent.[1] The aim is to achieve this primarily through private sector investment. So far, however, German businesses have invested little in Africa. One way to change this would be to broaden the spectrum of official foreign trade and investment policy tools. KfW and DEG have therefore commissioned a study to analyse the impacts of the Federal Government's investment promotion instruments – bilateral investment treaties and state investment guarantees – in Africa.[2] The analysis shows that these instruments are generally not being used to the extent expected. Nevertheless, it is noteworthy that in high-risk countries there is a correlation between development assistance and private investment.

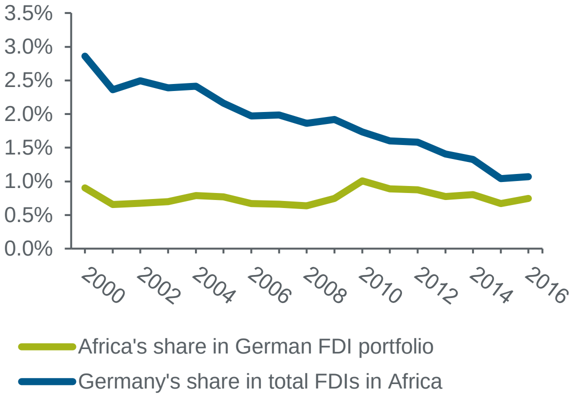
More investment in Africa is desirable

The German Federal Government regards private sector investment as crucial to Africa's economic development. Foreign direct investment (FDI) plays a key role. The Federal Government can rely on research that confirms the overall role of FDI as a driver of economic growth.[3] However, German enterprises have so far invested relatively little in Africa. A key mechanism available to the Federal Government for promoting foreign direct investment is its set of foreign economic policy instruments. There is constant debate about whether to expand these promotional instruments so as to increase the engagement of German firms in Africa. We therefore want to examine here the extent to which these instruments are effective in the African context and whether increasing the volume of guarantees for investments, for example, would lead to the desired result. We will refer to the key findings of the study conducted by Felbermayr et. al. in 2019 which was commissioned by KfW Research and DEG.[4]

To date, German businesses have primarily invested in regions other than Africa

Although German businesses have a relatively strong international presence,[5] they invest little on the African continent, which accounts for a less than 1% of German FDI. That share has not changed in the past years (Figure 1). The focus of German enterprises is on Asia as well as Central and Eastern Europe. The remaining major industrialised nations such as France, the United Kingdom and the US invest four to seven times more in Africa.

Figure 1: German investment in Africa

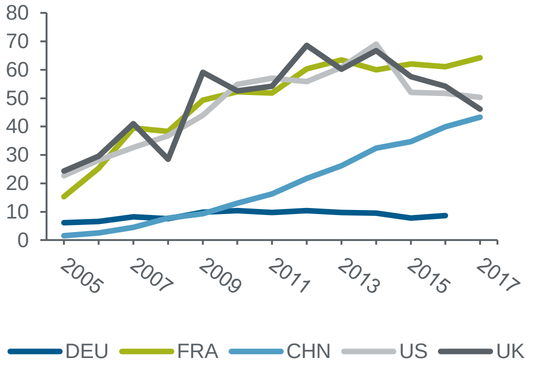


Source: Felbermayr et al 2019, Deutsche Bundesbank, UNCTAD, own rendition

Compared with other industrialised countries, Germany's involvement in Africa also lacks dynamic (Figure 2).

Figure 2: Direct investment portfolios in Africa by investors' country of origin

In USD billion



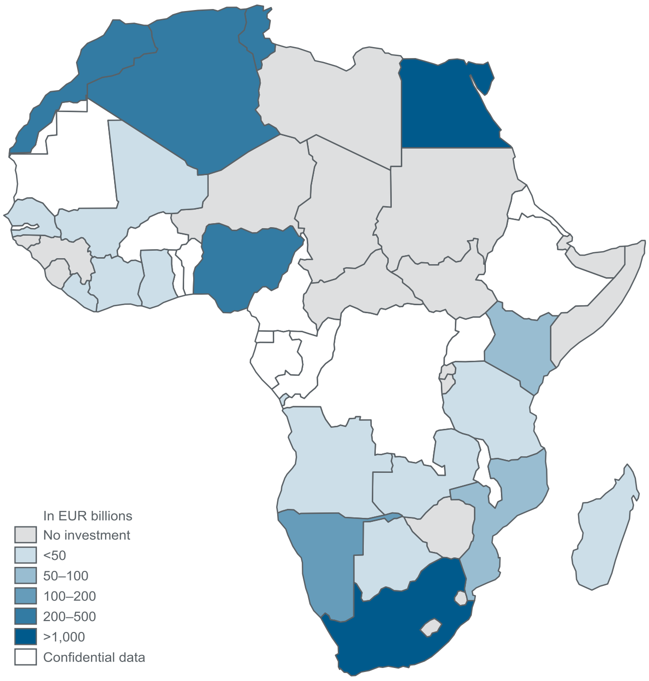
Source: IMF, UNCTAD, own rendition (GER=Germany, FRA=France, CHN=China, US=USA, UK=United Kingdom)

Unlike FDI from the above countries, investment portfolios of German companies in Africa have stagnated for almost 20 years.[6] Over the same period, investment by French firms has nearly quadrupled, while UK and US direct investment portfolios also grew significantly, although they have recently declined again. Chinese investment, however, showed the fastest growth, expanding by a factor of 40. Accordingly, the significance of German enterprises for African economies is shrinking.

Note: This paper contains the opinion of the authors and does not necessarily represent the position of KfW.

Figure 3: Regional distribution of German FDI portfolios

In EUR million



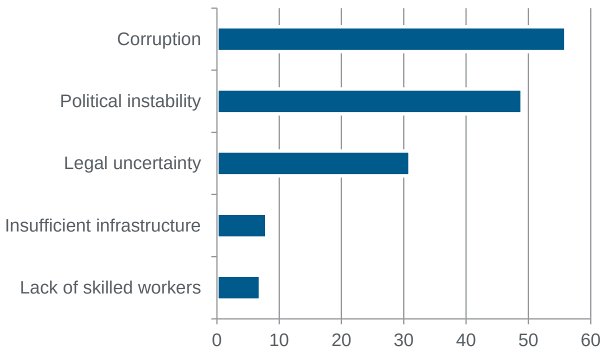
Source: Deutsche Bundesbank, own rendition, as at 2017

At the same time, German investment is heavily concentrated on certain countries. Around 60% of German investment in Africa is undertaken in South Africa and around 14% in Egypt. The portfolios in other countries that receive German FDI, such as Algeria, Morocco, Namibia or Nigeria, are well below the billion euro mark. Outside these approx. 20 countries, investment is even lower and sometimes even below the Bundesbank's reporting threshold (Figure 3).

Surveys illustrate that companies attach great importance to a degree of political stability and security[7] that they do not find in Africa. A survey conducted among enterprises operating in Africa shows that political risks and insufficient rule of law are the main reasons businesses are reluctant to invest in Africa (Figure 4).

Figure 4: Main risks to investment in Africa

In per cent



Source: Global Perspective Initiative, own rendition

The heightened risk to investment in developing countries, and in Africa in particular, is also reflected in the country risk categories developed by Euler Hermes based on standards set by the Organisation for Economic Cooperation and Development (OECD). Euler Hermes and the OECD classify the countries of the world into seven different risk categories (Table 1). Countries in risk category 1 have the lowest risk. Investments in countries assigned to category 7, on the other hand, are fraught with significant macroeconomic risks. Euler Hermes' country risk categories form the basis for assessing investment risks in granting state investment guarantees. It is also evident across the various risk categories that the bulk of German FDI goes to countries with low risk classifications. Willingness to invest generally declines as risk increases.

Statistical estimation methods illustrate that German FDI would theoretically decline by 96% if a country's Euler Hermes risk category were to change from best to worst.[8] However, this statistical correlation also works in reverse: A country's improvement within the risk classification triggers positive direct investment effects.

Table 1: Distribution of German FDI by Euler Hermes risk categories in 2017

In per cent

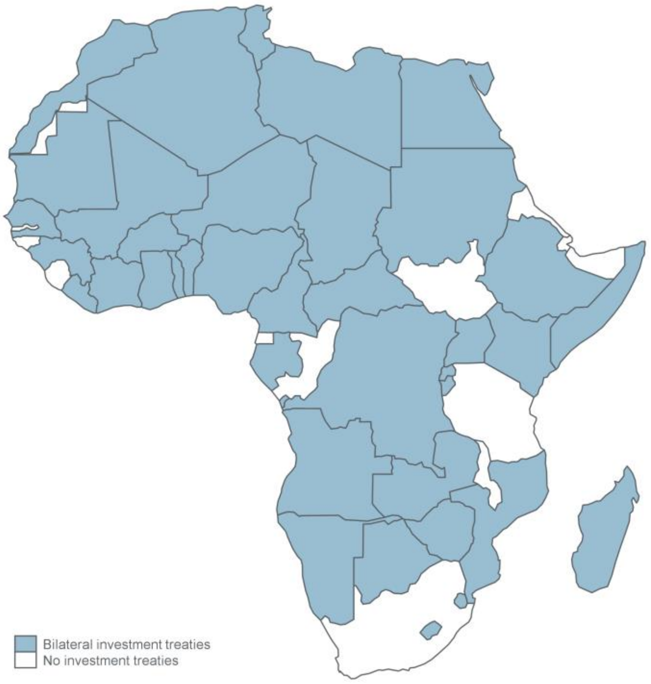
	Risk category 1	Risk category 2	Risk category 3	Risk category 4	Risk category 5	Risk category 6	Risk category 7
Share of DE investments worldwide	0.9%	43.3%	25.9%	14.6%	11.6%	0.9%	2.8%
Share of DE investments in Africa	./.	0.3%	8.6%	57.7%	22.2%	7.5%	3.6%
Country	./.	Botswana	Mauritius, Morocco	Algeria, South Africa	Egypt Namibia, Senegal, Tunisia	Angola, Benin, Cote d'Ivoire, Eswatini, Gabon, Ghana, Cape Verde, Cameroon Kenya, Lesotho, Nigeria, Rwanda, Tanzania, Togo, Uganda	Ethiopia, Equatorial Guinea, Burkina Faso, Burundi, Djibouti, Eritrea, Gambia, Guinea, Guinea-Bissau, Congo, Congo Rep., Libya, Mali, Mozambique, Niger, Chad, Central African Rep., Zambia,

Sources: Deutsche Bundesbank, OECD, own rendition

Bilateral investment treaties are the mainstay of foreign trade and investment promotion

The private sector is unable to buy protection against the risks mentioned above, or only at very high cost. This is where the Federal Government's foreign trade and investment promotion comes in with instruments that mitigate business risks.[9] These investment protection instruments are based on bilateral investment treaties (BIT) with partner countries. These treaties provide businesses with a minimum of protection against state arbitrariness. They require partner governments to abide by international rules, ensure independent legal services, allow business to be conducted without discrimination, protect companies from expropriation and guarantee the rule of law and the option to seek dispute settlements through international arbitration tribunals. The aim is to reduce political risks for investors in the respective country.

Figure 5: African states with which Germany has entered into an investment treaty



Source: German Federal Ministry for Economic Affairs and Energy, own rendition, as at 2019

Germany has used this instrument to promote German foreign direct investment since the 1960s. Its purpose was to make developing countries in particular more attractive for private capital. Since then, Germany has entered into 147 BITs around the world, 44 of which with African countries (see Figure 5). When we compare Figures 3 and 5, however, we see that African countries so far have benefited from this promotional instrument to widely varying degrees – in the meaning of a significant direct investment portfolio.[10]

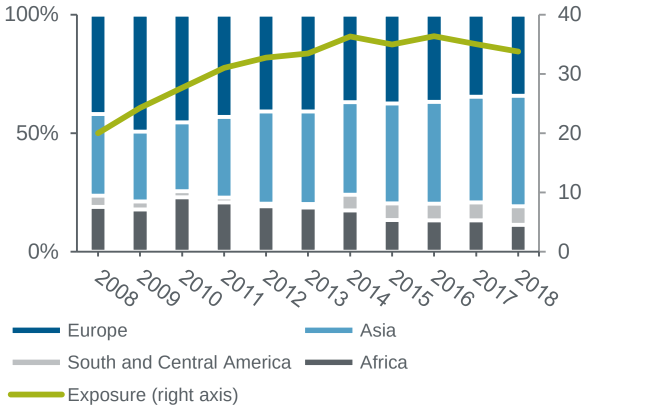
Investment guarantees promote German direct investment

The conclusion of a BIT is a prerequisite for the granting of state investment guarantees (SIGs), the Federal Government's second most important foreign trade and investment promotion instrument. A SIG provides protection against losses that may arise from political risks such as expropriation, war or the obstruction of business through political decisions. These guarantees currently have an exposure of some EUR 35 billion. The exposure is thus significantly higher than, for example, in France (around EUR 20 billion) and roughly as high as in the United Kingdom (approx. EUR 34 billion). It is therefore surprising that German businesses invest less in Africa than British and French companies despite the availability of the same or a much higher volume of support.

At the same time, in terms of the total volume of guarantees granted by the German Federal Government, Africa occupies only a marginal position. The guarantee portfolios are concentrated on Europe, especially Central and Eastern Europe, as well as Asia (Figure 6). While the share of guarantees issued for investments in Asia has clearly increased, Africa's share has dropped. The volume of outstanding guarantees has also decreased in absolute terms in the past years. The total exposure dropped from EUR 6.3 billion in 2014 to just EUR 3.8 billion in 2018. At the same time, the number of approved applications for guarantees has grown, however, which suggests lower average guarantee amounts. In other words, the guaranteed investments in Africa have tended to be smaller.[11] But the question remains why SIGs are so uncommon or relatively less common in Africa,[12] especially since the guarantees were developed for countries with high political risk, which is the case in many African countries.

Figure 6: Guarantees granted by region (all developing and emerging economies)

Regional shares in per cent, portfolio in EUR billions



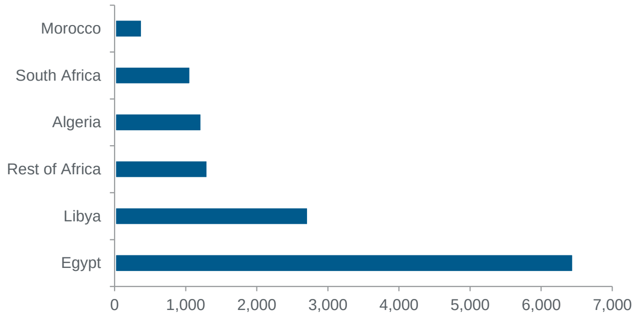
Sources: Felbermayr et al 2019, PwC, own rendition

The analysis of global FDI in the period of 2000–2012 shows that the share of investments protected by guarantees grows as the country risk increases. This is plausible because the need to 'insure' the investment increases with country risk. On the other hand, the use of guarantees grows only up to a certain risk category. The use of guarantees drops again in countries with the highest risk category, which is in line with

Euler Hermes country risks 6 and 7. This is a surprising finding. After all, the likelihood of a disruption to business activity or even loss of investment is highest in the countries that are in the highest risk category. This distribution pattern is also evident within Africa. In the higher-risk states of Sub-Saharan Africa, SIGs are scarcely used in relation to the investment volume at stake. Most guarantees are used for projects in states that are politically more stable and thus pose a lower regulatory risk. These include Algeria, Egypt, Morocco and South Africa. These are the states where guarantees – in terms of guarantee volume – are concentrated (Figure 8). The civil war-ravaged country of Libya is an exception. It has been in the highest risk category since the 2000s, yet German enterprises have made investments there and secured them with these guarantees.

Figure 7: Regional distribution of guarantees in Africa

In EUR million



Sources: Felbermayr et al 2019, PwC, own rendition

The number of guarantees granted, however, paints a different picture. Only around 20% of guarantees are given for investment projects in the countries of North Africa, while 80% of guarantees are distributed among projects in the remaining African states. This analysis corroborates the above-mentioned finding that investment projects in Sub-Saharan Africa are of lesser volume.

Promotion instruments have a positive impact on the direct investment portfolio

The statistical verification of these correlations also demonstrates that the effectiveness of foreign trade and investment promotion schemes varies by country risk and instrument.

It can thus be demonstrated that BITs can sometimes have a very positive effect on FDI but only in low to medium-risk countries. There, a BIT on average leads to an increase in investment of up to 153% compared with a situation without such a treaty (Table 2).[13] But the effect diminishes with growing risk and a BIT cannot be shown to have a statistically significant effect in countries that are in the highest risk category. Most of the Sub-Saharan African countries are in this group. The critical threshold is risk category 4. In the highest risk category, BITs have no positive effect on German FDI.

Table 2: Effect of state promotion schemes and development assistance on direct investment

In per cent

	Risk category 1	Risk category 2	Risk category 3	Risk category 4	Risk category 5
	Low				High
Bilateral investment treaties	152.6***	129.2***	44.4**	22.2	-1.8
State investment guarantees	2.8	33.8***	29.9***	46.2***	77.5***
Development assistance		-29.6	3.5	21.8***	32.4***

Source: Felbermayr et al 2019, own rendition. ***, ** and * show the statistical significance on 1%, 5% and 10% level.

But because BITs are also indispensable in these countries when SIGs are to be granted, their impact unfolds there indirectly. Interestingly, empirical estimates have shown that the positive impact of SIGs on FDI increases with rising country risk. Thus, German FDI in a country with the highest risk category is 78% higher when SIGs are available. Besides, a causal impact analysis shows that raising the state guarantee volume by 1% leads to an average increase of 0.35% in the direct investment portfolio.

Nonetheless, Figure 6 illustrates that African states have not yet benefited from an expansion of these guarantees. The increases were used to expand in other regions of the world. This corroborates the finding that relatively low investment sums have been protected with SIGs in high-risk countries. This is consistent with the observation that German investors avoid a large portion of the African continent (Figure 3).[14]

What is interesting in this context is a further finding of the commissioned study. Proceeding on the assumption that official development aid (ODA) funds go primarily to high-risk African countries, the authors examined ODA outflows and German FDI for possible links. While no significant effect can be observed in low-risk countries, FDI is up to 32% higher in destination countries that are in risk categories 5, 6 and 7 when these receive German development cooperation funds (Table 2). But this correlation does not provide any clues about the causal relationship. Possibly, however, German development cooperation may have a confidence-building effect on German investors, for example.

Conclusion: Germany's foreign trade and investment promotion instruments are effective but less so in Sub-Saharan Africa

The German Federal Government would like more engagement from the German private sector in Africa. Businesses, however, are reluctant to invest in Africa. Compared with other, large industrialised nations, direct investment portfolios in Africa have hardly increased in the past years and remain on a low level. This lack of dynamic indicates that German enterprises will become less important for most African economies if the current situation does not change.

In order to mitigate risks to investment that undoubtedly exist in Africa, the Federal Government provides foreign trade and investment promotion instruments. Although these instruments exhibit different degrees of effectiveness depending on the country risk category, empirically there is no doubt that they encourage FDI in principle. Still, they are hardly being used in Sub-Saharan Africa, so they do not have any effects there. It is therefore questionable whether a further expansion of the available guarantee volume or improvements to the conditions on which they are granted, for example, would have a substantial effect on German investment portfolios in Africa.

What is nevertheless noteworthy is that a correlation exists between ODA inflows and FDI inflows in high-risk countries. Further research is required here to establish the nature and direction of a possible correlation. If development cooperation indeed has a positive effect on investors' risk perception, this would also be an additional case for reform projects such as those envisioned by the Compact with Africa. If the regulatory framework and business environment in the destination country are improved as a result of reforms, the investment risk should decrease accordingly.

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[1] The German Federal Government (2019) 'Eine vertiefte Partnerschaft mit Afrika' (*'A deeper partnership with Africa* – in German only) Available at: https://www.auswaertiges-amt.de/blob/2204146/61736c06103e9a28e328371257ee34f7/afrikaleitlinien-data.pdf (retrieved on 17 December 2019).

[2] Felbermayr, G., Freytag, A., Thanh Tran, L. and Yalcin, E. (2019) 'Instrumente und Wirkung der Außenwirtschaftsförderung in Afrika' (*'Instruments and effectiveness of foreign trade and investment promotion in Africa* '– our title translation, in German), Friedrich-Schiller University, Jena. Unpublished study.

[3] Z. B. Borensztein, E., De Gregorio, J. and Lee, J. W. (1998) 'How Does Foreign Direct Investment Affect Economic Growth?' Journal of International Economics, 45 (Jun), 115–135, or Li and Liu, 2005 Li, X., Liu, X. (2005). Foreign direct investment and economic growth: an increasingly endogenous relationship. World Development 33, pp.393–407.

[4] See endnote 2.

[5] OECD (2019) OECD Data – International Direct Investments Statistics. Available at: https://data.oecd.org/fdi/fdi-stocks.htm (retrieved on 17 December 2019).

[6] The reluctance of German enterprises to invest in Africa is consistent with the results of statistical surveys across all German FDI activity. German FDI increases with GDP and the degree of industrialisation of the destination country (Felbermayr et al (2019), see above).

[7] World Bank (2018) Global Competitiveness Report 2017/2018. Foreign Investor Perspectives and Policy Implications, Washington DC.

[8] Felbermayr et al. (2009) based on data from the Deutsche Bundesbank.

[9] In addition to the BITs and SIGs, investment promotion instruments also include support by AKA-Bank, the develoPPP Programme and the AfricaConnect financing programme as a component of the Development Investment Fund.

[10] The reporting threshold of the Deutsche Bundesbank is an investment portfolio of at least EUR 100 million. These data thus provide no evidence of whether countries for which no FDI portfolios were reported had no German investments at all or whether these were merely very small.

[11] Bundesbank & PWC, Felbermayr et al. (2019).

[12] It is not possible to make a reasonable estimate of the ratio between the number of businesses covered by a SIG and the total number of investments by region. To do this, one would have to break down the SIGs and investments at country and sector level. As that would occasionally enable individual investments to be identified, such an approach would violate privacy laws and is therefore not possible.

[13] As the OECD's risk classification does not cover all economies, the risk measures were re-scaled from 5 to 7 categories in order to enable comparability with other risk classifications and thus be able to include countries outside the OECD classification. Here as well, a higher number means a higher risk category.

[14] Further research is necessary to determine the exact reasons that cause German investors to largely avoid vast parts of Africa. The available data do not permit any conclusions about this.