

**THE ROLE OF INVESTMENT INCENTIVES  
ON FOREIGN DIRECT INVESTMENT INFLOWS:  
A MALAWIAN PERSPECTIVE**

**By**

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**Submitted in partial fulfilment of the requirements for the degree of  
MASTERS IN BUSINESS ADMINISTRATION**

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**Date: July, 2003**

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## ABSTRACT

This study carries forward the exploration of the link between the enactment of the Malawi Investment Promotion Act (1991) and the investment incentives laid out therein, and the level of foreign direct investment to Malawi. In doing so, the study aims to establish the progress that Malawi has made in nurturing an investment climate that is attractive to foreign investors. The respondents were 26 foreign companies that have invested in Malawi following the enactment Investment Promotion Act. All participants completed a self-administered questionnaire covering several attributes pertaining to Malawi's investment environment. Interviews were also conducted with government officials and employees from the Malawi Investment Promotion Agency (MIPA). The data strongly suggest that FDI has contributed to Malawi's economic growth to a certain extent, and that foreign direct investment inflows have risen during the 1990s. However, the results must be viewed within the context of the broader macroeconomic environment. If Malawi is to see any increase in its FDI inflows, an overall strategy is essential to restore macroeconomic conditions that are conducive to growth, to strengthen the legal and regulatory framework for doing business in the country, and improve the infrastructure that supports the economy. Only when the fundamental determinants are attractive enough for investment to be profitable, will investment incentives have any significant effect.

# CHAPTER I

## INTRODUCTION

### 1.1 THE PROCESS OF GLOBALISATION

As an economic process, globalisation is the rapid integration of national economies through trade, capital and financial flows. It is characterised by the intensification of international trade in goods and services, capital flows (FDI and short-term flows), and the role of transnational corporations (TNCs). The importance of economic integration stems mainly from the opportunities it provides to pool resources for investment, enlarging markets for domestic products, and facilitating cross-border vertical integration and production sharing.

In describing globalisation, people sometimes tend to view it narrowly from the perspective of a single discipline. In essence, there are two schools of thought: one takes an economic and business perspective and challenges the view of substantial global integration. Globalisation is regarded as a myth and seen as “the activities of multinational enterprises engaged in foreign direct investment and the development of business networks to create value across national borders”(de silva, 2001). Another school adopts a wider and multidimensional perspective, seeing globalisation as a complex process that affects not only the economy and business, but also the nation-state, politics, social life and culture. The process of globalisation is viewed as a dismantling of trade and investment barriers between countries, an internationalisation of production systems, and the emergence of global product and capital markets.

Whether viewed from a narrow or broad perspective, the main driving forces behind globalisation are economic and technological, although the consequences are felt well beyond the economic, business and technological fields. Globalisation has contributed to a number of developments which include: more countries participating in trade, finance

and production; greater liberalisation and deregulation; increased economic interdependence among nations; and greater competition for investment and markets.

As compared to the early part of the twentieth century when “globalisation” was confined to a few countries, today many developing and emerging countries are participating in the process to varying degrees. One commonly used indicator of globalisation is the extent of investment flows, namely, foreign direct investment (FDI). The past twenty years have seen a marked increase in both the flow and stock of FDI in the world economy. In 1999, FDI reached a global record flow of US\$827 billion – a 25 percent rise over the 1998 figure of US\$660 billion, itself representing a 41 percent increase over the preceding year. Much of the recent surge in FDI is being driven by the dramatic political and social changes that have occurred in many of the world’s developing nations. FDI has come to be widely recognised over the past decade as a major potential contributor to growth and development - it can bring capital, technology, management know-how, and access to international markets. Foreign direct investment is welcomed and actively sought by virtually all developing countries as a crucial source of capital investment and a determinant of the future growth rate of an economy. Many of these economies have made considerable efforts over the past decade to improve their investment climate, by liberalising their investment regimes, and offering numerous incentives to foreign investors. The general shift toward democratic political institutions and free-market economies has encouraged FDI to many of these countries. Out of the global flow of US\$827 billion in 1999, developing countries attracted an estimated US\$198 billion – representing an increase of 15 percent over the previous year.

## 1.2 BACKGROUND OF THE STUDY

Malawi is a landlocked country that lies in the eastern part of South Central Africa. The integration of Malawi into the global economy began with colonialism just before the turn of the century. After independence, this relationship continued under numerous voluntary arrangements. Malawi has been engaged in extensive liberalisation and reform programmes, embracing market-oriented economic policies with an export-oriented approach. Since the early 1990s, economic reforms aimed at, among other things, attracting FDI, have been implemented.

Africa, in spite of its high profitability level, is regarded as the region least favourable to FDI. Reasons for this phenomenon are largely attributable to the political and economic problems that characterised the continent in the 1980s. Despite the constraints of the general negative attitude towards Africa as an investment destination, limited purchasing power, poor infrastructure, and a small domestic market, there is a potential for higher FDI flows to Malawi. In response to this, the Government of Malawi encourages the private sector to assume the leading role in economic development. The government thrust is to facilitate, rather than to regulate, private investment. To create a more conducive investment climate, specific measures to deregulate the private sector and offer new investment opportunities have already been enacted.

Malawi has a number of investment incentives on offer. A wide range of policy measures has been taken to induce foreign investment, to protect foreign-invested enterprises, and to facilitate their smooth operation. Towards this end, the Government of Malawi passed the Investment Promotion Act of 1991, which set out a range of incentives available to foreign investors. The Act also established the Malawi Investment Promotion Agency (MIPA) as an institution mandated to attract, promote and facilitate investment by ensuring streamlined investment procedures and supportive policy framework.

Being ranked as one of the least developed countries in the world, it is imperative for Malawi to boost its economic growth. As is the case with many other developing economies, FDI can be viewed as a major potential contributor to Malawi's growth and development. This study focuses on an aspect of this process, namely the efforts that have been made by the Malawi Government to encourage and attract foreign direct investment to the country. The study attempts to establish the effectiveness of the Malawi Investment Promotion Act (1991), in terms of the incentives that are offered to encourage foreign investors to consider Malawi as an FDI destination. Furthermore, the study will try to ascertain whether there has been a rise in the level of foreign direct investment to Malawi as a result of the enactment of the new Investment promotion Act. In doing so, the study aims to establish the progress that Malawi has made in nurturing an investment climate that is attractive to foreign investors, in its efforts to integrate Malawi into the global economy.

Chapter II begins with a review of the literature surrounding the numerous theoretical aspects of foreign direct investment, followed by an outline of the principal determinants of the location of FDI. Chapter III describes investment incentives, in terms of theory, their effects on foreign investors' decisions, and the various types of incentives available. Chapter IV highlights the recent trends in foreign direct investment to developing countries, and goes on to discuss the recent developments in Africa with regards to FDI inflows to the region. Chapter V describes the Malawian economy with respect to its macroeconomic performance in recent years, and the country's business and investment environment. Chapter VI outlines the problem statement and objectives of the study, giving a brief description of the hypotheses to be tested. The methodology used for the study is explained in Chapter VII. Chapter VIII concerns investment data pertaining to Malawi, with recent trends and figures. The results of the survey are detailed in Chapter IX, followed by a discussion of the study's findings in Chapter X. The paper ends with Chapter XI, which provides recommendations and conclusion.



## CHAPTER II

### REVIEW OF THE LITERATURE

#### 2.1 THEORETICAL ASPECTS OF FOREIGN DIRECT INVESTMENT

Foreign Direct Investment is, by definition, an investment in which the investor acquires a substantial controlling interest in a foreign firm or sets up a subsidiary in a foreign country (Markusen et al., 1995)<sup>1</sup>. One striking feature of the world economy in recent decades has been the growth of FDI, or investment by transnational corporations or multinational enterprises in foreign countries in order to control assets and manage production activities in these countries (Mallampally and Sauvant, 1999)<sup>2</sup>.

Investment can be financed either from internal sources, i.e. savings and government borrowing; or external sources, i.e. FDI, donor funding or overseas development assistance (ODI), and foreign loans. There is a strong correlation between the economic growth rate of a country and investment, and between growth and savings (Mohr and Fourie, 1998)<sup>3</sup>. In a closed economy, with no access to foreign savings, investment is financed solely from domestic savings. However, even in open economies, it remains an empirical regularity that countries that have achieved a high rate of investment also have high rates of domestic savings. This implies that, in most countries with superior investment performance, foreign savings normally play a complementary role in the provision of financial resources for development. They permit domestic investment in a country to exceed its own savings (World Investment Report 1999)<sup>4</sup>.

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<sup>1</sup> Markusen et al., 1995, *International Trade – Theory & Evidence*, International Edition, McGraw-Hill, US.

<sup>2</sup> Mallampally P. and Sauvant K.P., 1999, "Foreign Direct Investment in Developing Countries", *IMF Finance and Development Report*, Vol. 36, No. 1.

<sup>3</sup> Mohr P. and Fourie L., 1998, *Economics for South African Students*, J.L. Van Schaik Publishers, Pretoria, South Africa.

<sup>4</sup> UNCTAD, *World Investment Report 1999*, FDI and the Challenge of Development, United Nations Publication, New York and Geneva.

Hill (2002)<sup>5</sup>, states that another way of looking at the importance of FDI inflows in an economy, is to express them as a percentage of gross fixed capital formation. **Gross fixed capital formation** summarizes the total amount of capital invested in factories, stores, office buildings, and the like. Other things being equal, the greater the capital investment in an economy, the more favourable its future growth prospects are likely to be. Viewed this way, FDI can be seen as an important source of capital investment and a determinant of the future growth rate of an economy.

Economic theory suggests inward FDI has multiple impacts on the host economy (Narula and Dunning, 1995)<sup>6</sup>. The linkages between development and multinational companies' (MNC) involvement have tended to become closer and less avoidable as economic activity has become more globalized (Ballak, 2001)<sup>7</sup>. There is a great deal of evidence that foreign-owned firms in most countries trade more with their parent countries, but also trade more in general, than locally-owned firms. A summary of the evidence shows that "MNCs or their affiliates generally enjoy a larger share of home or host country exports and imports than they do output...this is partly explained by their being concentrated in trade-intensive sectors, and partly because their trading propensity in any given sector tends to be greater than that of unational or indigenous firms"(Dunning, 1994)<sup>8</sup>. Therefore, it is likely that high foreign ownership, or a large inflow of FDI, will increase the importance of trade for a host country, thus affecting growth indirectly. According to Mallampally and Sauvart (1999)<sup>9</sup>, the greater the supply and distribution links between foreign affiliates and domestic firms, and the stronger the capabilities of domestic firms to capture spillovers (which include imitation of the foreign investors' technologies and management techniques), from the presence of and competition from foreign firms, the more likely it is that the attributes of FDI that enhance productivity and competitiveness will spread.

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<sup>5</sup> Hill C.W., 2002, *Competing in the Global Marketplace*, 3rd Edition, McGraw-Hill, New York.

<sup>6</sup> Dunning J.H. and Narula R., 1995, "Transpacific Foreign Direct Investment and the Investment Development Path", *South Carolina Essays in International Business*, 10.

<sup>7</sup> Ballak C., 2001, *The Contribution of (Large, "Western") Multinationals to the Catching-Up of (Small, "Eastern") Countries*, Palgrave Publishers Ltd., New York

<sup>8</sup> Dunning J.H., 1994, "Re-evaluating the benefits of foreign direct investment", *Transnational Corporations*, 3, No.1.

<sup>9</sup> See Note 2.



Foreign direct investment does not displace a country's exports, but rather stimulates them (Graham, 1997)<sup>10</sup>. Host countries ability to use FDI as a means to increase exports in the short and medium term depends on the context. The clearest examples of FDI boosting exports are found where inward investment helps host countries that had been financially constrained make use either of their resource endowment (e.g. foreign investment in mineral extraction) or their geographical location (e.g. investment in some transition economies) (OECD, 2002)<sup>11</sup>.

Economic literature identifies technology transfers as perhaps the most important channel through which foreign corporate presence may produce positive externalities in the host developing country. TNCs are the developed world's most important source of R&D activity, and they generally possess a higher level of technology than is available in developing countries, so they have the potential to generate considerable technology spillovers (OECD, 2002)<sup>12</sup>.

With regards to human capital formation, empirical and anecdotal evidence indicates that, while considerable national and sectoral discrepancies persist, TNCs tend to provide more training and other upgrading of human capital than do domestic enterprises (OECD, 2002)<sup>13</sup>. According to an OECD Report on Foreign Direct Investment (2002)<sup>14</sup>, the major influence of FDI on human capital in host countries appears to be indirect, occurring not principally through the efforts of TNCs, but also from government policies seeking to attract FDI via enhanced human capital. Once individuals are employed by TNC subsidiaries, their human capital may be enhanced further through training and on-the-job learning. Those subsidiaries may also have a positive impact on human capital enhancement in other enterprises with which they develop links. Such enhancement can have further effects as that labour moves to other firms and some employees become

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<sup>10</sup> Graham E.M., 1997, "Working Together: Foreign Direct Investment and Trade", *Economic Reform Today*, No. 3.

<sup>11</sup> OECD, 2002, *Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs*, OECD Publications, France. (<http://www.oecd.org/pdf/M00034000/M00034678.pdf>)

<sup>12</sup> *ibid.*

<sup>13</sup> See Note 11.

<sup>14</sup> See Note 11.

entrepreneurs. Thus, the issue of human capital development is intimately related with other broader development issues.

### **2.1.1 Foreign Direct Investment in the Context of Growth and Development**

The factors that propel sustained economic development have not changed over time. They include the generation and efficient allocation of capital and labour, the application of technology, and the creation of skills and institutions. Most developing countries today consider FDI an important channel for obtaining access to resources for development – investible financial resources, modern technologies, market access, and skills and management techniques (World Investment Report, 1999)<sup>15</sup>. Twenty years ago or so, many governments saw TNCs as part of the “development problem”. Today, TNCs are seen as part of the “solution”. The significant upturn of FDI flows to developing countries, and the success of some countries in attracting large amounts of FDI, have led to predictions that FDI, as a more stable form of capital flow linked to an emerging international production system, is likely to offer new, and unprecedented growth opportunities to developing countries.

Beyond the initial macroeconomic stimulus from the actual investment, FDI influences growth by raising total factor productivity and, more generally, the efficiency of resource use in the recipient country (OECD, 2002)<sup>16</sup>. Most empirical studies conclude that FDI contributes to both factor productivity and income growth in host countries, beyond what domestic investment normally would trigger. However, it is more difficult to assess the magnitude of this impact, not least because large FDI inflows to developing countries often concur with unusually high growth rates triggered by unrelated factors. Whether, as sometimes asserted, the positive effects of FDI are mitigated by a partial “crowding out” of domestic investment, is far from clear. Some researchers have found evidence of crowding out, while others conclude that FDI may actually serve to increase domestic investment. Regardless, even where crowding out does take place, the net effect generally

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<sup>15</sup> See Note 4.

<sup>16</sup> See Note 11.

remains beneficial, not least as the replacement tends to result in the release of scarce domestic funds for other investment purposes (OECD, 2002)<sup>17</sup>.

Practically all empirical studies of inter-country differences in growth rates, without any necessary implications as to causation, suggest that high growth rates are associated with large inflows of FDI. Economic theory suggests that the efficient functioning of markets depends on an adequate level of competition between producers. By increasing consumer choice, foreign direct investment can help to increase the level of competition in national markets, thereby driving down prices and boosting the economic welfare of consumers. Increased competition tends to stimulate capital investments by firms in plant, equipment, and R&D as they struggle to gain an edge over their rivals. The long-term results may include increased productivity growth, product and process innovations, and greater economic growth (Hill, 2002)<sup>18</sup>. Rostow's theory of the stages of economic growth, also postulates that saving, investment, and foreign aid are critical elements of economic development (Mohr & Fourie, 1998)<sup>19</sup>.

A study conducted for 69 developing countries of growth in *per capita* GDP from 1970 to 1989, found that FDI was a significant positive influence on growth (Borensztein, De Gregorio and Lee, 1995)<sup>20</sup>. Few long-period cross-section studies have included a measure of FDI as a potential source of growth (Blomstrom, Lipsey and Zejan, 1994)<sup>21</sup>. However, some of the variables identified in these studies as factors of growth, are typically under the influence of FDI. For example, relatively "robust" relations were found between investment ratios (investment/GDP) and growth, and between investment ratios and trade ratios. Both investment ratios and trade ratios could be affected by FDI flows, and thus, indirectly form a channel for an effect of FDI on growth.

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<sup>17</sup> See Note 11.

<sup>18</sup> See Note 5.

<sup>19</sup> See Note 3.

<sup>20</sup> Borensztein E., Gregorio J. and Lee J.W., 1995, *How Does FDI Affect Economic Growth*, Working Paper No. 5057, (Cambridge MA: National Bureau of Economic Research).

<sup>21</sup> Blomstrom M., Lipsey R.E. and Zejan M., 1994, *What Explains Developing Country Growth?*, Working Paper No. W4132, (Cambridge MA: National Bureau of Economic Research).

Recent endogenous growth theories also reinforce the link between investment and growth. They postulate that, when investment is taken in a broad sense, to include not only expenditures on capital goods but also expenditures on technology enhancement and human capital formation, there may not exist diminishing returns to investment.

Therefore, countries that devote a high proportion of output to investment may sustain more rapid growth than countries that invest less (World Investment Report 1999)<sup>22</sup>.

Overall, empirical evidence of the social consequences of FDI supports the notion that foreign investment may help reduce poverty and improve social conditions. The general effects of FDI on growth are essential. Studies have found that higher incomes in developing countries generally benefit the poorest segments of the population proportionately. The beneficial effects of FDI on poverty reduction are potentially stronger when FDI is employed as a tool to develop labour-intensive industries (OECD, 2002)<sup>23</sup>.

In the least developed economies, FDI seems to have a somewhat smaller effect on growth, which has been attributed to the presence of “threshold externalities”. Developing countries need to have reached a certain level of development in education, technology, infrastructure, and health before being able to benefit from a foreign presence in their markets. Imperfect and underdeveloped financial markets may also prevent a country from reaping the full benefits of FDI. Yet even countries at levels of economic development that do not lend themselves to positive externalities from foreign presence, may benefit from inward FDI through the limited access to international funding. By easing financial restraint, FDI enables host countries to achieve the higher growth rates that generally emanate from a faster pace of gross fixed capital formation (OECD, 2002)<sup>24</sup>.

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<sup>22</sup> See Note 4.

<sup>23</sup> See Note 11.

<sup>24</sup> See Note 11.

The link between external payments and economic growth in developing countries has long been recognised. This led to the early formulation of this relationship in the 1960s of the so-called “two-gap approach” (UNCTAD, 1968)<sup>25</sup>.

This approach emphasises the dependence of capital accumulation and economic growth in developing countries on foreign capital and trade flows through two channels. The first involves the resources needed for investment: external capital flows allow developing countries to invest more than they can save, thereby closing their savings gap. The current account deficit is viewed as a measure of real resource transfers from abroad to supplement domestic savings. Accordingly, a real sustained increase in the deficit is expected to be associated with faster capital accumulation and growth.

The second gap relates to foreign exchange availability and arises because of the dependence of investment and growth in developing countries, on imported intermediate and capital goods. Even if domestic savings are sufficient to finance all the investment needed, a developing country would still be unable to undertake the investment if it does not earn enough foreign exchange to pay for the imports required. Investment would thus be constrained by the lack of adequate foreign exchange rather than domestic savings. Consequently, production capacity would be underutilized, income and savings would fall, and growth would be below potential. Capital inflows can fill this foreign exchange gap, allowing imports, investment, income, and savings to be raised above the levels otherwise constrained by export earnings.

However, the two-gap model does not fully capture the link between trade and growth. According to the Trade and Development Report (1996)<sup>26</sup>, the utilisation of existing capacity, income, and savings can also depend on exports. In this context, the role of exports is not only to earn foreign exchange for imports and investment, but also to provide markets for goods which would not otherwise be produced or, produced only to meet domestic consumer demand. In the first case, exports provide a “vent for surplus”, while in the second case they allow domestic savings to increase, as consumer goods industries can operate at full capacity without a commensurate increase in domestic

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<sup>25</sup> One of the pioneering studies based on the two-gap approach was done by UNCTAD – *Trade Prospects and Capital Needs of Developing Countries*, New York, United Nations, 1968.

<sup>26</sup> UNCTAD, *Trade and Development Report 1996*, United Nations Publications, New York.

consumption. Since export expansion in turn depends on investment, a sustainable growth process requires mutually reinforcing dynamic interactions between capital accumulation and exports.

The overall benefits of FDI for developing country economies are well documented. Given the appropriate host country policies and a basic level of development, a preponderance of studies shows that FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development (OECD, 2002)<sup>27</sup>. All these contribute to higher economic growth, which is a potent tool for alleviating poverty in developing countries.

## **2.2 THE PRINCIPAL DETERMINANTS OF THE LOCATION OF FDI**

To explain the differences in FDI performance among countries and to ascertain why firms invest where they do, it is necessary to understand how TNCs choose investment locations. In general, FDI takes place when firms combine their ownership-specific advantages with the location-specific advantages of host countries. Three broad factors determine where TNCs invest: the policies of host countries, the proactive measures countries adopt to promote and facilitate investment, and the characteristics of their economies (Mallampally and Sauvant, 1999)<sup>28</sup>.

The core enabling framework for FDI consists of rules and regulations governing entry and operations of foreign investors, standards of treatment of foreign affiliates and the functioning of markets. Complementing core FDI policies are other policies that affect foreign investors' locational decisions directly or indirectly, by influencing the effectiveness of FDI policies. These include trade policy and privatisation policy.

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<sup>27</sup> See Note 11.

<sup>28</sup> See Note 2.



Core FDI policies are important because FDI will simply not take place where it is forbidden or strongly impeded. However, changes in policies have an asymmetric effect on the location of FDI: changes in the direction of greater openness allow firms to establish themselves in a particular location, but they do not guarantee this. In contrast, changes in the direction of less openness (e.g. nationalization) will ensure a reduction in FDI (Mallampally and Sauvant, 1999)<sup>29</sup>.

Since the mid-1980s, an overwhelming majority of countries have introduced measures to liberalise FDI frameworks. Globalization and FDI liberalization have exerted mutually reinforcing pressures on each other and the momentum for neither has subsided. This has provided TNCs with an ever-increasing choice of locations and has made them more selective and demanding as regards other locational determinants. As the core FDI policies become similar across countries as part of the global trend towards investment liberalization, factors such as trade policies and privatisation policies gain more influence. Foreign investors assess a country's investment climate not only in terms of FDI policies, but also in terms of macroeconomic and macro-organizational policies (World Investment Report, 1998)<sup>30</sup>. According to the World Bank, the sluggishness in the world economy has seen a reduction in private capital flows to developing countries. FDI flows to developing countries peaked at \$180 billion in 1999, and fell back to the \$160 billion range by 2001. Rising global risk premiums have led to a reversal in debt capital flows. The precarious market conditions have also reduced infrastructure investment sharply. Besides the fall in investment in absolute terms, investors are becoming more selective in choosing their investment destinations. As a result, investment is flowing to countries with better domestic investment climates: good governance, sound institutions and a system of property rights.

With FDI policy frameworks becoming more similar, countries interested in encouraging investment flows are focusing on measures that facilitate business. These include investment promotion, investment incentives, after-investment services, improvements in amenities, and measures that reduce the "hassle" costs of doing business. While these

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<sup>29</sup> See Note 2.

<sup>30</sup> UNCTAD, *World Investment Report 1998*, Trends and Determinants, United Nations Publications, New York and Geneva.

measures are not new, they have proliferated as a means of competing for FDI as FDI policies converge towards greater openness (World Investment Report, 1998)<sup>31</sup>. Furthermore, business facilitation measures have become more sophisticated, increasingly targeting individual investors and investments in particular industries. Among these measures, after-investment services are noteworthy because they can encourage reinvestment by existing investors, who, if satisfied, provide publicity for the host country, sparking further investment. Financial or fiscal incentives are also used to attract investors even though they typically only enter location-decision processes when other principal economic determinants are in place.

The most important determinants for the location of FDI are economic considerations, which come into full play once an enabling FDI policy framework is in place. They may be divided into three groups corresponding to the main motives for investing abroad (See **Figure 2.1**): those related to the availability of location-bound resources or assets (resource/asset-seeking); those related to the size of markets for goods and services (market-seeking); and those related to cost advantages in production (efficiency-seeking) (World Investment Report 1998)<sup>32</sup>. Although many of the factors that attract investment to particular locations – such as abundant natural resources; large host country markets; or low-cost, flexible labour – remain important, their relative importance is changing as transnational corporations, within the context of a globalizing and liberalizing world economy, increasingly pursue new strategies to enhance their competitiveness (Mallampally and Sauvart, 1999)<sup>33</sup>.

National market size has been another important traditional determinant, leading to market-seeking investment. Large markets can accommodate more firms and allow each of them to reap the benefits of scale and scope economies – one of the principal reasons why regional integration frameworks can boost FDI. High market growth rates stimulate investment by both foreign and domestic investors. With regards to efficiency-seeking

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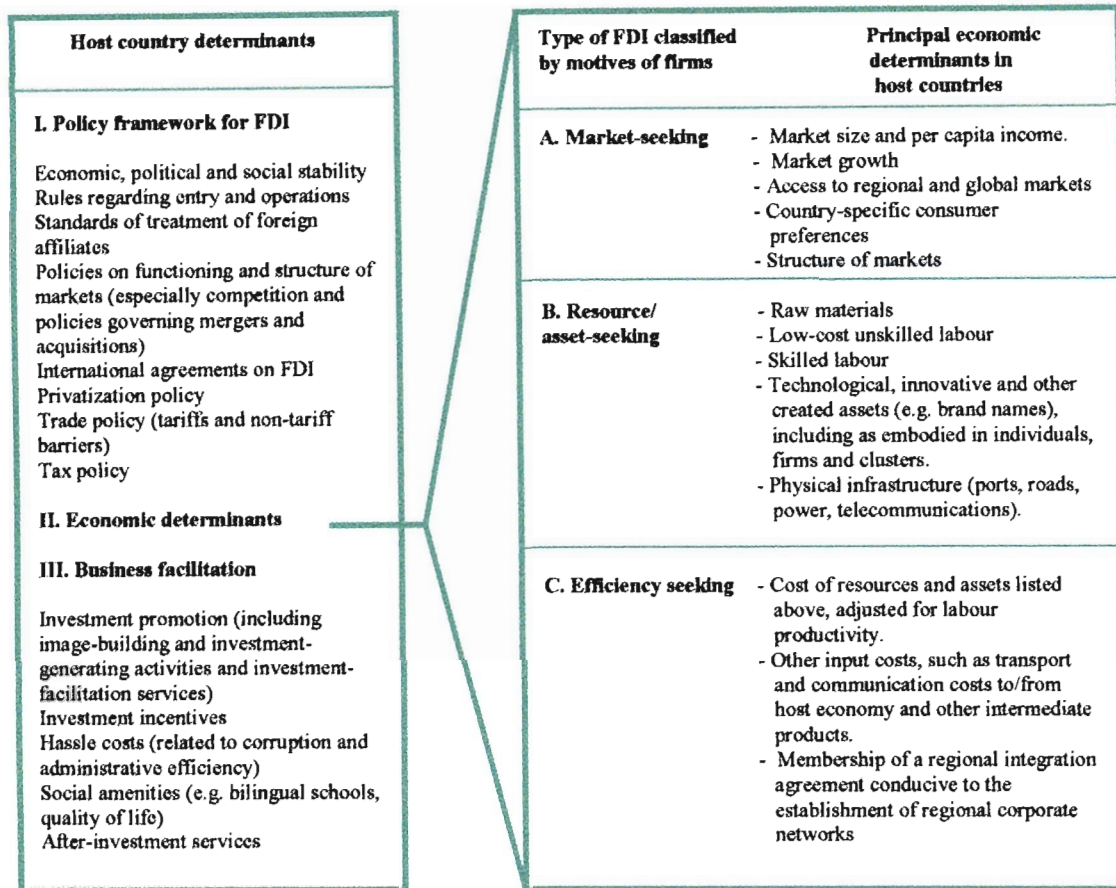
<sup>31</sup> *ibid.*

<sup>32</sup> See Note 30.

<sup>33</sup> See Note 2.



**Figure 2.1: Host Country Determinants of FDI**



Source: UNCTAD, *World Investment Report 1998: Trends and Determinants*, Table IV.1, p.91

The forces driving globalisation are also changing the ways in which TNCs pursue their objectives for investing abroad. Technology and innovation have become critical for competitiveness (World Investment Report 1999)<sup>35</sup>. Technology has always been important to economic well-being; but the current technological context makes it critical to development. This context, which some call a new “technological paradigm” (Freeman and Perez, 1988)<sup>36</sup>, is rapidly transforming all productive systems and facilitating globalization. Technological advances have enhanced firms’ ability to coordinate international production networks. More firms are developing portfolios of locational

<sup>35</sup> See Note 4.

<sup>36</sup> Freeman C. and Perez C., 1988, “Structural Crises of Adjustment, Business Cycles and Investment Behaviour”, in G. Dosi *et al.*, eds., *Technical Change and Economic Theory*, (London: Pinter).

assets – human resources, infrastructure, and market access – to complement their own strengths in order to improve their overall competitiveness. While traditional motives related to FDI have not disappeared, they are being incorporated into firms’ broader competitive-enhancing strategies (Mallampally and Sauvant, 1999)<sup>37</sup>. To attract such competitiveness-enhancing FDI, it is no longer sufficient to possess a single locational determinant. Transnational corporations seeking to invest, take for granted the presence of state-of-the-art FDI policy frameworks that provide them with the freedom to operate internationally, that are complemented by the relevant bilateral and international agreements, and that are further enhanced by a range of business facilitation measures. With regards to economic determinants, TNCs seek not only cost reductions and larger market shares, but also access to technology and innovative capacity (World Investment Report 1998)<sup>38</sup>. Evidence suggests that for FDI to have a more positive impact than domestic investment on productivity, the “technology gap” between domestic enterprises and foreign investors must be relatively limited. Where important differences prevail, or where the absolute technological level in the host country is low, local enterprises are unlikely to be able to absorb foreign technologies transferred via TNCs (OECD, 2002)<sup>39</sup>. The rising importance of such assets is probably the single most important shift that has occurred among the economic determinants of FDI in a liberalizing and globalizing world economy.

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<sup>37</sup> See Note 2.

<sup>38</sup> See Note 30.

## CHAPTER III

### INVESTMENT INCENTIVES

Today, most countries around the world are striving to create a favourable climate to attract foreign direct investment (FDI). Towards this end, they have taken steps to liberalize their foreign-direct-investment regimes by reducing distortions regarding FDI, adhering to certain standards of treatment for transnational corporations, and ensuring the proper functioning of the market.

In an open world economy, in which barriers to FDI are falling and an integrated international production system driven by TNCs is emerging, a country's incentive system enters the locational considerations of investors from abroad.

Efforts to influence the locational decisions of transnational corporations (TNCs) have led many governments to offer incentives to attract investment from other countries.

*Incentives are any measurable economic advantage afforded to specific enterprises or categories of enterprise by (or at the direction of) a government, in order to encourage them to behave in a certain manner.* (UNCTAD, 1996)<sup>40</sup>. They include measures specifically designed either to increase the rate of return of a particular FDI undertaking, or to reduce (or redistribute) its costs or risks.

FDI incentives, in the sense that they target or give preferential treatment to foreign investors, are by nature discriminatory (OECD, 2003)<sup>41</sup>. In practice, authorities often offer incentives that are available to any enterprise not previously located in their host economy. Moreover, specific approaches are sometimes applied to enterprises already located in the host economy to encourage expansion and to discourage them from moving away. While such practices may not necessarily meet the strict definition of FDI

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<sup>40</sup> UNCTAD, 1996, *Incentives and Foreign Direct Investment*, UNCTAD-DTCI/28, Current Series, Series A, No. 30, United Nations Publications, New York.

<sup>41</sup> OECD, 2003, CIMA, *Policies Toward Attracting Foreign Direct Investment*, OECD Publications, (<http://www.oecd.org/pdf/M00040000/M00040467.pdf>)

incentives, their effects are economically equivalent, and the policy challenges to which they give rise are in most cases the same.

### 3.1 A THEORETICAL ANALYSIS OF FOREIGN-DIRECT-INVESTMENT INCENTIVES

The rationale for incentives (first argued in welfare economics by Pigou, 1920) is to correct for the failure of markets to reflect the wider benefits arising from externalities in production. Positive externalities – or spillovers – can result from such factors as economies of scale, the creation of widely diffused new knowledge, or the upgrading of skills of workers. In addition, individual investments can lead to sequential investments by the same investor or associated investment by other TNCs (UNCTAD, 1996)<sup>42</sup>.

An ample body of economic literature stresses the importance of FDI in the context of positive externalities (spillovers) for the host economy i.e. through technology transfer, greater trade integration etc. The presence and magnitude of such spillovers is of crucial importance if FDI incentives are to be economically justified. If spillovers were thought to be negligible, host country authorities would, in the absence of financing constraints, be better advised to pursue generic investment promotion policies (Blomstrom, 2002)<sup>43</sup>.

The rationale for incentives can also be presented in the more dynamic context of growth and development, correcting for the failure of markets to reflect the gains that can accrue over time from declining unit costs and learning by doing. This is the classic infant industry argument for protection. As investment proceeds and unit costs decline with increased output, a country could acquire a comparative advantage in an expanding industry (UNCTAD, 1994)<sup>44</sup>.

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<sup>42</sup> See Note 40.

<sup>43</sup> Blomstrom M. ,2002, "The Economics of FDI Incentives", OECD 2002, *International Investment Perspectives*, Vol. 1, OECD Publications, France.

<sup>44</sup> UNCTAD, 1994, *Formulation and Implementation of Foreign Investment Policies: Selected Key Issues*, Current Studies, Series A, No. 10, United Nations Publications, New York.

FDI involves more than just the flow of capital: it typically entails the internal utilization of intangible assets e.g. technology, skills and managerial expertise, that are often specific to a given firm (World Investment Report, 1998)<sup>45</sup>. To the extent that these intangibles are completely internalized, the rate of return will fully capture the net benefits of an investment, and no incentives are required. However, to the extent that these intangible assets generate major beneficial effects for the rest of the host economy which are not internalised by the TNC, FDI need not take place at the socially optimal level. In such cases, FDI may generate sufficient positive externalities to justify incentives (UNCTAD, 1996)<sup>46</sup>.

Investment incentives involve gains as well as losses for the economies that grant them. Although intended to correct for market failures, they can introduce distortions in the production structure similar to those caused by restrictions on trade. For example, a report by the OECD Centre for Tax Policy and Administration<sup>47</sup> states that it is far from clear that “general” incentives such as corporate tax concessions can be used to address specific market imperfections. It has also been acknowledged that there is a risk of fuelling an environment where FDI flows primarily to countries with the “deepest pockets”, resulting in a situation where smaller countries are disadvantaged because of their inability to offset and absorb start-up losses from FDI (BIAC, 2002)<sup>48</sup>.

The quality of the enabling environment for investment – which affects a country’s ability to attract FDI, and benefit from it – is equally important to investors. Hence, rather than proposing narrowly defined FDI policies, attractive terms to investors should be seen as part of the country’s overall industrial policy and be available to on equal terms to all investors both foreign and domestic alike. Incentives should, following the same logic, focus on those activities that create the strongest potential for spillovers, including

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<sup>45</sup> See Note 30.

<sup>46</sup> See Note 40.

<sup>47</sup> OECD, 2001, “Corporate Tax Incentives for Foreign Direct Investment”, *OECD Tax Policy Studies*, No. 4, {<http://www.oecd.org/scripts/publications/bookshop/redirect.asp?pub=232001071P1>}

<sup>48</sup> BIAC, 2002, “Investment: BIAC Position on Incentives”, *In Response*, November 5<sup>th</sup>.

{<http://www.biac.org/Textes/BIAC TEXTES/BIAC SubmissionsPDF/MNEs/FIN BIAC Position on Incentives.pdf>}.



linkages between foreign-owned and domestic firms, education, training, and R&D (Blomstrom, 2001)<sup>49</sup>.

Another report emphasises the developmental impacts of FDI incentives policies<sup>50</sup>. The report draws the policy conclusion that it can be counterproductive and very costly for a government to offer investment incentives if the “fundamentals” of the potential investment sites fail to meet serious investors’ basic requirements. Moreover, while governments often formally justify FDI incentives with a need to steer corporate investment to poorer areas within the host country, in practice, incentives are of limited effectiveness in this regard.

Apart from the analytical difficulties involved in determining whether incentives are economically efficient, experience also suggests that the capacity to execute incentives measures effectively varies among countries, because of political pressures for incentives to be higher than warranted or because administrative capacities are not sufficient to implement and monitor incentives efficiently. Furthermore, it is imperative that incentives are offered on the basis of a thorough understanding of their effects, and not only to match incentives offered by other countries. FDI incentives should be: generally available; non-discriminatory; transparent; in proportion to the expected benefits; clearly causal or closely linked with the actual investment; non-trade distorting; oriented toward long-term investment; temporary; and rooted in a coherent business model (BIAC, 2002)<sup>51</sup>.

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<sup>49</sup> Blomstrom M., 2001, *The Economics of International Incentives*, Stockholm School of Economics, {<http://www.oecd.org/pdf/M00037000/M00037957.pdf>}

<sup>50</sup> Oman C., 2000, *Policy Competition and Foreign Direct Investment*, OECD Development Centre, Paris, {<http://www.oecd.org/scripts/publications/bookshop/redirect.asp?pub=412000031P1>}

<sup>51</sup> See Note 48.

### 3.2 EFFECTS OF INCENTIVES ON FOREIGN INVESTORS' DECISIONS

According to John Dunning (1988)<sup>52</sup>, the key factors that influence the decisions of TNCs fall under 3 broad categories: a) firm-specific (or ownership) advantages, which give a firm competitive advantages in global markets (these include, for example, technological assets, product differentiation, management skills, production efficiencies, size and concentration); b) internalisation advantages, which exist when the internalisation of cross-border transactions within a firm becomes a more efficient form of servicing markets than arm's length transactions; c) locational advantages, which occur when the local conditions of potential host countries make them more attractive sites for FDI operations than the home country, taking also into account how these conditions combine with the ownership and internalisation advantages of the firm. Locational determinants include natural factors (e.g. market characteristics, natural resource availability), political and economic stability, economic conditions (e.g. production costs, transport costs, exchange rates) and policy factors (such as trade barriers, openness to foreign ownership, fiscal regimes or investment incentives).

While incentives do not rank high among the many determinants cited by various theories, and empirical research on FDI motivations, the impact of FDI incentives on locational choices between countries can be perceptible at the margin. Survey data generally confirm the theoretical expectation that incentives play only a limited role, relative to other variables, in company decisions to locate FDI among different countries (Agarwal, 1980)<sup>53</sup>. For example, in an early survey of 205 companies involving investments in 67 countries, investors considered that the key non-policy determinant affecting their investment decisions was maintaining market share (or expanding into new markets) in the face of tariff or exchange barriers. Among the policy elements, non-discrimination and against foreign-controlled enterprises and commitment to economic development were considered to be influential factors; but political stability, a favourable government attitude towards private enterprise and economic and financial stability were

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<sup>52</sup> Dunning J.H., 1988, *Explaining International Production*, Unwin Hyman, London.

<sup>53</sup> Agarwal J.P., 1980, "Determinants of foreign direct investment: a survey", *Weltwirtschaftliches Archiv*, 116.

even more important factors. Thus, the conclusion from early surveys is that other policy and non-policy variables are more important determinants than incentives in the investment-location decisions of TNCs (Aharoni, 1966)<sup>54</sup>.

These conclusions have also been borne out by more recent surveys. For example, a 1984 survey of 52 TNCs found that, among 19 factors that were identified as influencing FDI flows, inducements offered by the host country ranked seventh in importance for investments in developing countries. In another survey of 30 TNCs covering 74 investment projects, many companies reported that incentives were frequently not even considered and simply made an already attractive country more attractive. Investment decisions were made mainly on the basis of economic and long-term strategic considerations concerning inputs, production costs and markets (UNCTAD, 1996)<sup>55</sup>.

Nevertheless, when the fundamental determinants are attractive enough for investment to be profitable and are more or less similar across alternative FDI locations, incentives appear to have an effect on investors' decisions. But even then, the evidence of the impact of regional incentives has been mixed, and factors such as access to regional markets, market growth, and wages have exerted greater influence than did incentives. This suggests that, as policy and non-policy conditions coverage, the role of incentives becomes more important at the margin, especially for projects that are cost-oriented and mobile.

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<sup>54</sup> Aharoni Y., 1966, *The Foreign Investment Decision Process*, Harvard Business School Press, Boston.

<sup>55</sup> See Note 40.



### 3.3 IMPACT OF SPECIFIC TYPES OF INCENTIVES

A report compiled by UNCTAD in 1996<sup>56</sup>, distinguishes between various investment incentives:

i) **Fiscal incentives:** affect after-tax profitability, the flow of funds and the cost of capital relative to labour, land and energy. Their overall objective is to reduce the tax burden for a foreign investor. **Table 3.1** lists the main types of fiscal incentives for FDI.

**Table 3.1: Main types of fiscal incentives for FDI**

Profit-based	Reduction of the standard corporate income-tax rate; tax holidays; allowing losses incurred during the holiday period to be written off against profits earned later (or earlier).
Capital investment-based	Accelerated depreciation; investment and reinvestment allowance.
Labour-based	Reductions in social security contributions; deductions from taxable earnings based on the number of employees or on other labour-related expenditure.
Sales-based	Corporate income-tax reductions based on total sales.
Value-added-based	Corporate income-tax reductions or credits based on the net local content of outputs; granting income-tax credits based on net value earned.
Based on other particular expenses	Corporate income-tax reductions based on, for example, expenditures relating to marketing and promotional activities.
Import-based	Exemption from import duties on capital goods, equipment or raw materials, parts and inputs related to the production process.
Export-based	a) Output-related, e.g. exemptions from export duties; preferential tax treatment of income from exports; income-tax reduction for special foreign-exchange-earning activities or for manufactured exports; tax credits on domestic sales in return for export performance. b) Input-related, e.g. duty drawbacks, tax credits for duties paid on imported materials or supplies; income-tax credits on net local content of exports; deduction of overseas expenditures and capital allowance for export industries.

Source: UNCTAD, Division on Transnational Corporations and Investment.

<sup>56</sup> See Note 40.

The various types of tax incentives in a host country can have a different effect on the overall corporate tax paid by a parent company, depending on the home country's tax laws and any tax treaties between the home and host countries. The purpose of double taxation agreements is to allow for taxes paid in the host country to be deducted from corporate income taxes at home. However, this does not necessarily prevent a home country from taxing the income that is exempted from tax in a host country. For this reason, certain types of double taxation agreements provide for tax sparing, whereby the home country gives credit to taxes that would have been paid in the host country if no tax exemption had been given. This device ensures that tax concessions given in a host country benefit foreign investors instead of resulting in a transfer of tax revenue from the host to the home country.

With respect to the effect of *fiscal incentives* on FDI flows in developing countries, an early study (Ahmad, 1973)<sup>57</sup> of 41 developing countries found that the typical tax burden on the manufacturing sector was one of six variables that were significant determinants of FDI per capita. Similarly, a subsequent study found that FDI by United States TNCs in both 1977 and 1982 was positively related to the inverse of the effective tax rate in the host country (UNCTAD, 1996)<sup>58</sup>. In principal, incentives can send a signal that a country has a favourable investment climate.

**ii) Financial incentives:** These incentives involve the provision of funds directly to firms to finance new foreign investments or certain operations, or to defray capital or operation costs. The most common types include government grants, subsidized credit, government equity participation and insurance at preferential rates (See **Table 3.2** below).

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<sup>57</sup> Ahmad K., 1973, "Incentive taxation for economic and social development", *Pakistan Economic and Social Review*, 11.

<sup>58</sup> See Note 40.

**Table 3.2: Main types of financial incentives for FDI**

Government grants	A variety of measures (also loosely referred to as “direct subsidies”) to cover (part of) capital, production or marketing costs in relation to an investment project.
Government credit at subsidized rates	Subsidized loans; loan guarantees; guaranteed export credits
Government equity participation	Publicly funded venture capital participating in investments involving high commercial risks.
Government insurance at preferential rates	Usually available to cover certain types of risks such as exchange-rate volatility, currency devaluation, or non-commercial risks such as expropriation and political turmoil.

Source: UNCTAD, Division on Transnational Corporations and Investment.

Surveys of foreign investors that have evaluated the differential importance of *financial incentives* relative to other incentives have found mixed results. One study found that financial incentives ranked in importance at about the same level as fiscal incentives. However, another study, found that financial incentives were rated at, or near, the bottom in importance among the firms in the sample (UNCTAD, 1996)<sup>59</sup>.

**iii) Other incentives:** Some types of incentives elude easy classification, their common denominator being that they are designed to increase the profitability of a foreign affiliate by non-financial means. Examples include subsidized dedicated infrastructure; certain subsidized services; market preferences; and preferential treatment on foreign exchange (See **Table 3.3** below).

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<sup>59</sup> See Note 40.

**Table 3.3: Main types of other incentives for FDI**

Subsidized dedicated infrastructure	Include provision, at less-than commercial prices, of land, buildings, industrial plants, or specific infrastructure such as telecommunications, transportation, water supply and electricity.
Subsidized services	Services offered may include assistance in identifying finance; implementing and managing projects; carrying out pre-investment studies; information on markets, availability of raw materials and supply of infrastructure; advice on production processes and marketing techniques; assistance in training and retraining; technical facilities for developing know-how or improving quality control.
Market preferences	Preferential government contracts; closing the market for further entry; protection from import competition; granting of monopoly rights.
Preferential treatment on foreign exchange	Special exchange rates; special foreign debt-to-equity conversion rates; elimination of exchange risks on foreign loans; concessions of foreign exchange credits for export earnings; special concessions on the repatriation of earnings and capital.

Source: UNCTAD, Division on Transnational Corporations and Investment.

With respect to *non-financial incentives*, the level of infrastructure development has found to influence FDI inflows (Ahmad, 1973)<sup>60</sup>. Another major motivation for FDI found in the past in many TNCs has been to protect and enhance their market share in a host country in the face of tariff and non-tariff barriers to trade, i.e. “tariff-hopping” FDI.

When properly managed, export incentives have proven to be very effective in attracting FDI, particularly to low-wage countries in labour-intensive industries. During the 1970s, the Republic of Korea set up a successful system of incentives that allowed exporters to

access imported and domestically produced inputs, domestic credit and foreign exchange at world prices. Export Processing Zones (EPZs) have been another way to remove anti-export biases from host economies (UNCTAD, 1996)<sup>61</sup>.

<sup>60</sup> See Note 57.

<sup>61</sup> See Note 40.

### 3.4 INVESTMENT INCENTIVES: A REVIEW OF THE EVIDENCE

The effects of the many incentives offered by host governments on FDI location choices between countries have proven to be difficult to unravel, despite decades of research. Given all the factors that can impinge on TNC decisions, it is difficult at best to isolate the effects of just one factor, such as incentives, on FDI location and characteristics. The impact of these factors on investment decisions can also differ among TNCs depending on their strategy and motivation for the investment, size, experience, whether the investment is a new one or an expansion, and a TNC's country of origin. Nevertheless, there is overwhelming evidence to suggest that incentives are a relatively minor factor in the locational decisions of TNCs relative to other locational advantages such as market size and growth, production costs, skill levels, political and economic stability, and the regulatory framework. However, once a decision has been made to undertake FDI in a given region or country, incentives may have an impact on influencing the precise choice of location within the region or country. If one country offers incentives and another does not, then, all other things being equal, foreign investors could be influenced in their locational choices between countries, tilting the balance in favour of the incentive provider (World Investment Report, 1999)<sup>62</sup>.

A report by UNCTAD in 1996<sup>63</sup> suggests that, to be effective, the design of incentive programs aimed at attracting FDI with specific characteristics not only involves careful targeting of those elements that are desirable, but, in addition, policy coordination at various levels of government is necessary to ensure that the incentives do not cause undesirable side effects. There is often a conflict between the goals that governments want to achieve, the incentives systems through which these goals can be achieved, and the capacity of the institutions charged with implementing the incentives systems

For policy makers, two important dimensions need to be considered. First, it matters greatly whether incentive schemes are being operated by national or sub-national jurisdictions. Second, the policy goal that is being pursued through the FDI incentives

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<sup>62</sup> See Note 4.

<sup>63</sup> See Note 40.

differs greatly among host locations, not least according to their state of economic development, which may have important implications for an assessment of the value of incentives (OECD, 2003)<sup>64</sup>.

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<sup>64</sup> See Note 41.

## CHAPTER IV

### TRENDS IN FOREIGN DIRECT INVESTMENT

#### 4.1 FOREIGN DIRECT INVESTMENT IN DEVELOPING COUNTRIES

The private capital-flow problem of developing countries in general has been starkly described as one in which “there is either too much capital or too little, and it is mostly hot rather than cold” (Feldstein, 1995)<sup>65</sup>. Although there is some evidence of increasing instability in short-term capital flows in the less developed countries (LDCs) in the 1990s, the LDCs have not experienced the kind of hot surges and sudden withdrawals of external finance that have characterised emerging markets in Latin America and East Asia during this period (Least Developed Countries Report, 2000)<sup>66</sup>. Instead, for almost all developing countries, the private capital-flow problem is that the international community of investors and lenders, which includes a small stratum of residents of the LDCs themselves as well as non-residents, places very little of its funds in these countries.

The size, composition, and geographical distribution of external capital flows to developing countries have undergone fundamental shifts during the past three decades. Developing countries, emerging economies and countries in transition have come increasingly to see FDI as a source of economic development, modernisation, income growth and employment.

Until the 1970s the most important sources of external financing for developing countries were official loans and aid, the provision of which was based on the recognition that developing countries suffered from resource gaps resulting from their low levels of income and savings and that their ability to fill these gaps through commercial borrowing

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<sup>65</sup> Feldstein M., 1995, “Global Capital Flows: Too Little, Not Too Much”, *The Economist*, June 24.

<sup>66</sup> UNCTAD, *Least Developed Countries Report 2000*, United Nations Publications, New York and Geneva.



was severely limited (Trade and Development Report, 1999)<sup>67</sup>. Official development assistance (ODA) continued to expand rapidly in the 1970s. However, the expansion came to an end with the debt crisis of the 1980s, when total net capital inflows of developing countries fell sharply due to a cutback in commercial bank lending. Official financing also stagnated, while its terms and conditions became more stringent, reflecting the policy of the major creditor countries and the multilateral financial institutions of emphasizing private financing for development.

As **Figure 4.1** indicates, the 1990s witnessed a rapid expansion of private capital inflows, while official financing declined. The surge in private inflows was greatly influenced by widespread and rapid trade liberalization in developing countries. An important proportion of private inflows have taken the form of so-called non-debt creating inflows, notably FDI. A SADC report on Investment and Growth Related Issues (2001)<sup>68</sup> stated that FDI represents a major source of capital in developing countries. With the decline in official financing and the instability of private financial flows, FDI is increasingly seen as a solution to the problem of resource gap and external financing (Trade and Development Report, 1999)<sup>69</sup>.

FDI inflows represent significant sums for many developing nations, several of them recording levels of FDI, relative to the size of the domestic economy, that overshadow of the world's developed countries (See **Figure 4.2**). Moreover, the flow of FDI to developing countries worldwide currently exceeds official development assistance by a wide margin, further highlighting the need to address the use of FDI as a tool for economic development<sup>70</sup>.

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<sup>67</sup> UNCTAD, *Trade and Development Report 1999*, United Nations Publications, New York.

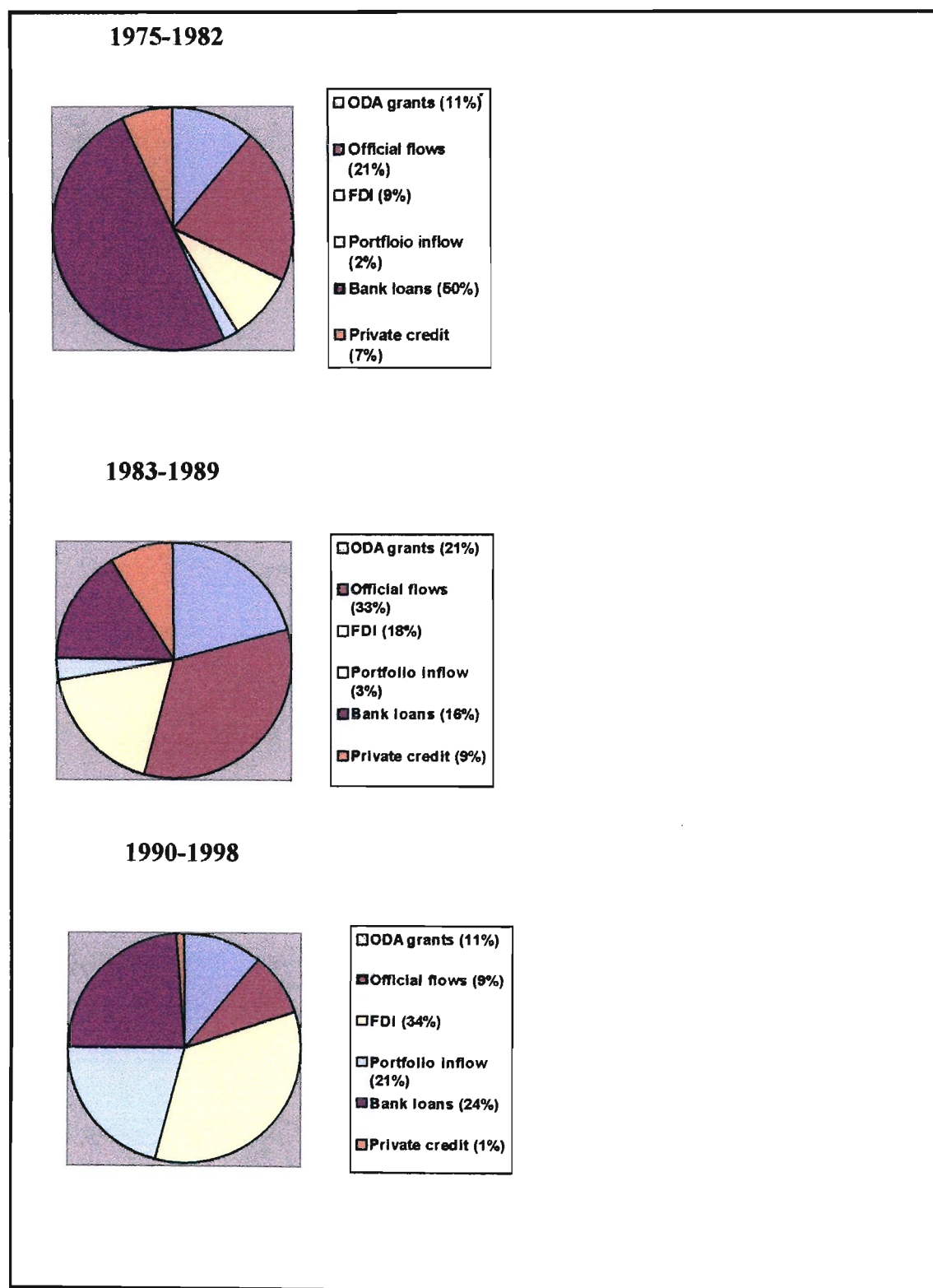
<sup>68</sup> The Association of SADC Chambers of Commerce & Industry, *White Paper on Economic Policy Issues in the SADC Region*, August 2001.

<sup>69</sup> See Note 67.

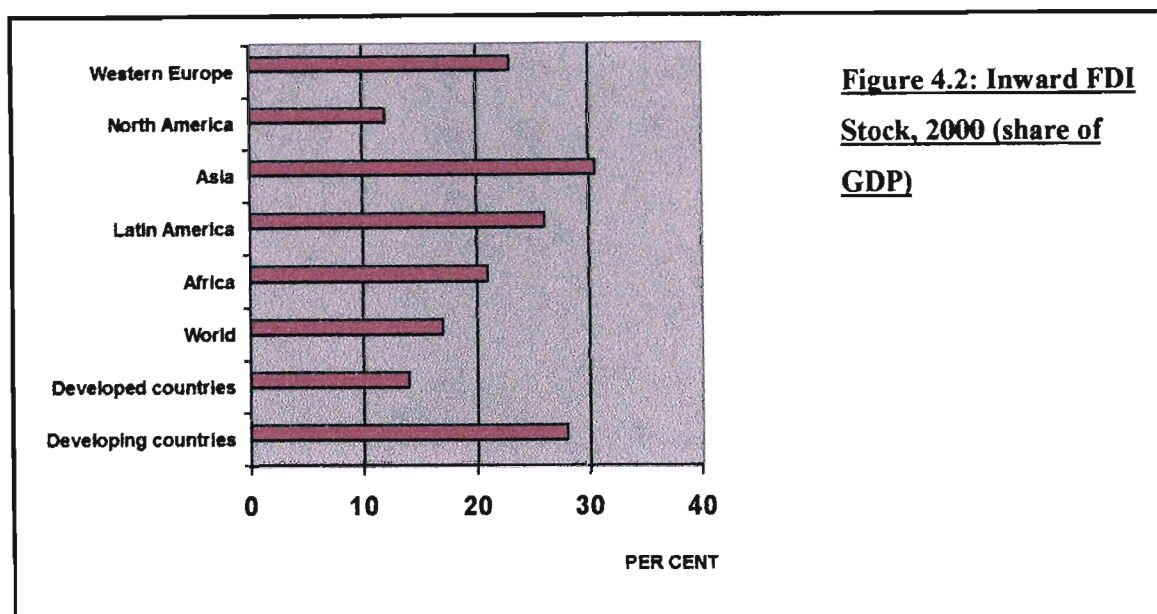
<sup>70</sup> See Note 11.



**Figure 4.1: Developing Countries: Net Capital Inflow by Type of Flow, 1975-1998**



Source: World Bank, *Global Development Finance*, 1999.



**Figure 4.2: Inward FDI Stock, 2000 (share of GDP)**

Source: OECD, *Foreign Direct Investment for Development*, 2002.

Developing countries' FDI policies in the past two decades have been characterized by a trend towards unilateral liberalization, with a view towards creating more favourable conditions for FDI. According to the Commission on Investment, Technology and Related Financial Issues (UNCTAD), many countries are engaging in fierce competition to attract FDI, especially, since, after a decade of steady and strong growth, FDI flows dropped sharply in 2001, in the wake of the world economic slowdown. These countries have used various policies and measures to attract and increase the benefits from FDI. In the past, restrictions on foreign investment, free enterprise and profit remittance certainly reduced private capital flows to developing countries. However, the importance of government restrictions as a constraint on private capital flows to developing economies has been diminishing as many of these countries have begun to undertake extensive economic reform programmes (Least Developed Countries Report, 2000)<sup>71</sup>. The network of bilateral investment treaties (BITs) has expanded along with double taxation treaties. The common thread that runs through the proliferation of both types of treaties is that they reflect the growing role of FDI in the world economy, and the desire of countries to facilitate it (World Investment Report, 1998)<sup>72</sup>.

<sup>71</sup> See Note 66.

Governments have gradually made entry and establishment easier by reducing sectoral restrictions on FDI, either by expanding the positive list of industries in which FDI is permitted or by reducing the negative list of industries closed to FDI, notably in services industries and (increasingly) in infrastructure. Privatization programmes are often open to foreign investors; and foreign equity participation restrictions and compulsory joint ventures, once a common policy tool in developing countries, have been removed in most industries. Control restrictions are less common than in the past, although they continue to be used particularly in large investments, in activities of strategic importance for the local economy, or in cases of privatisation of public enterprises. Minimum amounts of equity investment requirements have also been reduced or abolished, thus removing an obstacle to FDI inflows from SMEs. Screening and authorization requirements tend to be replaced by simple registration on the basis of minimum and generally-applicable requirements. Some types of operational restrictions, such as restrictions on the entry of professional and managerial personnel, are being relaxed in some countries, subject to emigration law requirements. Outright performance requirements are less prevalent than in the past. There is also a relaxation of foreign exchange controls, although countries reserve the right to impose temporal exchange control restrictions in the event of balance-of-payments crises.

The reduction of obstacles to FDI inflows is being complemented, at the national level, by the strengthening of standards of treatment of foreign affiliates. In particular, most countries today provide guarantees of legal protection, national treatment, fair and equitable treatment and most-favoured-nation (MFN) treatment, along with the free transfer of profits and repatriation of capital and dispute settlement. Furthermore, to ensure the proper functioning of markets, a growing number of countries have adopted competition laws (World Investment Report, 1999)<sup>73</sup>.

During this liberalization trend, many host countries have adopted FDI-specific laws in one form or another, spelling out the main features of their FDI regimes. These laws have

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<sup>73</sup> See Note 4.

been superseded or amended over the years, and new laws have been adopted to reflect various policy changes.

Targeted measures to harness the benefits of FDI for integrating host economies more closely into international trade flows, notably by establishing export processing zones (EPZs), have attracted increasing attention. Since the 1970s, a growing tendency to set up EPZs can be observed in developing countries and territories. In Africa, the increasing popularity in recent years of EPZs has been encouraged in part by the success of such zones in Mauritius and other developing countries. The aim of these EPZs is to attract, in particular, manufacturing industries which are considered to be the dynamic force behind GDP growth and rapid export expansion (UNCTAD, 1992)<sup>74</sup>. At the broadest level, EPZs are created by developing countries for the purpose of promoting the development of export-oriented manufacturing industries. Foreign investment is expected to provide the main impetus (UNCTAD, 1985)<sup>75</sup>. EPZs rely primarily on private sector initiatives supported by appropriate institutions and incentives. A survey conducted by the United Nations Economic Commission for Africa in 1996<sup>76</sup> states that through the establishment of EPZs, governments aim to create a free market environment, provide a number of concessions, a flexible regulatory framework, and minimum bureaucratic obligations. The expectation is that these measures will attract investors to take advantage of the opportunities offered within the zones, thereby contributing to industrial growth, employment, and foreign exchange earnings.

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<sup>74</sup> UNCTAD, 1992, *Export Processing Zones and sub-Saharan Africa*, UNCTAD Bulletin, No.15, July/August, United Nations Publications, New York.

<sup>75</sup> UNCTAD, 1985, *EPZs in Developing Countries: Implications for Trade and Industrialization Policies*, UN Publications, New York

<sup>76</sup> UN Economic Commission for Africa, 1996, *Economic and Social Survey of Africa*, UN Publications, New York and Geneva,

## 4.2 FOREIGN DIRECT INVESTMENT IN AFRICA

The World Bank, in its 1999 Report on Development in Sub-Saharan Africa<sup>77</sup> stated:

*“Sub-Saharan Africa will be the most important development challenge of the 21<sup>st</sup> century...5 years of steady growth in Africa have fostered economic revival in several countries, after decades of stagnation. In 1998, economic growth was less strong – at around 3.6%, compared to 4.6% in 1997 and 4.9% in 1996.*

*But 13 countries (out of a total of 48) had a GDP growth rate of 5% or more, and at least 29 countries had positive GDP growth i.e. national income grew faster than population”.*

The recovery was partly driven by the significant progress towards greater macroeconomic stability, and by improved resource allocation due largely to the implementation of macroeconomic policies in most countries of the region. Although real output growth barely kept pace with the population increase in 1998, the positive trend in per capita income since the mid-1990s was sustained. Most African countries have experienced positive per capita growth of 1-2% a year, and more than half have recorded per capita income growth above 2.5%<sup>78</sup>.

Three conditions identified by the World Bank as necessary for economic growth in Sub-Saharan Africa, are regarded as being achievable: a minimal degree of social stability; a minimal degree of macroeconomic stability; and a minimal degree of allocative efficiency. Presently, about 60% of Sub-Saharan African countries have met two or all three conditions for growth and, considering other factors, conducive for foreign investment.

According to the World Investment Report 1999<sup>79</sup>, Africa benefited from a rise in inward FDI since the early 1990s, but growth in FDI flows to the region was much less than that

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<sup>77</sup> Wali M.A., 2000, Africa: Viability and Challenges – Democratization and Investment Climate in Sub-Saharan Africa, World Bank Policy Research Working Paper, World Bank, Washington DC.

<sup>78</sup> *ibid.*

<sup>79</sup> See Note 4.



in FDI flows to other developing countries, leaving much of Africa's potential for FDI underutilized. As shown in **Figure 4.3**, Africa has much to offer, in terms of its general attractiveness as a location for FDI.

**Figure 4.3: Africa: Determinants for the Location of Foreign Direct Investment**

**Size of the Local Markets**

With a population of over 600 million, coupled with economic growth, the region provides immense opportunities for investment. Apart from the needs of the local markets, the region has access to developed countries for non-traditional, labour-intensive goods. The Lomé Convention, a recent initiative by the US as reflected in the Africa Growth and Opportunity Act (AGOA), is intended to confer duty-free status on textile and apparel products exported from designated African countries, including Botswana, Cameroon, Ghana, Zambia and Malawi. This Act is undoubtedly the most revolutionary in the US's trade relation with African countries and provides seemingly unlimited potential for companies operating in these countries to export goods to the US, thereby enhancing economic growth of such countries. Liberalised access to developed countries' markets can also lead to additional FDI.

**Low Cost of Doing Business**

Africa's main advantages are in operating costs, driven by low labour costs brought about by the comparatively low standard of living in most African countries. In addition, several export processing zones (EPZs) have been established which lowers the costs of doing business.

**High Returns on Investment**

The profitability of investments is of prime importance to foreign investors. From the viewpoint of some foreign companies, investment in Africa seems to be highly profitable, and more profitable than in most other regions. Since 1990, the rate of return in Africa has averaged 29%; since 1991, it has been higher than in any other region, including developed countries as a group, in many years by a factor of two or more.

**Membership in Multilateral Agreements**

The majority of African countries have signed multilateral agreements dealing with the protection of FDI. These include the Convention establishing The Multilateral Investment Guarantee Agency (MIGA), and The Convention on the Settlement of Investment Disputes between States and National of Other States.



A survey undertaken by UNCTAD in 1999<sup>80</sup>, indicated that despite the reforms that have taken place and the progress expected in a number of African countries in terms of improving the business environment, further work is needed to change the image of Africa and to develop among foreign investors a more differentiated view of the continent and its opportunities.

A report by the Centre for Research into Economics and Finance in Southern Africa (1998)<sup>81</sup> pointed out that there has been a marked increase in total FDI, but developing countries have been taking a significantly larger proportion. However, according to the report, even after the sharp rise in 1995 when the region attracted FDI of US\$ 1,708 million, SADC inflows accounted for less than 2% of FDI flows to developing countries.

While Africa trails other developing regions in attracting FDI, a few countries such as Ghana, Mozambique and Uganda, stand out in terms of relative FDI inflows and growth, not only in comparison to other African countries but also to developing countries as a whole (World Investment Report, 1998)<sup>82</sup>. While natural resources are an important determinant for FDI flows to most of these countries, they are by no means the only explanation for their relative success in attracting FDI. What all these “frontrunner” countries have in common is significant progress in improving their regulatory FDI frameworks as well as significant progress in strengthening political and macroeconomic stability. Most of them have stepped up efforts to create an FDI-friendly business climate, particularly through investment-promotion activities (World Investment Report, 1998)<sup>83</sup>.

An Economic and Social Survey of Africa (1996)<sup>84</sup> reported that as the growing number of countries pursuing reform programmes show signs of sound recovery and profitability, and as economic liberalization improves prospects for private investment, there is increasing expectations that foreign investors will be attracted to Africa in larger

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<sup>80</sup> See Note 4.

<sup>81</sup> Centre for Research into Economics & Finance in South Africa, 1998, *The Complimentary Policies to Underpin the SADC Free Trade Area*, London School of Economics.

<sup>82</sup> See Note 30.

<sup>83</sup> See Note 30.

<sup>84</sup> See Note 76.

numbers. Studies on FDI in Africa conducted by UNCTAD in 1995<sup>85</sup> showed that the rate of return on overseas direct investment is higher in Africa than in any other region of the world, and that the continent's investment potential remains largely untapped. The impressive track record of return on FDI in Africa belies the "miserable" image or pessimistic view that the average foreign investor generally has of Africa.

The results of a survey conducted by UNCTAD for the World Investment Report (1999)<sup>86</sup> of 44 African investment promotion agencies (IPAs), found that prospects for increased FDI inflows into Africa have improved. Of the 31 agencies that responded, the vast majority indicated that FDI prospects for the period 2000-2003 were expected to "improve" or be "significantly improved". Many of the respondents also considered that "many African countries" are a better place to do business than the overall negative image of Africa would suggest (See **Annex 1a** and **1b**).

#### **4.2.1 Constraints on Foreign Direct Investment to Africa**

The main factors motivating FDI into Africa in recent decades appear to have been the availability of natural resources in the host countries (e.g. investment in the oil industries in Nigeria and Angola) and, to a lesser extent, the size of the domestic economy (OECD, 2002)<sup>87</sup>. The reasons for the lacklustre FDI into most other African countries are most likely the same factors that have contributed to a generally low rate of private investment to GDP across the continent. Studies have attributed this to the fact that, while gross returns on investment can be very high in Africa, the effect is more than counterbalanced by high taxes and a significant risk of capital losses. As for the risk factors, analysts now agree that three of them may be particularly pertinent: macroeconomic instability; loss of assets due to non-enforceability of contracts; and physical destruction caused by armed conflicts (Hernandez-Cata, 2000)<sup>88</sup>.

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<sup>85</sup> See Note 76.

<sup>86</sup> See Note 4.

<sup>87</sup> See Note 11.

<sup>88</sup> Hernandez-Cata E., 2000, *Raising Growth and Investment in Sub-Saharan Africa: What Can Be Done?*, IMF Policy Discussion Paper, PDP/00/4.

A report by the Centre for Research into Economics and Finance in Southern Africa (1998)<sup>89</sup> identified unstable political and macroeconomic environments in some SADC countries as being the most significant factors in the constraints on FDI to the region. The report stipulates that uncertainty about the future economic environment causes investors to postpone investment decisions, as the irreversible nature of direct investment makes an error extremely costly. This factor was identified by the World Economic Forum in the Africa Competitiveness Report (2000) as the single most damaging problem in attracting investment to Africa. The report found that even stable SADC countries suffer from some contagion effect, so that instability in one country affects all, albeit to a lesser extent. Investors from within the region can accept a greater degree of instability, both because they are more accustomed to it, and because they know that their future rests within the region. However, for extra-regional investors, these problems are much more profound.

Discussions held by the Association of SADC Chambers of Commerce and Industry (ASCCI) in 1998<sup>90</sup>, highlighted the serious and dramatic impediment that insecurity of investment can represent for the region's competitiveness to attract FDI and investment in general. A major concern was the more recent incidents in Zimbabwe and the civil unrest in some other countries, which only reinforced the negative perception of the region in terms of insecurity of investment. The Member Chambers of ASCCI highlighted the need to establish and secure a stable and predictable political and macroeconomic environment in the entire region, in an effort to attract both national and non-national sources of investment.

Several other factors holding back FDI have been proposed in recent studies, notably the perceived sustainability of national economic policies, poor quality of public services, and closed trade regimes (Dollar and Easterly, 1998)<sup>91</sup>. Even where the obstacles to FDI do not seem insurmountable, investors may have powerful incentives to adopt a wait-and-see attitude. FDI contains an important irreversible element, so where investors' risk

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<sup>89</sup> See Note 81.

<sup>90</sup> See Note 68.

<sup>91</sup> Dollar D. and Easterly W., 1998, *The Search for the Key: Aid, Investment and Policies in Africa*, World Bank Working Paper, Washington DC.

perception is heightened the inducement would have to be massive to make them undertake FDI as opposed to deferring their decision (Servan, 1996)<sup>92</sup>. This problem is compounded where a deficit of democracy, or of other kinds of political legitimacy, makes the system of government prone to changes. Finally, a lack of effective regional trade integration efforts has been singled out as a factor (Odenthal, 2001)<sup>93</sup>.

Removing restrictions on foreign investors may be a necessary condition for attracting private capital flows, but it is not a sufficient condition. The Least Developed Countries Report (2000)<sup>94</sup> highlights the reason why economic liberalization does not automatically lead to much larger private capital inflows. As more and more developing countries remove restrictions on private capital, the choices available to foreign firms regarding where to invest and locate each of their activities, increase, and basic economic factors become more important. Economic reforms can certainly act as a device signalling that the government is establishing a business-friendly environment. However, the empirical finding in Africa is that though (foreign) investors see the existence of a programme with the IMF or World Bank as a sign of stability and intent to reform, they do not rank this as an important factor in investment decisions.

In this regard, the reform programmes can even have contrary results. For example, the incentive for some of the earlier FDI inflows into LDCs was based on the existence of protected markets, and thus trade liberalization has in some cases prompted a process of disinvestments (Least Developed Countries Report, 2000)<sup>95</sup>. Devaluation has also sometimes acted as a disincentive for foreign investment, for even though projects might be highly profitable in local currency terms, foreign exchange profits have considerably diminished. Another crucial area that business people have identified is the availability and quality of infrastructure services, which have often declined with reduction in public expenditure (UNCTAD, 1999)<sup>96</sup>.

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<sup>92</sup> Servan L., 1996, *Irreversibility, Uncertainty and Private Investment: Analytical Issues and Some Lessons for Africa*, World Bank Working Paper, Washington DC.

<sup>93</sup> Odenthal N., 2001, *FDI in Sub-Saharan Africa*, Technical Paper No. 173, OECD Development Centre.

<sup>94</sup> See Note 66.

<sup>95</sup> See Note 66.

<sup>96</sup> See Note 4.

As developing countries reform their legal and regulatory framework governing FDI, as well as the tax regime and trade policy, emphasis is now being placed on other aspects of the national policy environment which might be regarded as constraining capital flows. The Least Developed Countries Report 2000<sup>97</sup> identifies the main areas of concern. These include:

*i) A lack of readily marketable assets or products to buy or sell.* Potentially interesting assets can and do exist, but an investment principle is deterred by the costs and related risks required to give them marketable status (Least Developed Countries Report, 1996)<sup>98</sup>.

*ii) Weak financial systems.* The weakness of the financial system has important negative effects on private capital flows since foreign investors use the financial system as a source of current information on macroeconomic conditions and company performance. Insofar as local banks cannot provide this information effectively, foreign investors stay away from a country. The World Bank's Foreign Investment Advisory Service (FIAS) has also found that the availability of domestic financing is a key factor in attracting FDI.

*iii) The profitability and risks of individual projects depend on investments in other projects.* A critical problem for all activities is the high cost and general lack of efficient business services that are essential for competitive pricing and quality standards.

*iv) There is underinvestment in all kinds of goods which are necessary for a thriving private sector.* Inadequate physical infrastructure, particularly in transport, communications and information technology, is a central problem which has adverse effects on international competitiveness. Other difficulties experienced in LDCs include, crime, disease and inadequate health care, and low skilled labour forces.

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<sup>97</sup> See Note 66.

<sup>98</sup> UNCTAD, *Least Developed Countries Report 1996*, United Nations Publications, New York and Geneva.



## CHAPTER V

# THE ECONOMY OF MALAWI

### 5.1 BACKGROUND TO THE COUNTRY

Malawi is a landlocked country that lies in the eastern part of South Central Africa. The country is dominated by Lake Malawi, which runs virtually the entire length of the eastern part of the country. The Malawi economy is largely agro-based with the agriculture sector accounting for over 38.6% of GDP in 2001/2, contributes for over 82.5% of the country's foreign exchange earnings, and supports 90% of the population (World Bank figures, 2000). The sector is characterised by a dual structure consisting of commercial estates and a large smallholder sub-sector, which is mainly engaged in mixed subsistence and cash crop agriculture. Malawi is an exporter of primary produce and net importer of industrial goods. Its major exports include tobacco, tea, cotton, coffee and sugar, while its chief imports are intermediate (chemical and allied) goods for industry.

Malawi is grouped amongst the least developed countries in the world. The Human Development Index (1999) ranked Malawi at 161 out of 174 countries. In terms of national income, the country was amongst the world's 10 poorest nations at US\$200 per capita. Malawi is also one of the most highly indebted countries in Africa. Since 1992, the outstanding debt for the country accelerated from 93.2% of GDP, to 155.1% in 1998. Malawi's competitive position is the lowest among SADC countries (Refer to **Annex 2**). Similarly, both the improvement and optimism indices and the opportunity to trade index also put Malawi among the least-favoured countries in the region.

Malawi became an independent nation in 1964 after 73 years of British rule. Hastings Kamuzu Banda, was elected President for life in 1971, and instituted authoritarian one-party rule.



Up until 1979, Malawi's economy prospered, with an average annual GDP growth rate of 6%, which was largely driven by tobacco and tea exports. Malawi adopted an export-oriented growth strategy following independence, based on agriculture and agro-based manufacturing, using foreign capital and managerial skills. The economy was directed at supporting private and parastatal projects in the productive agricultural sector through the provision of essential infrastructure, utilities, and supporting services. After a period of impressive and constant growth up to 1979, the economy faltered and stagnated as Malawi began to face severe balance-of-payment problems. This was due to a combination of structural weaknesses, adverse external factors, and drought, resulting in a recession that lasted from 1979 to 1982. This called for the need to undergo structural reforms, which were pursued with the assistance of the World Bank and IMF. It was envisaged that reforms would remove structural and institutional imperfections and, in consequence, encourage private investment in the country.

In general, though, 30 years of authoritarian rule did not spur significant and broad-based economic development. Banda's control lasted until 1994, when he was defeated by Mr. Bakili Muluzi in the first multi-party elections held in Malawi. The new government, which initiated an economic reform agenda, faced challenges on several fronts, among them, slow growth (real GDP between 1991 and 2000 averaged 2.9% per annum), severe poverty, a high HIV/AIDS infection rate (about 14.9% in 2000), limited natural resources, high levels of inequality resulting from years of an elitist development strategy, heavy dependence on donor assistance, and investor uncertainty surrounding Malawi's political developments.

The Government of Malawi followed sound economic policies from 1995 to 1997, but in more recent years, the pace of reforms has decelerated, expenditure control has weakened, and agricultural prospects have become more mixed.

## 5.2 MALAWI'S MACROECONOMIC PERFORMANCE

### 5.2.1 Growth Rates and Inflation

The overall economic performance of the Malawian economy during the period 1990-2002 has been mixed due to external shocks and poor domestic policy management. After improving from an average rate of 1.9% in 1980-89 to 4.1% in 1990-99, real GDP growth contracted by 4.1% in 2001. Provisional estimates from the National Statistics Office (NSO) for 2002, suggest that the economy may have been stagnant in 2002, but even this would lead to a contraction in GDP per capita of approximately 2.2%. The high real interest rates, which have made borrowing prohibitively expensive, have been the most significant factor in the slowdown in business activity, compounded in 2002 by the maize shortages, which affected real disposable incomes.

**Table 5.1: National Income and Prices Annual Percentage Changes (1980-2002)**

	1980-1989	1990-1999	2000	2001	2002*
	%	%	%	%	%
Real GDP	1.9	4.1	0.8	-4.1	0.1
Real per capita GDP	-1.8	0.8	-1.6	-6.3	-2.2
Period average consumer price index	17.0	30.5	29.6	27.2	14.7

Source: Ministry of Finance and Reserve Bank of Malawi

\* Rate of natural increase was 2.4% for 2000-2002

The rate of inflation as measured by the consumer price index, accelerated from an average 30.5% in 1990-99, and peaked at 56.6% in March 1999. Since then, inflation has been brought down to a year on year rate of under 11% in January 2003, which suggests that single figure inflation is achievable in the near future.

### 5.2.2 Government Revenues, Expenditures and Budget Deficits

Government revenues and expenditures have fallen as a proportion of GDP according to the Ministry of Finance and the Reserve Bank of Malawi. The fall in revenues as a percentage of GDP seems unlikely given the increase in revenue collection reported in

2002. The figures are therefore subject to revision. The budget deficit (including grants) as a ratio of GDP, worsened to 7.4% in 2001 from an average of 6.2% in 1990-99.

**Table 5.2: Central Government Revenue, Expenditure & Deficit as a Proportion of GDP**

	1980-89	1990-99	2000	2001	2002*
	%	%	%	%	%
Revenue	20.6	17.2	18.7	14.9	14.6
Total expenditure	32.5	28.5	32.8	28.5	23.1
Current expenditure	22.0	21.4	22.6	21.3	19.4
Capital expenditure	9.7	7.1	10.3	7.2	3.7
Overall deficit excluding grants	-9.6	-11.3	-14.1	-13.5	-8.5
Overall deficit including grants	-6.3	-6.2	-2.0	-7.4	-3.1

Source: Ministry of Finance and Reserve Bank of Malawi

\*Provisional estimate

The cost of the maize shortage has been high at an estimated K7.2 billion since mid-2002, but the continued shortfall in budgetary support due to the lack of an agreement being reached with the IMF, has resulted in a massive and unsustainable increase in domestic debt to finance government expenditure. The domestic debt has doubled to K45 billion as at February 2003, up from K21 billion at the end of 2001.

**Table 5.3: Outstanding Domestic Debt (2000-2003), (K millions)**

	At 31 Dec 2000	At 31 Dec 2001	At 31 Dec 2002	At 19 Feb 2003
	K (millions)	K (millions)	K (millions)	K (millions)
Treasury bills	9,173	5,216	28,933	28,674
Other forms	3,193	16,539	13,470	16,496
Total	12,366	21,755	42,403	45,170

Source: Reserve Bank of Malawi

The cost of servicing domestic debt has risen sharply both as a proportion of government revenue and as a proportion of GDP. By the end of 2002, servicing domestic debt accounted for 24.7% of government revenues and 4.5 % of GDP.

**Table 5.4: Cost of Servicing Domestic Debt as % of Government Revenues and GDP**

As % of:	1998	1999	2000	2001	2002
	%	%	%	%	%
Govt. revenue	13.2	10.7	16.0	21.5	24.7
GDP	2.1	1.9	2.7	3.9	4.5

Source: Reserve Bank of Malawi

The trend is still upward and unsustainable, even as government revenue collections have improved dramatically over the last year. Urgent action is now required to narrow the deficit through significant cuts in government expenditure. In addition to domestic debt, external debt as a proportion of GDP has increased from 110.2% over the period 1990-1999 to 191.4% in 2001, reflecting a high and increasing dependency on external financing.

**Table 5.5: Domestic Debt & Current Account Deficit as a % of GDP**

	1980-89	1990-99	2000	2001	2002
External debt stock %	4.4	110.2	197.6	191.4	N/A

Source: Ministry of Finance and Reserve Bank of Malawi

### 5.2.3 Interest Rates

In a liberalized financial system, an increase in government domestic debt leads to an increase in interest rates. This is precipitated by the government's demand of scarce domestic financial resources from the private sector – demand of these resources exerts upward pressure on interest rates. Available data on Malawi supports this cause and effect relationship. As government domestic debt rose, real Treasury Bills yields also increased from an average of -0.76% in 1994 to 25.9% in 2002.

The level of interest rates is also a reflection of the stance of the monetary policy – the higher the bank rate, the tighter the monetary policy stance, and vice versa. In Malawi, the bank rate has remained above 40% for the past three years, as a result of the adoption of a tight monetary policy by the Reserve Bank aimed at reducing inflation to single digit

levels. Reserve Bank lending to the government increased from K1.6 billion at the end of 2000 to K15.7 billion at the end of 2002.

The tight monetary policy stance has helped somewhat in slowing down the depreciation of the Malawi Kwacha, but at a high cost to business and investment. The Malawi Kwacha depreciated by 16.4% from June 2002 to January 2003, against a fall in foreign reserves of 37.0% over the same period. The sharp decrease in foreign reserves, coupled with the inability of the government to resume its IMF Programme, has had drastic results for both the public and private sectors.

**Table 5.6: Private Sector Credit as a % of GDP (1980-2002)**

	1980-89	1990-99	2000	2001	2002
<b>Credit to the private sector</b>	5.2	11.3	14.5	1.5	N/A

*Source:* Reserve Bank of Malawi and Ministry of Finance

#### 5.2.4 Balance of Payments

The current account deficit as a proportion of GDP has steadily increased over the past few years, reaching an unsustainable level of 10.9% in 2001.

**Table 5.7: Current Account Deficit as a % of GDP**

	1980-89	1990-99	2000	2001
<b>Trade Balance</b>	4.0	-4.2	-3.5	-3.3
<b>Current Account Deficit (including official transfers)</b>	-0.7	-2.2	-5.9	-10.9
<b>Real effective exchange rate K:\$</b>	63.0	77.4	88.4	84.1
<b>Terms of trade index</b>	189.8	138.2	130.1	107.5

*Source:* Ministry of Finance and Reserve Bank of Malawi

Malawi continues to be heavily dependent on foreign aid and therefore, greatly susceptible to the flow of donor funds. The current account is also affected by changes in the terms of trade and exchange rate movements. The high dependence of the Malawian

economy on tobacco, tea, sugar, and other agricultural commodity exports, also makes it vulnerable to fluctuations in world supply, demand, and prices.

In 1994, the exchange rate regime was liberalized. However, this was immediately followed by the administrative fixing of the nominal rate from 1995 to mid-1998, which resulted in an appreciation in the real exchange rate. As a result, a massive 62% depreciation was experienced in August 1998 when the nominal rate was suddenly loosened. The post-1998 fiscal crises has contributed to a highly volatile business environment not just in terms of borrowing costs, but also the effects on the real exchange rate and feedback effects on inflation.

The Kwacha has continued to depreciate against the US dollar by 37.4% in 2000 and 21.3% in 2001 (World Bank/IMF figures). There was a period of appreciation of the currency in mid 2001 and into early 2002, but this was reversed and the depreciation continued. The instability of the Kwacha has had serious repercussions for all businesses operating in Malawi. The appreciation was particularly damaging to some exporters depending on the timing of their inputs and exports, for example, those in the tea industry.

**Table 5.8: Depreciation of the Kwacha & Trade Dependence**

	1980-89	1990-94	1995-99	2000	2001
<b>Nominal depreciation (K:\$)</b>	-11.2	-18.6	-168.2	-34.7	-21.3
<b>Exports plus imports (% of GDP)</b>	54.6	62.0	64.0	75.0	45.2

*Source:* World Bank/IMF

### **5.2.5 Investment and Savings**

Gross investment expenditure as a percentage of GDP declined from an average level of 18.4% in 1980-89, to 16.8% in 1990-99 and 10.9% in 2002. Public investment which accounts for the larger share of total investment, dropped from 14.9% to 9.9% of GDP between 1990-99; whilst private investment declined to a minimal 2.0% of GDP over the same period of time.



**Table 5.9: Savings & Investment as a % of GDP (1980-2002)**

	1980-89	1990-99	2000	2001	2002
Domestic Savings	18.4	16.8	13.6	13.7	1.3
National Savings	8.7	8.2	8.8	11.1	4.2
Gross Investment	18.4	16.8	13.6	13.7	10.9

*Source:* Ministry of Finance and Reserve Bank of Malawi

The major factors contributing to the slowdown in investment included general economic deterioration, high interest rates, and low domestic savings.

Domestic savings have dropped from 13.7% of GDP in 2000 to 1.3% in 2002, reflecting the major slowdown in economic activity and inflation. Similarly, national and foreign savings declined over the same period, due to both low economic activity and negligible foreign assistance. National savings fell from 11.1% of GDP in 2001 to 4.2% in 2002, whilst foreign savings plunged from 15.8% in 1994 to 6.7% in 2002.

### **5.3 MALAWI'S BUSINESS AND INVESTMENT ENVIRONMENT**

The integration of Malawi into the global economy began with colonialism at the turn of the century. After independence, this relationship continued under numerous voluntary arrangements, such as the Lomé Convention. Malawi has been engaged in extensive liberalisation and reform programmes, embracing market-oriented economic policies with an export-oriented approach. Since the early 1990s, economic reforms aimed at, among other things, attracting foreign investment, have been implemented (Bhalla et al., 2000)<sup>96</sup>.

Despite the country's adverse economic conditions, Malawi has a long track record of the implementation of stabilization measures and structural reforms aimed at promoting sound macroeconomic policies. The country has been implementing Structural

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<sup>96</sup> Bhalla A., Chipeta C., Taye H. and Mkandawire M., 2000, "Globalisation and Sustainable Human Development: Progress and Challenges for Malawi", *Occasional Paper*, UNCTAD/EDM/Misc.129

Adjustment Programmes (SAPs) since 1981. The general objectives of the adjustment programmes were:

- Diversification of Malawi's export base;
- Encouragement of efficient import substitution;
- Ensuring appropriate price and income policies;
- Improvement of the public sector's performance; and
- Strengthening of the government's economic planning and monitoring capabilities.

Prior to these reforms, administrative controls served as hindrances to the efficient allocation of resources due to existing price controls and structural rigidities, including bureaucratic tendencies in investment approval processes.

Among other things, the SAP's implemented several policies and measures, some of which impacted on investment during the period. These can broadly be categorized into:

- Price decontrols;
- Liberalization of agricultural marketing;
- Financial sector liberalization which included active exchange rate policy;
- Public enterprises or parastatal reforms;
- Liberalization of burley growing and marketing by smallholder farmers.

In principle, these reforms were aimed at allowing the free market forces to determine resource use – hence, the link with investment.

Malawi is one of the most indebted countries in Africa. Since 1994, its outstanding long-term debt exceeded its gross national product (GNP) (Refer to **Annex 7**). The percentage of debt service payments to export earnings is also significant. This highlights the fact that Malawi has been borrowing not only for investment but also for other expenditures, since investment only accounts for a small proportion of GNP. With such huge debt service payments, Malawi's ability to increase its expenditure on infrastructure for instance, to become globally competitive, is limited. Furthermore, such a huge debt burden is likely to discourage flows of FDI via what is referred to as the "debt overhang".

Despite the obvious constraints of the general negative attitude towards Africa as an investment destination, limited purchasing power, poor infrastructure, and a small domestic market, there is a potential for higher foreign direct investment flows to Malawi. In response to this, the Government of Malawi encourages the private sector to assume the leading role in economic development. The government thrust is to facilitate, rather than to regulate, private investment. To create a more conducive investment climate, specific measures to deregulate the private sector and offer new investment opportunities have already been enacted.

Malawi compares favourably with many African countries as a pleasant and relatively easy place to do business. A survey conducted by UNCTAD for the World Investment Report (1999)<sup>97</sup> of 44 African investment promotion agencies (IPAs), revealed that, Malawi was found to have a higher ranking for its progress on business environment than for its general attractiveness as a location for FDI. These findings support the proposition that, in particular in developing countries, the creation of a business-friendly environment (including a better regulatory framework) does not automatically make a country more attractive for FDI.

Another study conducted on Malawi found that the country has not attracted much new investment from outside sources. This is partly because investment incentives have not been marketed, and also because their availability has not been a major consideration for investors (Whiteside, 1989)<sup>98</sup>. The study concluded that Malawi's investment incentive package needs to be revised. It was found that little effort has been made to promote Malawi, but it would seem that promotion would give immediate positive results. Recommendations were made to look at the promotion carried out by a number of other countries and perhaps emulate them.

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<sup>97</sup> See Note 4.

<sup>98</sup> Whiteside A.W., 1989, *Industrialization and Investment Incentives in Southern Africa*, University of Natal Press, South Africa.

Since Whiteside's study was conducted, a wide range of policy measures have been taken to induce foreign investment, to protect foreign invested enterprises, and to facilitate their smooth operation. Toward this end, the Government of Malawi passed the Investment Promotion Act of 1991, which established the Malawi Investment Promotion Agency (MIPA). MIPA was officially opened in September 1993, and serves to act as a "one stop shop window" for any investor in Malawi. The Act establishes MIPA as an institution mandated to attract, promote and facilitate investment by ensuring streamlined investment procedures and a supportive policy framework. The same Act also clearly defines a range of incentives designed to attract productive investments to Malawi.

### **5.3.1 The Impact of Policy Reforms on Private Capital Flows and Stocks**

After liberalization of the exchange controls, there has been an influx of unmonitored foreign exchange inflows, and outflows in the form of private investments and remittances. The mushrooming of the foreign exchange bureaus has created another problem of misreporting and failing to report at all on foreign exchange transactions. In this regard, the balance of payments statistics are underreported. Taking cognisance of this problem and in attempt to address it, the Reserve Bank of Malawi has put in place a new system for tracking private capital transactions including registration of foreign investors in Malawi.

### **5.3.2 Alternative Sources of Private Capital Flows and Stocks Data**

The Annual World Investment Report (AWIR) produced by UNCTAD, is one of the most commonly used sources of figures on FDI flows. According to the AWIR 2001<sup>99</sup>, global FDI inflows stood at US\$1,271 billion in 2000, up from US\$865 billion in 1999. This was driven mainly by a wave of cross-border mergers and acquisitions. The share of developing countries in global FDI flows fell for the second year in a row to 19%, relative to the peak of 41% in 1994.

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<sup>99</sup> UNCTAD, *World Investment Report 2001*, United Nations Publications, New York and Geneva.

Inflows of FDI into Africa (including South Africa) declined by 13.3% from a high of US\$10.5 billion in 1999 to US\$9.1 billion in 2000, after an increase of US\$2 billion the previous year. Therefore, the share of Africa in world FDI flows, while already low, shrank to below 1%. Nonetheless, FDI flows to Africa as a whole (and to major recipients such as Angola, Morocco and South Africa) were still higher than those recorded during the early 1990s, mainly as a result of sustained government efforts to create conducive investment climates. SADC's share in total FDI inflows into Africa was recorded at 44%, compared to 21% during the first half of the 1990s.

The AWIR 2001<sup>100</sup> estimated that FDI inflows into Malawi were US\$51 million in 2000, compared to US\$60 million in 1999, and compared to the Malawi Investment Promotion Agency's record which showed that MIPA facilitated close to US\$40 million in 1999, and US\$27 million in 2000.

An increase in the domestic savings rate and the efficient channelling of resources into productive investment are preconditions for sustained growth and development. A survey conducted by Maarsdorp and Whiteside (1993)<sup>101</sup> found that domestic savings rates in Southern Africa are low since the environment is not conducive to saving. The low savings potential and chronic shortage of domestic financial resources constitutes a major constraint for African countries. The dependency rate is high; levels of economic growth are low; there are often no institutions to encourage saving; and in most countries real interest rates have been negative or nearly negative for almost a decade. In 1995, the World Bank<sup>102</sup> reported that for the region as a whole, with a ratio of savings to GDP of 14%, the Bank's long-term perspective goal of achieving 18% by the year 2000 seemed unachievable for most African countries.

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<sup>100</sup> See Note 99.

<sup>101</sup> Maarsdorp G. and Whiteside A., 1993, *Rethinking Economic Cooperation in Southern Africa: Trade & Investment*, Konrad-Adenauer-Stiftung, Johannesburg, South Africa.

<sup>102</sup> World Bank, 1995, "A Continent in Transition: Sub-Saharan Africa in the Mid-1990s", *African Region*, The World Bank, November.



According to a SADC Report on Investment and Growth Related Issues (2001)<sup>103</sup>, the low Gross Domestic Savings rate for the period 1990-1999, shows the difficulties of most SADC countries to achieve a sufficiently high level of capital formation to respond to investment needs. Given the low levels of both public and private domestic savings in the SADC region, the report states that the only alternative to reach a satisfactory level of economic growth is through foreign direct investment.

The major factors contributing to the slowdown in investment in Malawi have included general economic deterioration, high interest rates, and low domestic savings. Domestic savings have dropped from 13.7% of GDP in 2000 to 1.3% in 2002, reflecting the major slowdown in economic activity and inflation. Similarly, national and foreign savings declined over the same period, due to both low economic activity and negligible foreign assistance. Being ranked as one of the least developed countries in the world, it is imperative for Malawi to boost its economic growth. Analysts estimate that real GDP growth stuttered in at about 1.5% in 2002, well below the government's 4% target.

As economic theory suggests, FDI represents a major source of capital in developing countries. With a low domestic savings level and the instability of private financial flows, FDI should increasingly be seen as a solution to the problem of resource gap and external financing in Malawi. Foreign direct investment, as a more stable form of capital flow linked to an emerging international production system, is likely to offer new, and unprecedented growth opportunities to the country.

Given the benefits that FDI can bring to the country, this study attempts to identify the efforts that have been made by the Malawi government to attract private capital flows to the country. The study will focus on the changes that have occurred in Malawi with regards to FDI, since the enactment of the Investment Promotion Act in 1991. Not only will this study serve to highlight the accomplishments that the Malawi government has made in recent years in respect of foreign direct investment, but will also aim to identify

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<sup>103</sup> See Note 68.



those areas of weakness that need to be addressed in order to contribute to the country's economic growth and successfully integrate Malawi into the global economy.

## CHAPTER VI

### **PROBLEM STATEMENT & OBJECTIVES OF THE STUDY**

Malawi's integration into the global economy began with colonialism just before the turn of the century. Since then it has made considerable efforts to implement the standard prescriptions of structural adjustment and stabilization policies. The country has maintained one of the most stable political environments in Africa, and both the flows of multilateral and bilateral aid have been moderate but steady.

For a developing country like Malawi, private capital flows are an essential means of complementing the country's limited domestic savings level, and strengthening market links with sources of that private capital. Any efforts to attract such capital flows should be an important government initiative for the development of the country.

Since 1993, extensive liberalization and reform programmes have been implemented and the government has attempted to put in place an appropriate macroeconomic environment necessary for private sector growth including, attracting private capital flows. A wide range of policy measures have been taken to induce foreign investment, to protect foreign invested enterprises, and to facilitate their smooth operation. Toward this end, the Government of Malawi passed the Investment Promotion Act in 1991, which established the Malawi Investment Promotion Agency (MIPA), and clearly defines a range of incentives designed to attract productive investments to Malawi.

The purpose of this study is to determine how successful the Act has been in attracting FDI to the country, and whether or not the country has seen a marked increase in FDI flows as a result of the various investment incentives offered. Whiteside's study on Malawi's investment climate was conducted in 1989 – prior to the enactment of the Investment Promotion Act. This study will thus, attempt to build upon previous research

that has been carried out on Malawi's investment climate, utilizing Whiteside's survey as a framework to measure the effectiveness of Malawi's new Investment Promotion Act in attracting FDI to the economy.

- ***Hypothesis I:*** The Investment Promotion Act (1991) has offered a wider and more attractive range of investment incentives to foreign investors.
- ***Hypothesis II:*** The investment incentives offered have led to an increase in the level of FDI to Malawi.
- ***Hypothesis III:*** The amount of FDI inflows in to Malawi has contributed to the economic growth of the country.

Since the early 1990s, when Malawi began to increasingly adopt proactive measures to attract foreign investment, there have been indications that there has been an increase in private capital flows to the country. However, there has been no empirical evidence about the composition, magnitude, and sustainability of such flows, due to the lack of a proper monitoring mechanism.

Although the Reserve Bank of Malawi (RBM), the Malawi Investment Promotion Agency (MIPA), and the National Statistical Office (NSO) have been in a position to collect and compile information on investment, gaining reliable data on FDI has always been a problem. During the era of exchange controls, the Reserve Bank of Malawi was in a position to gather reliable data on investment flows. Following economic liberalization, all current account transactions do not require prior approval by the monetary authorities. However, there is a requirement to register all capital account transactions. Despite this requirement, some companies still borrow externally without registration. As a result, there have been gaps in data required in the compilation of the financial accounts of the balance of payments. The National Statistical Office previously conducted surveys on the private sector in order to gain information regarding foreign investments. However, the response rate was only in the range of 20-25%.

The objective of this study was to determine the magnitude of foreign private investment into Malawi since economic liberalization, as a means of assessing the effectiveness of the Investment Promotion Act. The study also attempted to identify the links that exist between the types of investment incentives offered and the degree of foreign direct investment to Malawi. Furthermore, the study aimed to establish the progress that Malawi has made in nurturing an investment climate that is attractive to foreign investors, in its efforts to integrate Malawi into the global economy.

## CHAPTER VII

### METHODOLOGY

There are approximately 250 foreign companies operating in Malawi. Being essentially an exploratory study, nonprobability sampling was used, by selecting sample members that conformed to some criteria (i.e. foreign investors that have entered the Malawi following the enactment of the Investment Promotion Act). A total of 26 questionnaires were distributed to various companies (foreign investors) during the survey, thereby representing a sample size of 10% of the population. The sample included investors from the northern, southern, and central regions of Malawi. The survey captured details from investors in various sectors of the economy. The survey involved administration of the questionnaire through briefs with company chief executives or their representatives. For most questions the respondents were asked to score in the appropriate attribute. Follow-ups were made to some companies via telephone and email. However, physical visits were found to be the most effective manner to gather information from the respondents.

Data regarding Malawi's recent FDI levels, in terms of its sources, magnitude, and composition, was obtained from the Malawi Investment Promotion Agency, through official records and information, and interviews with officials from the Investment Agency. In order to gain a deeper insight of the progress that has been made towards improving Malawi's investment climate, interviews were also conducted with officials from the Malawi Confederation of Chambers of Commerce and Industry, the University of Malawi, and the Privatisation Commission of Malawi.

The companies were served with a self-administered questionnaire covering several attributes, which included:

- Economic and financial factors;
- Political and governance factors;
- Efficiency of infrastructure and services;

- Effectiveness of investment incentives;
- Efficiency of MIPA;
- Factors influencing initial investment; and
- Direction of investment in the medium-term.



## CHAPTER VIII

### INVESTMENT DATA PERTAINING TO MALAWI

Following recommendations by the World Bank, the Malawi Investment Promotion Agency (MIPA) was established in 1991 to promote foreign investment into Malawi. The Investment Promotion Act was enacted in 1991, and came into full operation in 1993. The Act demonstrated Malawi's commitment to attracting foreign investment, and eliminated the need for general investment licenses (Refer to **Annex 9**). MIPA was officially opened in September 1993, and serves to act as a "one stop shop window" for both domestic and foreign investors. MIPA is responsible for facilitating the investment process, providing investment-related information, making suggestions to government on how to improve the investment climate, and marketing Malawi (both regionally and abroad) as a favourable location for investment.

Since Malawi gained its independence, there were virtually no new foreign investments into the country. Most the foreign companies that were established had been operating in the country during colonialism. Many of the companies that were present in Malawi, had strong ties and relationships with the previous president, Kamuzu Banda, for example, Lonrho. Since the establishment of MIPA, lots of progress has been made with regards to foreign investment in Malawi. For example, in 1993, FDI inflows into Malawi were recorded as US\$9 million; whereas by 1995, the figure stood at US\$25 million. The main factor that contributed to this increase in FDI flows was the first multi-party elections held in Malawi in 1994. The introduction of a democratic government enhanced investor perceptions of the country, and spurred inward FDI flows to the country.

Malawi has seen a steady decline in foreign investment figures since 1998. Mr. Muluzi and his United Democratic Front (UDF) party were re-elected in the country's second multi-party elections, in June 1999. There were many disputes surrounding the actual election process and the outcome. This adversely affected Malawi's image to foreign

investors.

The stock of foreign direct investment in Malawi has been relatively small but as a whole, seems to be comparable to the average for African countries.

**Table 8.1: Malawi Inward FDI Stock**

Year	Value (US\$ million)	% of GDP	% of GDP (for Sub-Saharan Africa)
1980	100	8.1	4.0
1985	143	12.6	7.8
1990	215	11.6	13.5
1996	267	18.2	21.8
1997	284	11.4	-----

*Source: UNCTAD, World Investment Report, 1998.*

From a low of US\$100 million in 1980, the stock of FDI reached US\$284 million by 1997 and averaged about 10% of GDP. Total FDI stocks (comprising equity investment, retained earnings, and shareholder and inter-company borrowings) were US\$324.7 million as at the end of 1999, and declined to US\$291.3 million by the end of 2000.

**Table 8.2: Total Stock of FDI in Malawi (US\$ million)**

	Dec 31 1999	Dec 31 2000
(A) Stocks of FDI equity at market values	245.1	188.7
Retained earnings	-	12.6
(B) Stocks of shareholder and inter-company borrowings	79.6	102.5
<b>(C) Total FDI stocks (A+B)</b>	<b>324.7</b>	<b>291.3</b>
GDP at current market value	1,793.2	1,743.2
Total FDI stocks as a percentage of GDP (%)	18.1	16.7

*Source: MIPA and Reserve Bank of Malawi*

This decline arose from a drop of 23.0% in FDI equity, but should also be seen in the context of the substantial Kwacha depreciation against the US dollar. The 10.3% decrease in FDI stocks as a percentage of GDP also reflected the exchange rate depreciation.

During 1993-2001, MIPA facilitated close to US\$188 million of FDI.

**Table 8.3: Stocks and Flows of FDI (MIPA)**

Year	FDI stocks (US\$ million)	FDI Flow (US\$ million)
1993	4.0	4.0
1994	13.2	9.2
1995	30.6	17.4
1996	69.4	38.8
1997	83.0	13.6
1998	101.1	18.1
1999	141.3	40.2
2000	168.2	27.0

Source: MIPA, Investor Tracking System

Investment declined largely on account of adverse macroeconomic conditions in Malawi. A recent World Bank survey (1997) of private businesses cites poor infrastructure, crime and theft, inflation and corruption as major obstacles to private business. The survey also cites tax regulation and policy instability among moderate obstacles.

The US\$27 million recorded in foreign investment in 2000 reflected a marked decline compared to the previous two years. Investment officials in Malawi conceded that the country's level of FDI declined in 2000 due to stiff competition from neighbouring countries offering better incentives. The downturn in 2000 was also attributed to macroeconomic instability, unstable exchange rates and high inflation rates, which deterred potential investors from entering the country<sup>104</sup>.

The year 2001 saw a further drop in foreign investment levels by 75% to a mere US\$6.6 million out of a projected US\$34 million. Reasons cited for this drastic decline included the less than satisfactory condition of Malawi's economic infrastructure, high inflation rates of almost 25%, and interest rates of 50%<sup>105</sup>. Furthermore, it was added that MIPA's

<sup>104</sup> A press release in January 2001 given by Ted Kalebe who heads the Malawi Investment Promotion Agency. See [www.Misanet.com](http://www.Misanet.com) for full details of the article.

<sup>105</sup> A press release in July 2002 given by Aretha Kamwendo, publicist at the Malawi Investment Promotion Agency. See [www.Misanet.com](http://www.Misanet.com) for full details of the article.

efforts to attract and retain foreign investment “have been hampered by bureaucratic tendencies that delay assistance to potential investors”<sup>106</sup>.

FDI declined from nearly all source countries. The largest investing countries such as the United Kingdom, the US, and South Africa, which accounted for 31.9, 26.6, and 19.0 percent in 2000, respectively, experienced huge reductions in FDI equity stocks.

**Table 8.4: Foreign Direct Equity Investment Stocks in Malawi by Source**

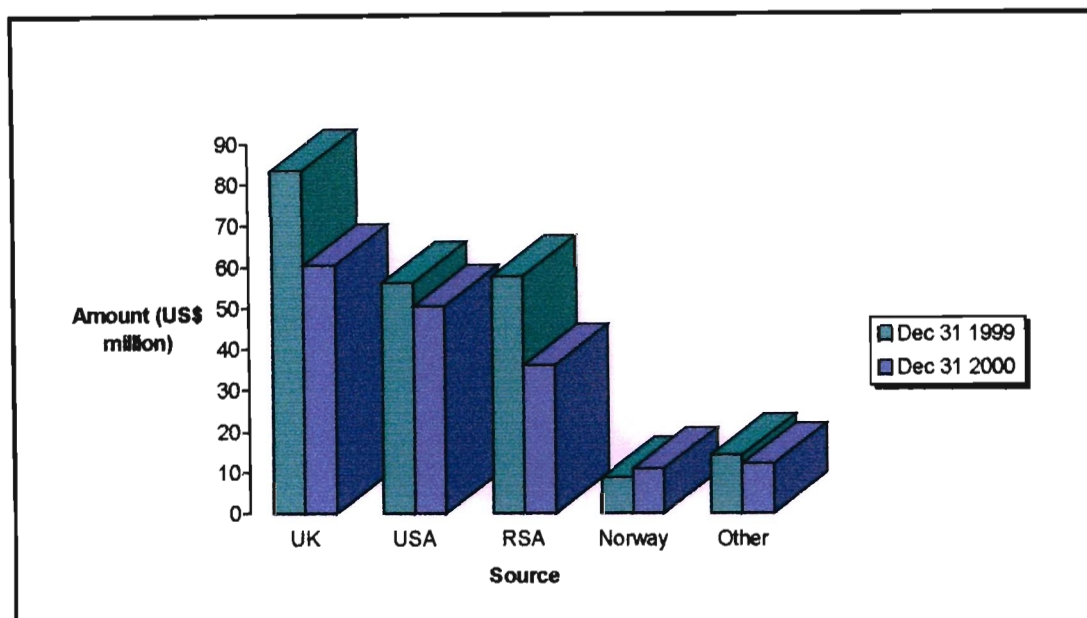
Source	Dec 31 1999		Dec 31 2000	
	US\$ million	As % of total	US\$ million	As % of total
United Kingdom	83.3	34.0	60.2	31.9
United States of America	56.0	22.8	50.2	26.6
Republic of South Africa	57.2	23.4	35.8	19.0
Norway	8.6	3.5	10.6	5.6
Ireland	3.2	1.3	6.2	3.3
Switzerland	5.9	2.4	3.6	1.9
Netherlands	6.4	2.6	3.5	1.8
Isle of Man	3.9	1.6	2.5	1.3
Mauritius	3.7	1.5	2.1	1.1
Zimbabwe	2.9	1.2	2.1	1.1
Other	13.9	5.7	11.8	6.3
<b>Total</b>	<b>245.1</b>	<b>100.0</b>	<b>188.7</b>	<b>100.0</b>

*Source: Malawi Private Capital Stocks Survey, 2002.*

Of the FDI equity stocks from the United Kingdom, 33.9% was invested in the agriculture sector, 27.6% in manufacturing, 20.3% in distribution, 15.6% in financial intermediation, and 2.6% invested in other sectors in 2000. The USA mainly invested in the manufacturing and distribution sectors with percentage contributions of 77.7 and 20.1 respectively of all FDI stocks from the US. Of the FDI equity stocks from South Africa, 74.9% was invested in manufacturing, while 19.0% and 5.0% went to the distribution and financial intermediation sectors respectively (Refer to **Annex 5**).

<sup>106</sup> See Note 104.

**Figure 8.1: Distribution of FDI Equity Stocks in Malawi by Source**



*Source: Malawi Private Capital Stocks Survey, 2002.*

Cross-border investment has increased. The main flow of cross-border investment is from South Africa. There have also been flows of cross-border investment from other countries such as Zimbabwe and Zambia in the financial sectors of the Malawian economy; and Tanzania in the dairy industry. The liberalization of the economy, which includes capital inflows, the privatisation of public enterprises, and the establishment of stock exchanges in recipient countries have facilitated these flows.

Although the manufacturing sector performance has been poor in recent years, it has been the leading recipient of foreign direct investment, accounting for 50% of total FDI equity stocks at the end of 1999 and 47.6% at the end of 2000. Within the manufacturing sector, the most dominant sub-sectors were agro-industry, chemicals and petroleum, textiles, and food and beverages. The next sector that benefited significantly from FDI equity was distribution, which accounted for 20.5% of the total FDI equity stocks at the end of 1999 and 24.0% at the end of 2000. The agriculture sector accounted for 12.6% in 1999 and 10.8% at the end of 2000, while the financial sector received 10.1% of total FDI equity stocks at the end of 1999 and 12.0% in 2000. The figures show a high concentration of FDI in the four sectors of the economy.



**Table 8.5 : Sectoral Distribution of FDI Equity Stocks in Malawi**

Sector	Dec 31 1999		Dec 31 2000	
	US\$ million	As % of total	US\$ million	As % of total
Manufacturing	122.6	50.0	89.8	47.6
Agriculture	30.9	12.6	20.4	10.8
Financial intermediation	24.6	10.1	22.7	12.0
Wholesale and retail	50.3	20.5	45.3	24.0
Transport, storage & communication	11.8	4.8	7.4	3.9
Other	4.9	2.0	3.0	1.6
<b>Total</b>	<b>245.1</b>	<b>100.0</b>	<b>188.7</b>	<b>100.0</b>

Source: Malawi Private Capital Stocks Survey, 2002.

According to sources from MIPA<sup>107</sup>, the low cost of labour, EPZ incentives, zero-rated duty rates on raw materials for manufacturing, and domestic availability of agricultural raw materials seem to have helped boost FDI flows to the manufacturing sector.

Despite being the mainstay of the economy, the agriculture sector recorded insignificant FDI levels, though a considerable number of manufacturing concerns were agro-industries which should have translated into pronounced industrial linkages.

As outlined above, most of the FDI in Malawi is concentrated in the manufacturing sector (47.6%), distribution (24.0%), financial intermediation (12%), and agriculture (10.8%). Below are the rates of return on investment for some selected sectors. The agriculture sector has the lowest rate of return possibly reflecting lower capital intensity prevalent in the sector.

<sup>107</sup> Kamwendo A., Publicist at MIPA, March 2003, Personal interview. See Annex 12a for full details of the interview.



**Table 8.6: Rate of Return on Investment by Sector**

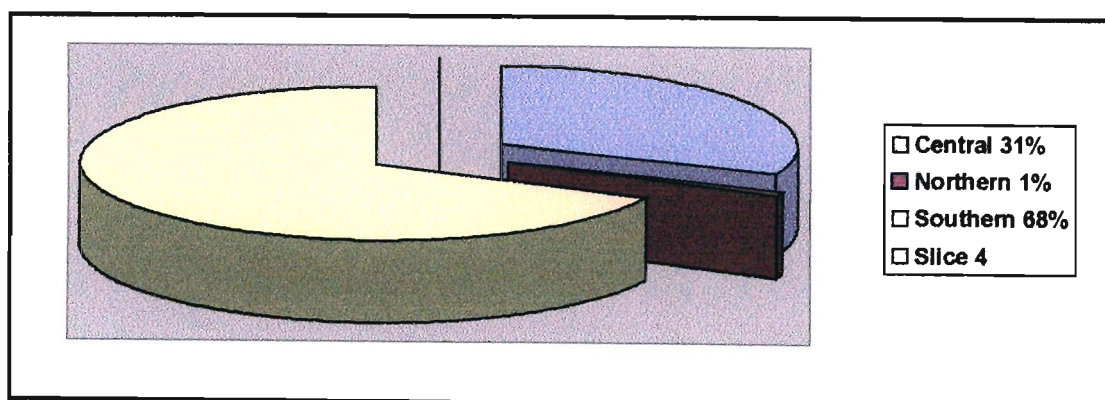
Sector	Rate of Return on Investment in 2000 (%)
Agriculture	26.0
Manufacturing	34.3
Distribution	31.4
Financial intermediation	34.7
Other community, social and personal services	78.7

Source: Malawi Private Capital Stocks Survey, 2002.

Despite the relatively poor performance experienced in recent years in the manufacturing sector, its rate of return for 2000 was one of the highest, at 34.3%. It has been cited that the poor performance of the sector is due to external factors other than the profitability of the sector<sup>108</sup>. The financial intermediation and distribution sectors are equally profitable.

With regards to those regions within Malawi that have attracted foreign investors, FDI seems to be mostly concentrated in the southern region with 68.0% of total FDI equity stocks, followed by the central region with 31.0% and 1.0% in the northern region, at the end of 2000, as illustrated in **Figure 8.2**.

**Figure 8.2: Distribution of FDEI Stocks by Region in 2000**



Source: Reserve Bank of Malawi and MIPA.

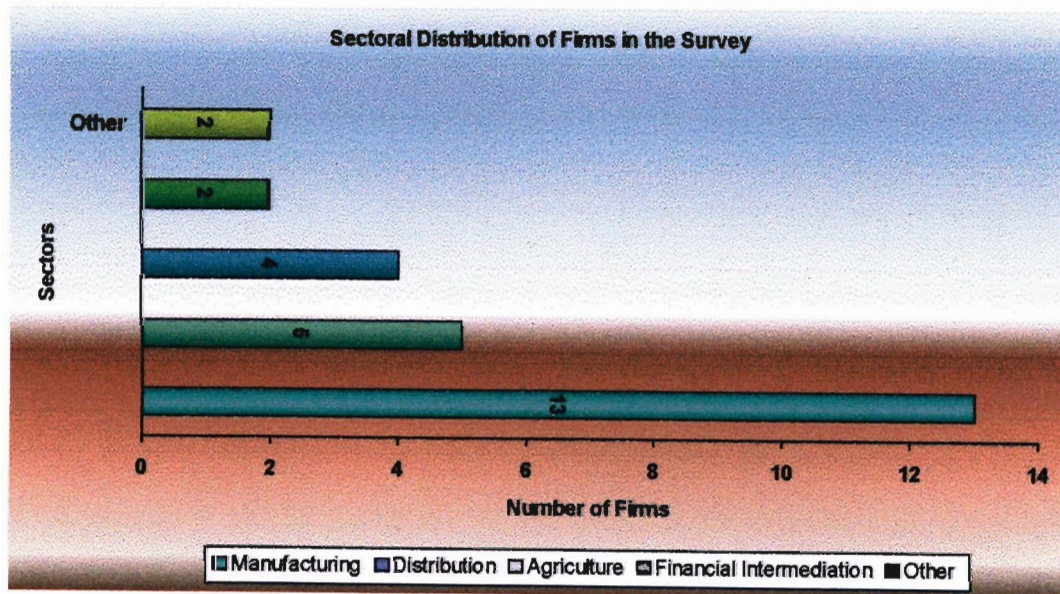
<sup>108</sup> Malawi Private Capital Stocks Survey, March 2002, Summary Report. MIPA and the Reserve Bank of Malawi.

## CHAPTER IX

### RESULTS OF THE STUDY: INVESTOR PERCEPTIONS

Most of the firms included in the sample have invested in the four main sectors of the Malawian economy, namely, manufacturing, distribution (i.e. wholesale, retail, and hotels), financial intermediation, and agriculture. Of the 26 firms surveyed, 50% were in the manufacturing sector, 20% in the distribution sector, the agriculture sector represented 15%, while financial intermediation and other sectors represented 8% and 7% respectively.

Figure 9.1: Sectoral Distribution of Firms in the Survey



**Table 9.1: Sectoral Distribution of Firms in the Survey**

Sector	Number of firms	Percent
Manufacturing	13	50
Distribution (wholesale & retail)	5	20
Agriculture	4	15
Financial intermediation	2	8
Other	2	7
<b>Total</b>	<b>26</b>	<b>100.0</b>

## 9.1 FACTORS INFLUENCING INITIAL INVESTMENT DECISION

The most common factor influencing initial investment decision in Malawi was principally to exploit various niches in the domestic market as well as the general environment in Malawi. The soundness of the economic policy in general, was also cited as another significant factor at the point of making the investment decision. Other factors taken into consideration, and in the order of importance, included access to the African market, the availability of local business finance, tax incentives and the repatriation of profits.

**Table 9.2: Leading Factors Influencing Initial Investment Decision**

1	Domestic economic situation and market size
2	Economic policy
3	Access to regional markets
4	Availability of local business finance/credit
5	Tax incentives
6	Exchange (dividend/capital remittance) control
7	Trade policy

## **9.2 MALAWI'S INVESTMENT CLIMATE IN COMPARISON TO OTHER AFRICAN COUNTRIES**

The majority of investors rated Malawi's investment climate favourably in relation to other African countries. For example, some cited problems associated with immigration, harbour duties etc. which have not been encountered in Malawi.

## **9.3 INSTITUTIONS FACILITATING INVESTMENT**

In rating some of the decision-making institutions pertaining to investment, the Reserve Bank of Malawi, the Malawi Investment Promotion Agency (MIPA), and the Ministry of Finance were rated favourably. However, there were concerns raised against the Malawi Revenue Authority (MRA). The MRA is the public institution that has the greatest effect on the private sector. The overriding investor sentiment was that the MRA tends to target the smaller companies, and that it lacks efficiency in dealing with surtax returns and refunds. Many stated that legitimate businesses in Malawi now have to devote considerable resources to managing their tax position to avoid undue penalties; yet the non-taxpaying formal/informal sector for whom many of the taxes and draconian penalties are specifically designed for, are seen simply to be able to bribe officials in order to avoid payment.

## **9.4 INCENTIVES**

An interview with a senior MIPA official, revealed that Malawi does not have a comprehensive incentive regime for each sector within the economy. The general incentives apply and investors in all sectors may apply to the government to be considered<sup>109</sup>.

With regards to the numerous investment incentives on offer, the remittance of dividends and the repatriation of profits were considered as having a positive effect on investments in Malawi. Tax incentives were regarded as having a limited positive effect on

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<sup>109</sup> See Note 107.

investments, whereas import duties were seen as having an adverse impact on investments in Malawi. According to MIPA, the investment incentives on offer have greatly reduced the operational and start-up costs of doing business in Malawi<sup>110</sup>. Some investors claimed that there are not enough incentives in place, and that although the Investment Promotion Act may specify that there are no licence requirements, this is not the case – permits are required for numerous items. Furthermore, it was cited that even when incentives are granted to individual firms they appear to be overridden by other arms of government, including the MRA and Ministry of Finance. The recent suspension of duty waivers has also caused confusion amongst investors without generating significant incremental revenue. This merely deters investors or delays actual investments. With regards to how attractive Malawi's investment incentives are in comparison to its regional competitors, MIPA stated that Malawi's incentives can only be viewed in the context of the domestic investment climate. Given the nature of the business environment in Malawi (i.e. high transport costs, expensive utilities, weak infrastructure etc.), incentives are used as a means of reducing the cost of production for investors. Whereas, the nature of incentives offered by Malawi's competitors' differ due to differences in the economies and the sectors being promoted<sup>111</sup>. Overall, the investment incentives are not sufficiently attractive to make international investors select Malawi as a location for doing business.

## **9.5 PERFORMANCE OF MIPA**

With regards to the numerous investor services that MIPA is charged with in order to encourage and facilitate investment in Malawi, many investors asserted that the Agency carried out the requisite services effectively. Overall, investors rated the Agency's performance as satisfactory, although many cited problems with unnecessary delays and red tape.

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<sup>110</sup> See Note 107.

<sup>111</sup> See Note 107.



During 1993-2001, MIPA facilitated close to US\$188 million of FDI mainly from South Africa. A senior government official<sup>112</sup> stated that the management of MIPA is well organized and has managed to create good ties with other government ministries, as a means of informing them of its activities without alienating them.

In terms of its weaknesses, although MIPA falls under the office of the President and Cabinet, it does not have overriding decision-making capabilities of the senior ministry. Although investors can access incentives through MIPA, the Agency does not have the authority to grant them. Although it is a one-stop window for investment, it does not have the abilities to make on the spot decisions. The approval of incentives and then variations by other parts of the government are reported to be problematic especially in some sub-sectors, such as tourism. With an incoming investment, MIPA must get clearance from numerous departments and ministries, and ultimately it is found that self-interests play an important part in what investments are encouraged and allowed into Malawi. Decisions are based solely on self-interests and not to the benefit of the Malawian economy. Several major investors have been lost over the years due to delays in the approval. Many of the people with authoritative powers either do not understand, or choose to ignore, the vast benefits that foreign investment has to offer for the country, in terms of growth and boosting the domestic economy. This is also evident in the lack of investment by the government in local infrastructure and other facilities which would attract more foreign investors<sup>113</sup>.

## **9.6 MACROECONOMIC FACTORS**

Almost all the companies surveyed asserted that high interest rates, inflation, and the exchange rate of the Kwacha have had the most negative impacts on the operations of their businesses. The study showed that, on average, 69% of the respondents indicated that inflation rates, interest rates and the depreciation of the Kwacha negatively affect investment.

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<sup>112</sup> Kaferapanjira Chancellor L., Chief Executive of Malawi Confederation of Chambers of Commerce & Industry, April 2003. Personal interview. See **Annex 12b** for full details of the interview.

<sup>113</sup> *ibid.*



## 9.7 GOVERNMENT POLICIES

The majority of investors believe that a good political system and good governance are catalytic to investment. Following the ushering in of the new political dispensation in 1993, coupled with economic liberalization policies, there was a mushrooming of private industries in the country. There was a noticeable increase in the number of establishments in the wholesale, retail, hotel, and restaurant sectors. Despite receiving the largest portion of FDI, the performance of the manufacturing sector has been poor, and its contribution to GDP has stagnated around 12%.

The survey results revealed that a large proportion of investors find that the policy environment in Malawi is not entirely conducive to investment and business development. At present, many investors feel that the legal and regulatory environment is not supportive to the growth and well-being of businesses, but often appears to be designed to maximise short-term revenues from companies, irrespective of the medium or long-term damage. Furthermore, the lack of consistency of policies is important as policy reversals are detrimental for investment prospects. For example, the recent suspension of duty waivers signals to investors that incentives can be granted and overturned at will by the government.

In assessing the impact of trade policy on investment, 66% of respondents favourably rated the prevailing trade regime. In terms of sectors, positive ratings came from firms in agriculture, while the rating of trade policy by manufacturing firms was generally adverse.

## 9.8 OPENING UP OF THE ECONOMY

According to the survey results, the opening up of the Malawian economy in the context of SADC and COMESA has negatively affected the industry through increased competition and the removal of protection (reduced tariffs). Some respondents cited unfair competition caused by smuggling. The survey also revealed that most manufacturing companies depend on imported inputs, and given the depreciation of the kwacha during the period under review, the manufacturing sector was put at a competitive disadvantage.

Nevertheless, some industries claim to have benefited from SADC and COMESA, stating that it has stimulated competition and should therefore contribute to Malawi's economic growth. Companies that export indicated that there are more market expansion opportunities under SADC and COMESA as the two trade blocks move into a freer trade regime<sup>114</sup>. Furthermore, some investors welcomed the Africa Growth Opportunity Act (AGOA) and the European Union Africa Caribbean Pacific Agreement (EU-ACP), under the Everything But Arms (EBA) initiative.

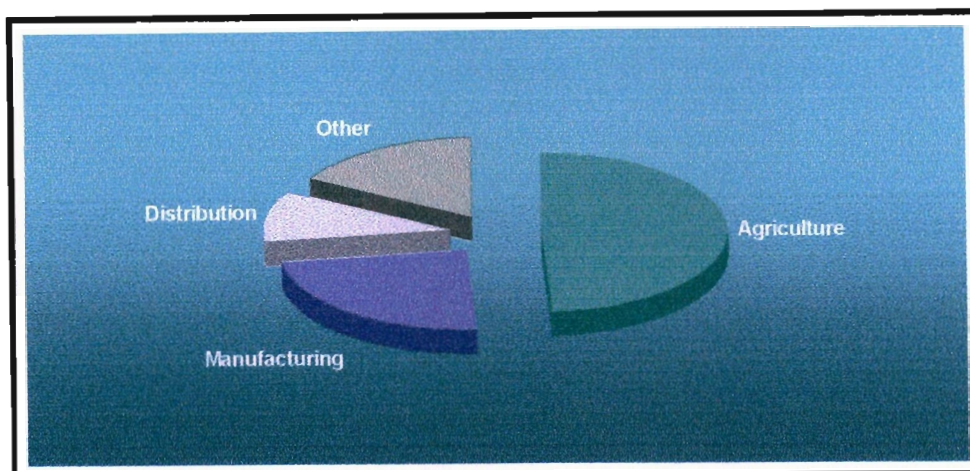
## 9.9 LABOUR FACTORS

Being an agricultural based economy, the majority of Malawi's workforce is employed in the agriculture sector. Estimates based on the survey indicate that 49.3% of the labour force is employed in the agriculture sector, 23.4% in manufacturing, and 10.7% is engaged in the distribution sector (which includes wholesale and retail trade, hotels, restaurants, and bars), as illustrated in **Figure 9.2**.

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<sup>114</sup> A program for a free trade area for COMESA began in October 2001, expecting completion by all members by 2004; while for SADC, the regime is set for 2008.

**Figure 9.2: Employment by Sector**



Employment patterns indicate that the majority of investors engage unskilled workers. Respondents complained that the majority of the workforce is unskilled and generally characterized by low levels of productivity. Most investors found Malawi's cost of labour to be cheap, with minimum wages currently stipulated as K55 (US\$0.78) per day in urban areas and K37 (US\$0.53) per day in rural areas.

### **9.10 REGIONAL AND DOMESTIC POLITICAL SCENARIO**

With respect to the regional political scenario, a significant number of respondents (40%) raised concerns about the recent political crisis in Zimbabwe as it adversely affects the supply of intermediate inputs, long-term planning in business, disrupts trade, and discourages the inflow of investment into the region as a whole.

With regards to the domestic political scenario, 36% of the respondents indicated that the local political environment had a limited negative effect, although no specific details were given. According to the Chief Executive of the Malawi Chambers of Commerce and

Industry<sup>115</sup>, the upcoming elections in 2004 may see the introduction of a new government, which in turn may see a greater commitment to promote, attract, and encourage foreign investment in Malawi. He further stated that “only once there is a change of leadership, will Malawi see any improvement in its economic environment.”

## **9.11 CORRUPTION**

The issue of corruption was prominent, with an overwhelming 81% of companies indicating that corruption had a strong negative effect on their businesses. Some of the complaints were that corruption presents an indirect operating cost, and defeats the essence of fair competition as quality services are not honoured, contracts are awarded in a non-transparent manner, and as one investor commented “...decision makers who love a bribe are bad news for honest business people”.

## **9.12 INFRASTRUCTURE AND PUBLIC SERVICES**

Infrastructure is a silent factor of production, with its efficiency and effectiveness often influencing the cost structure of existing firms and new investment decisions. In the survey, investors were asked to assess the cost and efficiency of various types of infrastructure services including inland transport, utilities (electricity and water supply), and telecommunications services.

Malawi is a landlocked economy and depends largely on an overland transport system, mainly road transportation. The country’s landlocked status serves as a major disadvantage to businesses as it increases the costs for importers and exporters relative to regional competitors. 63% of the respondents indicated that the cost of transport had a negative effect on business operations. Some investors stated that transport costs accounted for up to 20-30% of the landed cost of imported inputs and adversely affected

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<sup>115</sup> See Note 112.

the competitiveness of exports. It was also alleged that the poor rural road network represented a prohibiting factor for businesses targeting expansions in the rural areas. Given the limited air links, poor access to ports, limited rail capacity, and the poor condition of roads, this increases the costs for businesses, and provides opportunities for high prices to be charged by transport providers.

73% of manufacturing firms rated the cost and efficiency of water and electricity unfavourably. Tariff rates are regarded as particularly distorting. Problems with power supply involves protecting electrical equipment from surges and providing back up for outages adds costs. Frequent interruptions in the power supply results in production losses and is particularly damaging for manufacturers with processes that cannot be stopped and restarted. The cost of back up generation is high and generation licences are an extra cost that penalise those that need a continuous supply. Some companies noted that the billing systems for both water and electricity are unreliable, with bills often being issued even when firms have been idle for several months. Respondents further stated that the supply of basic utilities is generally unsatisfactory during peak periods.

In terms of land, most investors feel that both the cost and process of acquiring land is relatively reasonable.

With respect to telecommunications, 66% of the respondents rated the cost and efficiency of telecommunications as being unfavourable. Investors felt that there are undue delays in processing installations for new applications or the repairing of reported faults. Getting new telephone lines in many urban areas is difficult or impossible due to inefficiencies and limited capacity. Respondents cited the cost of international calls as high in relative and absolute terms. Some also stated that mobile phones are significantly more expensive in Malawi than other regional competitors, adding further costs to businesses.



### **9.13 HIV/AIDS**

The AIDS pandemic has had a devastating impact on the workforce in Malawi. Respondents complain about businesses being affected through the deaths of productive personnel, high costs related to health care, training requirements when replacements are hired, and the loss of production. The survey revealed that 80% of the firms reported that HIV/AIDS has had an economic impact on their businesses in one form or another.

### **9.14 FISCAL AND MONETARY POLICY**

In the survey, there were mixed reactions to the effects of fiscal policy, with 27% of the respondents stating that fiscal policy had a strong positive effect on the current operations of their businesses, while close to 40% indicated that fiscal policy had a strong negative effect on their operations. With regards to the latter group, most companies, particularly those in the manufacturing sector, reported that surtax (currently at 20% for manufacturing firms) has had an adverse effect on their business operations.

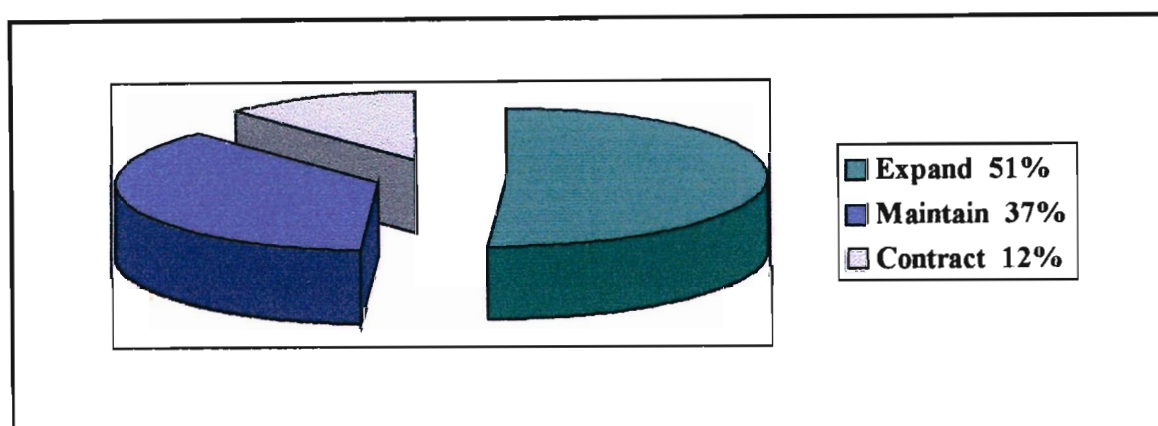
The Reserve Bank of Malawi is responsible for the formulation and implementation of monetary policy in Malawi. In this respect, investors were generally satisfied, although a significant proportion (41%) reported that the monetary policy has affected their businesses negatively. Over the past three years, Malawi has experienced high rates of inflation averaging 26% per annum. High inflation rates, high interest rates and depreciation were commonly cited as hindrances to business expansion as they, to some extent, affected the cost of obtaining finance credit and also placed the companies at a disadvantage competitively.



## 9.15 DIRECTION OF INVESTMENT

In the survey, the majority of investors expressed an intention to continue their operations in Malawi. For some firms, their plans are long-term, whereas others indicated that they plan to expand the operations of their business during the next three to four years.

**Figure 9.3: Direction of Investment in the Next 3-4 Years**



The survey revealed that 80%<sup>116</sup> of enterprises indicated that they had plans to increase their profits. Growth is expected to be largely concentrated in the existing sectors and markets for both imports and exports. The opening up of both the European and US markets under the Everything But Arms Initiative and the Africa Growth Opportunity Act (AGOA), respectively, has necessitated Malawian companies to plan for expansions in staff training, research and development, and investment in technology. However, most investors premised their plans for expansion and continuation of operations on the stability of the macroeconomic environment in the medium and long-term.

<sup>116</sup> Overall 51% of firms intend to expand all their activities (i.e. diversify by sector, region, staff training, R&D, recruitment, investment in technology, turnover, profits etc), while 37% plan to maintain their operations.

## 9.16 OUTLOOK FOR MALAWI'S INVESTMENT CLIMATE

Some respondents felt that it was difficult to predict whether or not Malawi's investment climate could be favourable in the near future. Concerns were raised regarding the negative publicity surrounding Malawi in terms of the unpredictable political environment and millions of starving people, which could in turn lead to negative perceptions of Malawi as an investment location.

One government official<sup>117</sup> commented on the many disputes surrounding the election process in 1999 and the outcome. The year 2002 saw the pursuit by Mr. Muluzi for a third term in office and an amendment to the constitution. This adversely affected Malawi's image to foreign investors. Furthermore, the Government of Malawi followed good economic policies from 1995 to 1997, but in more recent years the pace of reforms has decelerated. Poor economic conditions in terms of high annual inflation, high real interest rates, together with a sharp depreciation of the Kwacha, has resulted in slow growth of the economy. This has been compounded by weak expenditure control and acute fiscal indiscipline i.e. funds are grossly misused and corruption is rife. Current perceptions surrounding the upcoming elections in 2004, have also contributed to low investment levels.

The current crisis in Zimbabwe has had somewhat of a negative impact, and Malawi has been affected especially with regards to the supply of raw materials. Investor attitudes towards the region as a whole are negative, with the perception that the same problems could arise in other neighbouring countries. However, some respondents stated that all potential investors in Africa realise that there is always some element of risk attached to investing in the continent, and should therefore be prepared for the numerous problems which may arise. Furthermore, many investors commented that the success of some foreign companies in Malawi might be a signal to potential investors that there are significant investment opportunities available in Malawi.

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<sup>117</sup> See Note 112.

## CHAPTER X

### DISCUSSION

The objective of the study was to determine the extent to which the Malawi Investment Promotion Act (1991) has attracted FDI to the country. Furthermore, the study attempted to identify what links, if any, exist between the types of investment incentives offered and the degree of foreign direct investment to Malawi. In doing so, the study aimed to establish the progress that Malawi has made in nurturing an investment climate that is attractive to foreign investors, in its efforts to integrate Malawi into the global economy.

The following hypotheses were formulated at the outset of the study:

- ***Hypothesis I:*** The Investment Promotion Act (1991) has offered a wider and more attractive range of investment incentives to foreign investors.
- ***Hypothesis II:*** The investment incentives offered have led to an increase in the level of FDI to Malawi.
- ***Hypothesis III:*** The amount of FDI inflows in to Malawi has contributed to the economic growth of the country.

Below is a discussion of the above hypotheses in the context of the findings from the study.

## 10.1 THE IMPORTANCE OF FDI FOR MALAWI

As outlined in Chapter III of the study, the overall benefits of FDI for developing country economies are well documented. Given appropriate host country policies and a basic level of development, a preponderance of studies show that FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment, and enhances enterprise development. All these contribute to higher economic growth, which is a potent tool for alleviating poverty in developing countries.

With regards to the economic growth of a host country, practically all empirical studies of inter-country differences in growth rates, suggest that high growth rates are associated with large inflows of FDI. In the least developed economies, FDI seems to have a somewhat smaller effect on growth. According to an OECD Report released in 2002, LDCs need to have reached a certain level of development in education, technology, infrastructure, and health before being able to benefit from a foreign presence in their markets. However, the Report goes on to state that even countries at levels of development that do not lend themselves to the externalities from foreign presence, may benefit from inward FDI through the limited access to international funding. By easing financial restraint, FDI enables host countries to achieve the higher growth rates that generally emanate from a faster pace of gross fixed capital formation.

The above discussion highlights the many benefits that can accrue to the Malawian economy through foreign direct investment. Being ranked as one of the least developed countries in the world, Malawi has been heavily dependent on foreign assistance. In recent years, Malawi has seen a drastic decline in ODA from the donor community, with the International Monetary Fund halting any development assistance due to excessive government spending. Furthermore, the domestic savings rate in Malawi is low since the environment is not conducive to saving. Domestic savings in Malawi have fallen dramatically reflecting the major slowdown in economic activity. Similarly, national and foreign savings have declined due to both low economic activity and negligible foreign

assistance. Therefore, in accordance with a SADC Report given in 2001, given the low levels of both public and private domestic savings, the instability of private financial flows, and the low levels of foreign assistance, foreign direct investment should increasingly be seen as a solution to the problem of resource gap and external financing, and as the only alternative to reach a satisfactory level of economic growth in Malawi.

## **10.2 GLOBAL INTEGRATION OF THE ECONOMY**

Many studies show that the importance of government restrictions as a constraint on private capital flows to developing countries has been diminishing as many LDCs have begun to undertake extensive economic reform programmes. Since the mid-1980s, an overwhelming majority of countries have introduced measures to liberalise FDI frameworks. Governments have gradually made entry and establishment easier by reducing sectoral restrictions on FDI. Privatisation programmes are often open to foreign investors, and minimum amounts of equity investment requirements have also been reduced or abolished.

In 1981, Malawi implemented an IMF and World Bank supported Structural Adjustment Programme to restore medium to long-term growth prospects based on efficient resource use. In principle, these reforms were aimed at allowing the free market forces to determine resource use, hence the link with investment. As part of its efforts to ingrate into the global economy, Malawi is a member of the Common Market for Eastern and Southern Africa (COMESA), the Southern African Development Community (SADC), ACP/EU Cotonou, the World Trade Organisation (WTO), as well as a beneficiary of the African Growth Opportunities Act (AGOA), and Everything But Arms (EBA) agreement. Bilaterally, agreements exist with South Africa, Zimbabwe and Botswana, with further agreements currently under consideration with Zambia, Tanzania, and Mozambique.

The Malawi Investment Promotion Act was enacted in 1991 as a means of improving the investment climate in Malawi. The same Act established the Malawi Investment Promotion Agency (MIPA) as an institution mandated to attract, promote and facilitate investment by ensuring streamlined investment procedures and supportive policy framework.

However, Malawi has not succeeded in integrating into the world economy. Despite liberalizing the economy and implementing most of the required policy changes, results from this study suggest that the conditions in the Malawian economy as whole in the last few years have undermined investment into the country.

### **10.3 MALAWI'S INVESTMENT INCENTIVES**

Today, most countries around the world are striving to create a more favourable climate to attract foreign direct investment. Efforts to influence the locational decisions of transnational corporations have led many governments to offer incentives to attract investment from other countries. Towards this end, Malawi has taken steps to liberalise its foreign-direct-investment regime by reducing distortions regarding FDI, adhering to certain standards of treatment for transnational corporations, and ensuring the proper functioning of the market.

According to Whiteside's study in 1989, the incentives offered by Malawi were "rather confused" with even local businessmen unsure as to what was available. At the time of the study, Whiteside stated that the incentives had not been marketed, and their availability was not a major consideration for investors. The results of this study seem to be consistent with those proposed by Whiteside in 1989. The survey data generally confirmed the theoretical explanation given by Agarwal (1980) that incentives play only a limited role, relative to other variables, in company decisions to locate FDI in Malawi. Both the fiscal and financial incentives offered to foreign investors play a limited role in investments in the country. The study revealed that Malawi does not have a



comprehensive incentive regime for each sector within the economy - the general incentives apply and investors in all sectors may apply to the government to be considered – this therefore refutes the hypothesis that the Malawi Investment Promotion Act (1991) offers a wide and attractive range of incentives to foreign investors. The current investment incentives do tend to favour new and Greenfield investments, thus putting existing operators at a disadvantage for re-investing. However, these incentives are unclear, as they are granted on a case-by-case basis, and this is not transparent or fair.

The incentives for any investment in Malawi are weak compared to those available in other regional countries, and thus result in the low amount of new investment and re-investment in Malawi. Most of the incentives laid out in the Act are currently unavailable, and are only granted at the discretion of individuals in the government. Even when incentives are granted to foreign firms, other arms of government, including the Malawi Revenue Authority (MRA) and the Ministry of Finance, often override them. Furthermore, the recent suspension of duty waivers has caused confusion among potential and actual investors without generating significant incremental revenue. This in turn has deterred investors and delayed investment in Malawi.

The results indicate that the process of investment in Malawi has been improved through the MIPA “one stop shop window”, but areas of concern still remain. The approval of incentives and then variations by other parts of government are reported to be problematic. Moreover, the value of the incentive is open to discretion by government and then not guaranteed once granted.

In addressing the second hypothesis, which regards the effect of investment incentives on the level of FDI to Malawi, an examination of the survey results reveals some correlation between the level of FDI inflows and the introduction of investment incentives. During 1993-2001, MIPA facilitated close to US\$188 million of FDI. From a low of US\$100 million in 1980, the stock of FDI reached US\$284 million by 1997 and averaged about 10% of GDP. This rise in FDI to Malawi concurred with the enactment of the Investment Promotion Act in 1991, and the establishment of MIPA in 1993. These figures seem to

suggest that the passing of the Investment Act contributed significantly to the increase in FDI flows to the country.

The same could be said with regards to the third hypothesis concerning the impact of FDI flows on the economic growth rate of the Malawian economy. The overall performance of the economy during the period 1990-2002 has been mixed due to external and internal shocks. The real GDP growth rate improved from an average of 1.9% in 1980-1989, to 4.1% in 1990-1999. Similarly, FDI inflows to Malawi rose during the period 1990-1999, and then fell drastically as GDP declined to from 4.1% to 0.8% in 2000. These figures indicate some correlation between the level of FDI in Malawi and real GDP per capita. However, although most empirical studies conclude that FDI contributes to economic growth in host countries, the survey results are consistent with an OECD Report (2002) which states that it is more difficult to assess the magnitude of this impact, not least because large FDI inflows to developing countries often concur with unusually high growth rates triggered by unrelated factors.

Although it can be said that the enactment of the Investment Promotion Act in 1991 and the numerous investment incentives offered may have had somewhat of a positive effect on the economic growth rate and FDI levels in Malawi, the results of the survey need to be viewed in the context of other events which occurred concurrently within the domestic economy. The 1990s saw the first multi-party elections held in Malawi. The introduction of a democratic government enhanced investor perceptions of the country, and spurred inward FDI flows to the country. There were many disputes surrounding the second multi-party elections in 1999 and the outcome. This adversely affected Malawi's image to foreign investors, and the country saw a steady decline in foreign investment figures. However, the political environment in Malawi has not been the only decisive factor in the country's inability to attract FDI. Provisional estimates from the National Statistics Office (NSO) suggest that the high real interest rates, which have made borrowing prohibitively expensive, have been the most significant factor in the slowdown of the economy, compounded by severe maize shortages. Another contributing factor was the withdrawal of significant IMF funding from the country, which has had severe

repercussions for the economy as a whole. In the same vein, the downturn in FDI flows in 2000 was also attributed to macroeconomic instability, unstable exchange rates, and high inflation rates, which deterred potential investors from entering the country.

The above findings support the theoretical proposition that, given all the factors that can impinge on investors' decisions, it is difficult at best to isolate the effects of just one factor, such as incentives, on the level of FDI inflows to Malawi, and the country's growth rate. However, it can be said that the current investment incentives available to foreign investors are not sufficiently attractive to make international investors select Malawi as a place for doing business.

#### **10.4 MALAWI'S INVESTMENT CLIMATE**

The quality of an enabling environment for investment – which affects a country's ability to attract FDI, and benefit from it – is equally important for investors. As the core FDI policies become more similar across countries as part of the global trend towards investment liberalization, factors such as trade policies and privatisation programmes gain more influence. Foreign investors are found to assess a country's investment climate not only in terms of its FDI policies, but also in terms of its macroeconomic policies. As a result, investment is flowing to countries with better domestic investment climates: good governance, sound institutions, and a stable macroeconomic environment.

As mentioned in Chapter V, the results of a survey conducted by UNCTAD for the *World Investment Report 1999*, revealed that Malawi was found to have a higher ranking for its progress on business environment than for its general attractiveness as a location for FDI. These findings support the proposition that, in respect of Malawi, removing restrictions on foreign investors may be a necessary condition for attracting private capital flows, but it is not a sufficient condition. Economic reforms can certainly act as a device signalling that the government is establishing a business-friendly environment. However, the empirical finding in Africa is that though (foreign) investors see the existence of a

programme with the IMF or World Bank as a sign of stability and intent to reform, they do not rank this as an important factor in investment decisions.

Results from the survey reveal that Malawi's poor macroeconomic conditions are the largest constraint to private sector investment and trade. High real interest rates, relatively high inflation, unpredictable exchange rates, and weak domestic demand, have had an adverse impact on the business community, and have directly deterred trade and investment.

*High real interest rates:* With commercial Kwacha borrowing rates at over 45% and real interest rates in excess of 30%, there are few business opportunities that can yield sufficient returns at these rates of interest. Effectively, the vast majority of businesses are unable to access finance for investment. There are some foreign firms that can borrow in hard currency, but this carries an additional cost especially as the risk premium for Malawi is relatively high, and such loans are susceptible to devaluation effects. The underlying problem is that much of the country's domestic resources are being absorbed by external debt payments. As of December 2002, the cost of servicing this debt now accounts for 24.7% of government expenditure and 4.5% of GDP.

*High inflation:* High inflation rates are a problem for businesses as they make pricing decisions more difficult and uncertain, due to fluctuating costs. The recent slowdown in inflation towards single figures is promising, though it has been a consequence of weak economic activity and high interest rates. The volatility of inflation rates is a major disincentive to investment as it makes returns more uncertain for foreign investors.

*Exchange rate instability:* Fluctuations in the exchange rate makes costing and pricing decisions more difficult and uncertain, because costs are unpredictable and constantly moving. Companies dependent on imports are severely affected as devaluations feed directly and rapidly into business costs. This is offset to some extent by export-oriented companies, but not wholly, and not at all for non-exporting businesses.

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*Weak domestic demand:* Economic theory cites national market size as an important traditional determinant of the location of FDI. With 85% of Malawi's population living in rural areas mostly on subsistence incomes, and limited growth in urban incomes, the domestic market is small and not contributing to growth for consumer-related goods and services. The overall negative growth rates of the last two fiscal years has resulted in shrinking average real incomes, thus further reducing opportunities for trade and investment. Malawi's weak domestic demand and small domestic market acts as a disincentive to potential investors.

Weaknesses in the legal and regulatory environment represent a constraint to investment and trade in Malawi. There are still cumbersome procedures when interacting with government and weak administration of these procedures, which leaves room for corruption. The survey results showed that corruption has a detrimental impact on businesses. According to the World Bank's Country Economic Memorandum (2003) high levels of corruption and lack of political will to combat corruption, are some of the main reasons for the slow economic growth in the country. Malawi has a reasonable institutional and legal infrastructure for addressing corruption through public education, prevention and enforcement. These institutions, however, suffer from lack of political support, low budgetary resources and a weak court system for effective prosecution of high profile cases.

With regards to investment, although MIPA serves to act as a "one stop shop window" for investors in Malawi, the results indicate otherwise. Minimal authority is awarded to the Agency and, in the absence of an Incentives Act, there is no specific set of criteria to judge who qualifies for incentives, which sectors are eligible for incentives, what incentives are available for investors, and how these incentives will be awarded. With an incoming investment, MIPA must get clearance from numerous departments and ministries, and ultimately it is found that self-interests play an important part in what investments are encouraged and allowed into Malawi.



Malawi's infrastructure to support businesses is weak, particularly in relation to transport and utilities. The economy suffers from a poor transport infrastructure, high costs of transportation, and unreliable and expensive utilities. These weaknesses contribute to the high costs of doing business in Malawi, and is then passed on to other businesses and consumers. It also impacts on Malawi's ability to export and compete internationally.

The above constraints which affect all businesses and which are resulting in low investment and growth in Malawi, need to be urgently addressed if Malawi is ever to become fully integrated into the global economy. There is overwhelming evidence which shows that the quality of the environment for investment in a country, is extremely important to investors. The survey results are consistent with Blomstrom (2001), who states that, rather than proposing narrowly defined FDI policies, attractive terms to investors should be seen as part of the country's overall industrial policy. If Malawi is to see any increase in its FDI inflows, an overall strategy is essential to restore macroeconomic conditions that are conducive to growth, to strengthen the legal and regulatory framework for doing business in the country, and improve the infrastructure that supports the economy. Only when the fundamental determinants are attractive enough for investment to be profitable, will investment incentives have any significant effect.



## CHAPTER XI

### RECOMMENDATIONS & CONCLUSION

#### 11.1 RECOMMENDATIONS

With FDI policy frameworks becoming more similar across countries, as a means of encouraging foreign investment flows, Malawi should focus on measures that facilitate investment – namely, improving its macroeconomic climate, boosting its investment promotion, re-examining its investment incentives, and improving its infrastructure.

An essential precondition for attracting FDI is an FDI-enabling environment. Economic theory has shown that economic conditions conducive to investment play an important role in investors' decisions for the location of FDI. Malawi needs to considerably improve its climate for doing business. At present, the business environment is regarded as hostile to investors, with high start up and production costs, expensive utilities, and bureaucratic procedures. Therefore, the government must ensure that its management of the economy will create the conditions that are conducive to the growth of investment and trade. This would involve a reduction in the cost of finance, maintaining stable prices, and managing exchange rates to avoid erratic fluctuations. Furthermore, Malawi's status as one of the most indebted countries in Africa, implies that huge debt-service payments reduce Malawi's capacity to invest in essential activities such as infrastructure building, without which the country cannot hope to achieve either global competitiveness or attractive foreign capital flows. A reduction in the debt-service burden and debt relief will go a long way in helping to achieve greater competitiveness, higher investment flows, and quicker growth.

Malawi requires a fundamental improvement in the infrastructure that enables businesses to operate efficiently, particularly with regards to transport infrastructure and utilities. Domestic resources need to be allocated for infrastructure development and the

government should ensure efficient management of the infrastructure investment. Privatisation of key utilities such as telecommunications and power generation will improve reliability and promote competition as a means of increasing efficiency.

With regards to the efforts that are required to attract FDI, Malawi first needs to look at companies that are already investing in the country: are they reinvesting their earnings? Could they invest more? Next, a study of the types of FDI entering other host countries with similar locational advantages should be conducted: why are they investing there and not in Malawi? Answers to such questions can provide valuable information on the effectiveness of the country's investment policy and procedures, and where their functioning can be improved. It is important that foreign investors are not favoured over local ones in granting incentives. Offering superior benefits to attract international capital is not only unfair to national businesses but may also encourage questionable joint ventures, in which foreign partners will be sought merely to qualify for incentives. Ideally, government policy should be non-discriminatory to domestic and foreign firms alike, in line with the principle of national treatment.

Steps must be taken to improve the incentives for investment in terms of their clarity. The general investment incentives need to be made substantially more attractive to encourage inward investment and re-investment. Furthermore, there needs to be specific incentives for the priority core and growth sub-sectors of the economy. It is important that the incentives offered should be affordable and do not support uneconomic industries or opportunistic ones. Targeting specific types of investors will help to take due account of overall national objectives for FDI (e.g. priorities for specific sectors such as manufacturing or textiles). For example, Malawi could target investors who seek to locate facilities in countries with special trade privileges to otherwise closed third-country markets, by positioning itself as a gateway to specific regional markets, by virtue of its membership in numerous regional trade blocs.

Administrative procedures and regulations need to be addressed. There has been increasing recognition that administrative procedures and the costs and delays associated

with them, can significantly influence the location of foreign firms. The existence of appropriate government institutions for FDI policy administration, coordination and problem resolution is an important ingredient of a country's investment climate. There is a conflict between the goals that the government wants to achieve, the incentives system through which these goals are being achieved, and MIPA, which is charged with implementing the incentives system. The level of administrative barriers in Malawi discourages foreign (and domestic) investors, and is positively correlated with corruption incidence (See **Annex 13**). This increases the transaction costs of investment and operations significantly. These correlations suggest that administrative reforms must be incorporated into the broader agenda of improving the investment climate in Malawi.

It is imperative that MIPA is given the appropriate authority with regards to the granting of incentives and approval of investments. Incentives need to be available as of right, and protected from revocation or overriding by other government departments. Moreover, the process of approval needs to be streamlined, more transparent, and certain to prevent the loss of investors. Moreover, before international efforts are made to attract new investors, MIPA should first establish a "service function" to help foreign investors who come to Malawi on their own initiative.

## **11.2 CONCLUSION**

Being ranked as one of the least developed countries in the world, it is imperative for Malawi to boost its economic growth. In light of the low domestic savings level and a fall in foreign assistance, FDI can be viewed as a major potential contributor to Malawi's growth and development, whilst also facilitating access to international markets.

This study attempted to identify the extent to which Malawi's investment incentives are attracting FDI to the country. The study examined the changes that have occurred in Malawi with regards to FDI, since the enactment of the Investment Promotion Act in 1991. Not only did this study serve to highlight the accomplishments that the Malawi government has made in recent years in respect to foreign direct investment, but also

aimed to identify those areas of weakness that need to be addressed in order to contribute the country's economic growth, and successfully integrate Malawi into the global economy.

Using Whiteside's study in 1989 as a framework to assess what progress has been made in Malawi, the results reveal that with regards to the overall investment climate in Malawi, there has not been much improvement in the 1990s. The country may have seen an increase in FDI flows during this period, but investors still encounter much of the same problems that were associated with investing in Malawi in the 1980s. Although the study aimed to assess the effectiveness of the Investment Promotion Act in Malawi and the incentives set out therein, the data collection and analysis revealed that it is difficult to isolate this factor to determine its effect on the levels of FDI and the growth rate of the country. Other important macroeconomic factors also play a decisive role as to whether or not foreign investors select Malawi as a location for FDI.

Nevertheless, there is evidence to suggest that investment incentives are a relatively minor factor in the levels of FDI achieved in Malawi. The structural weaknesses of the economy, the inefficiencies of the small market, and the poor macroeconomic environment, are all characteristics that depress the prospective profitability of investment. These factors also make it less worthwhile for potential international investors to incur the costs of a serious examination of local investment opportunities. At present, it is somewhat counterproductive and costly for the Malawi government to offer investment incentives, since the fundamental determinants of FDI fail to meet investors' basic requirements. For the incentives system to have any significant impact on investors' decisions to invest in Malawi, priority must be given by the Malawi government to improve its overall macroeconomic and investment environment. Only once these constraints on possible investment are addressed, will Malawi receive notable levels of FDI that can boost its economic growth rate and contribute to the overall economic development of the country.

### **Case Study: Shoprite Group of Companies: Experience in Malawi**

The Shoprite Group of Companies, Africa's largest food retailer, operates 634 corporate outlets and reported a turnover of R12,694 billion for the six months ended 31 December 2002 (twelve months to June 2002: R22 billion). The Company's head quarters are situated in the Western Cape province of South Africa, and the Group currently trades in 13 African countries, apart from its diverse interests throughout South Africa. The Group is currently implementing a strategic expansion program throughout Africa and on the adjoining islands to maintain its position as the leading food retailer on the continent.

Over the past nine years, Shoprite has expanded its thrust northward beyond South African borders. Currently, 95 outlets serve consumers in the 13 African countries outside of South Africa. In each of these countries (Egypt, Mauritius, Madagascar, Uganda, Zambia, Tanzania, Mozambique, Zimbabwe, Namibia, Lesotho, Swaziland, Botswana and Malawi) Shoprite has created world-class supermarkets. Shoprite's long-term aim is to increase the operating income from its non-South African operations to more than 50 percent of Group revenue. Expansion beyond the borders of South Africa is an essential development for Shoprite as the potential for more large supermarkets in the country has almost reached saturation point. The underdeveloped African retail environment offers a market with considerable growth potential and substantial rewards. Africa's GDP currently stands at US\$522 billion, of which SA contributes US\$112 billion, a clear indication of the significant potential these markets hold.

Shoprite entered Malawi in December 2001, and has now established branches in the main commercial towns, Lilongwe and Blantyre. The company's decision to invest in Malawi was based on its expansion strategy throughout Africa, and was not specifically due to the domestic investment climate.

At the outset, Shoprite was cautious with its investment, and start-up costs with respect to store fittings etc. were kept to a bare minimum, as there was still an element of uncertainty with regards to the profitability of its investment. The company's first store was opened in Blantyre. However, the store was a huge success, with sales of almost K12 million on the first day of its opening. Being the first foreign supermarket chain in Malawi, Shoprite offered consumers a wider range of goods at lower prices. Operating with profit margins of almost 200-300%, local competitors had to slash their prices. Previously, many of these stores stocked locally-made products of a low quality, and due to limited choice, consumers were compelled to purchase them. Shoprite's presence in the domestic market soon saw the closure of several government-owned retail chains, which were unable to match Shoprite's prices or high-quality products.

By December 2002, Shoprite Blantyre was one of the highest profit earners for Shoprite Holdings, with only a few South African outlets earning more. The company's success in Malawi was unanticipated, and Shoprite soon opened another branch in Lilongwe.



Shoprite's investment in Malawi was facilitated by the Malawi Investment Promotion Agency (MIPA). The investment by Shoprite in Malawi was a huge achievement for the Agency, as it marked the entrance of the first major South African retail chain in the market. However, MIPA came under huge criticism by various arms of government, which regarded the foreign firm as being a direct threat to local competitors. Overall, the company was satisfied with MIPA, in terms of its assistance, performance and services that were offered. However, Shoprite found that there was much red tape involved, with MIPA not having much decision-making authority in certain aspects of the investment process. The same was said about the policy environment in Malawi (i.e. economic policies pertaining to trade, commerce etc.), which the company found was not entirely conducive to investment and business development – there were many delays and certain restrictions on imports that made trading difficult. Furthermore, it was felt that more investment incentives need to be introduced in Malawi. With respect to license requirements on imports – although the Act specifies that there are no license requirements, this is not the case – Shoprite still has to obtain permits for a number of products, such as poultry and batteries.

The South African retail chain has been adversely affected by certain macroeconomic factors, namely, the high inflation rate and fluctuations in the exchange rate of the Kwacha. The company regarded the country's economic infrastructure as being unfavourable, in particular, the utilities available in Malawi.

Despite all the problems associated with operating in Malawi, the management of Shoprite Malawi rated the country's investment climate favourably in comparison to other African countries. Due to its success, Shoprite plans to continue to operate in Malawi in the long-term. As part of these plans, the company is now in the process of establishing the new "U Save" concept, of smaller convenience stores throughout the country.

When asked about the outlook for Malawi's investment climate, Svan Eckhoff, General Manager of Shoprite Malawi, stated that the negative publicity surrounding Malawi (i.e. unpredictable political environment, poverty), could be a deterrent to potential foreign investors...."however, Shoprite's success in Malawi may be a signal to potential investors that there are significant investment opportunities available in Malawi". In order to attract more investment, he added that "investment incentives need to be clearer, and that it is important that all parties involved understand the benefits of foreign investment to Malawi".

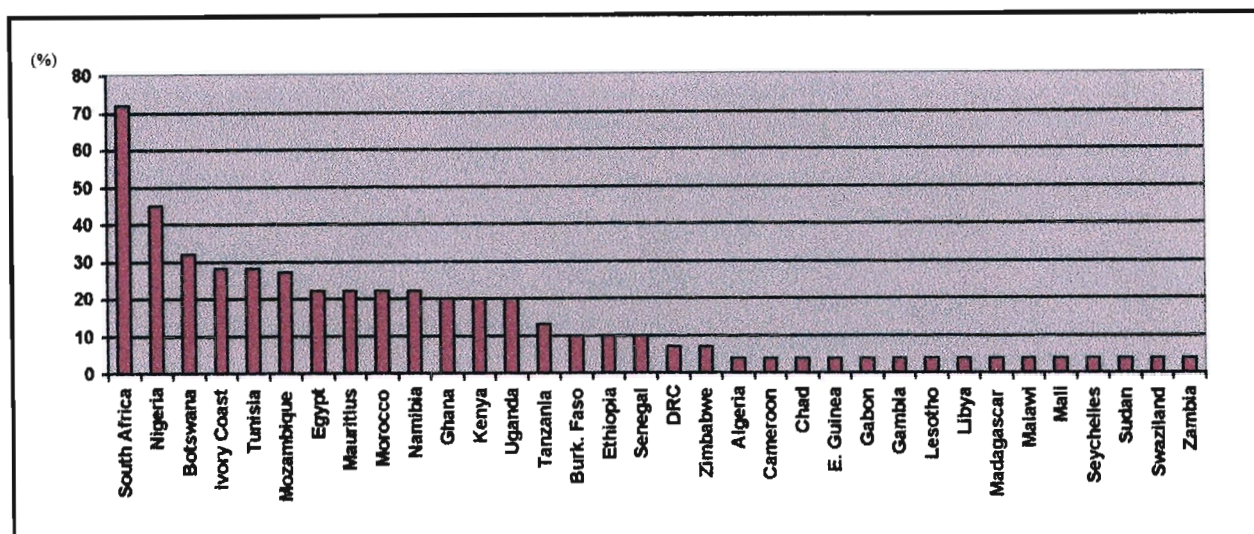


## APPENDIX

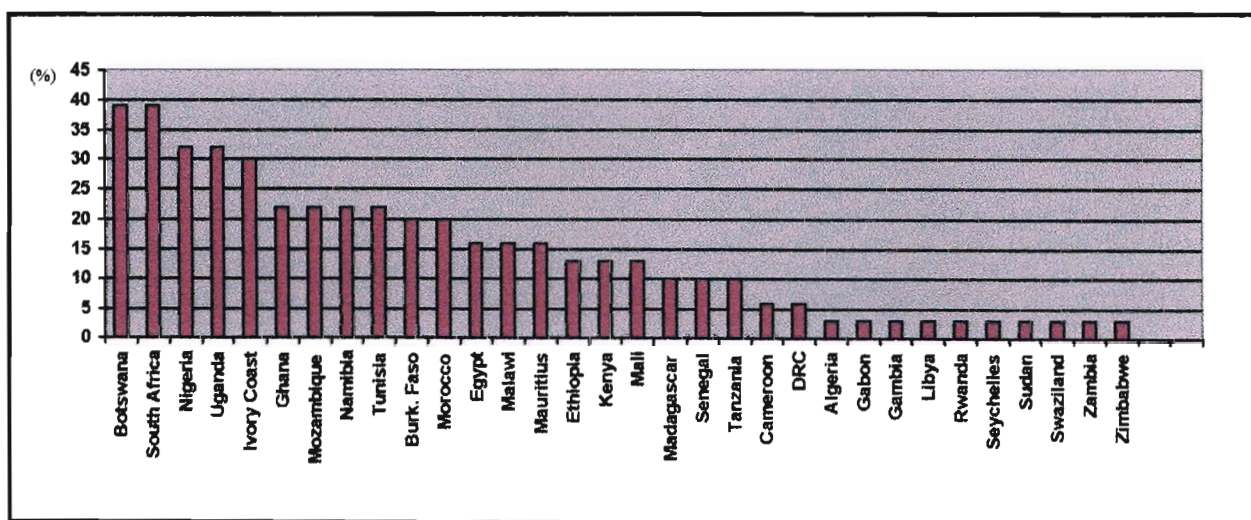
### BASIC DATA ON MALAWI

<b>Capital</b>	Lilongwe
<b>Surface area (2001)</b>	118.5 thousand sq. km
<b>Population</b>	2002 estimate: 10.4 million Annual growth rate (2002) : 1.8% Annual growth rate (2001) : 2.3%
<b>Life Expectancy (1998)</b>	38 years.
<b>GNI per capita</b>	US\$170
<b>Cities (1998) – population</b>	Lilongwe: 0.440 million Blantyre: 0.502 million Mzuzu: 0.086 million
<b>Currency exchange rate (June, 2003)</b>	US\$ 1.00 = MK 91.7236
<b>Value of Exports (Fob)</b>	US\$ 28,229.0 million (2001)
<b>Value of Imports (CIF)</b>	US\$ 38,013.3 million (2001)
<b>Visible Trade Balance</b>	US\$ -9,784.3 million (2001)
<b>External Debt</b>	US\$ 3,000.3 million (2001)
<b>Languages</b>	English and Chichewa

**Annex 1a: African Countries Ranked According to Their Attractiveness for FDI in 2000-2003 (Percentage)**



**Annex 1b: African Countries Ranked According to Their Progress in Creating a Business-Friendly Environment in 2000-2003**



Source: UNCTAD, based on results of an UNCTAD Survey of African investment promotion agencies, *World Investment Report*, 1999.

## Annex 2: Malawi – Competitiveness Index

Country	Competitiveness	Improvement (1992-1997)	Optimism (1997-1999)	Trading opportunity
Malawi	-0.43	10.39	12.60	4.33
Mauritius	0.87	13.0	11.27	6.02
Botswana	0.54	9.6	8.99	4.57
Namibia	0.43	10.02	6.99	5.19
South Africa	0.34	9.22	3.61	5.38
Zambia	-0.09	13.35	15.06	4.13
Tanzania	-0.24	20.03	20.55	4.8
Mozambique	-0.32	19.44	23.13	3.85
Zimbabwe	-0.4	18.37	9.55	4.8
<b>Maximum score</b>	<b>1</b>	<b>30</b>	<b>30</b>	<b>7</b>

Source: World Economic Forum, *The Africa Competitiveness Report*, 1998.

## Annex 3: Per Capita GDP and Population: Levels and Growth

Country	Per capita GDP (in 1999 dollars)		Annual average growth rates of per capita real GDP (%)		Population Level (millions)	Annual average growth rates of population (%)	
	1980	1999	1980-90	1990-99		1980-90	1990-99
Malawi	168	171	-1.8	2.6	10.6	4.4	1.3
All LDCs	284	288	-0.2	1.1	637.4	2.5	2.5
All developing countries	893	1,326	1.9	3.0	4,770.7	2.1	1.7
Developed market economy countries	18,491	26,692	2.5	1.6	889.5	0.7	0.6

Source: UNCTAD, *Least Developed Countries Report 2002*

#### Annex 4: GDP by Sector of Origin at 1994 Factor Cost (K' million)

Sector	1999	2000	2001
<b>Agriculture</b>	<b>4,943.8</b>	<b>5,210.0</b>	<b>5,266.6</b>
Small-scale	3,992.4	4,058.8	4,288.2
Large-scale	951.4	1,151.1	978.4
<b>Manufacturing</b>	<b>1,748.6</b>	<b>1,695.9</b>	<b>1,455.7</b>
<b>Mining and Quarrying</b>	<b>169.6</b>	<b>187.9</b>	<b>206.1</b>
<b>Electricity &amp; Water</b>	<b>171.5</b>	<b>189.0</b>	<b>182.3</b>
<b>Construction</b>	<b>293.4</b>	<b>287.9</b>	<b>267.7</b>
<b>Distribution</b>	<b>2,765.5</b>	<b>2,758.9</b>	<b>2,706.5</b>
<b>Transport &amp; Communication</b>	<b>575.5</b>	<b>552.1</b>	<b>576.3</b>
<b>Financial/Professional Services</b>	<b>1,032.5</b>	<b>1,053.7</b>	<b>1,252.6</b>
<b>Ownership of Dwellings</b>	<b>179.9</b>	<b>184.6</b>	<b>1,005.7</b>
<b>Private &amp; Social Services</b>	<b>263.9</b>	<b>271.2</b>	<b>279.0</b>
<b>Government Services</b>	<b>1,257.0</b>	<b>1,282.0</b>	<b>1,305.1</b>
<b>Unallocatable finance charges</b>	<b>-378.4</b>	<b>-387.4</b>	<b>-360.0</b>
<b>TOTAL GDP</b>	<b>13,023.2</b>	<b>13,286.4</b>	<b>13,080.7</b>

Source: Malawi Economic Report, 2002

#### Annex 5: FDI Equity Liabilities by Source and Sector

Source	Sector	US\$ million	
		Dec 31. 1999	Dec 31. 2000
<b>United Kingdom</b>	Agriculture, hunting & forestry	29.0	20.4
	Manufacturing	25.6	16.6
	Distribution	11.3	12.2
	Financial intermediation	14.7	9.4
	Other	2.7	1.6
	<i>Sub-total</i>	<i>83.3</i>	<i>60.2</i>
<b>USA</b>	Manufacturing	40.4	39.0
	Distribution	15.4	10.1
	Other	0.2	1.0
	<i>Sub-total</i>	<i>56.0</i>	<i>50.2</i>
<b>South Africa</b>	Manufacturing	45.6	26.8
	Distribution	9.1	6.8
	Financial intermediation	1.5	1.8
	Other	1.0	0.5
	<i>Sub-total</i>	<i>57.2</i>	<i>35.8</i>
<b>Other countries</b>		48.6	42.5
<b>All countries</b>		<b>245.1</b>	<b>188.7</b>

Source: Reserve Bank of Malawi and MIPA, Private Capital Stocks Survey, 2002.



**Annex 6: FDI Equity Liabilities for Malawi by Region (US\$ million)**

Region	Dec 31, 1999	Dec 31, 2000
North	1.8	1.0
Central	57.8	58.4
South	185.4	129.2
<b>Total</b>	<b>245.1</b>	<b>188.7</b>

Source: Reserve Bank of Malawi and MIPA, *Private Capital Stocks Survey*, 2002.

**Annex 7: Profitability of Investment by Region in 2000 (US\$ million)**

	North	Central	South	Total
Total net profit earned	1.0	14.3	37.5	<b>52.7</b>
Dividends remitted to all shareholders	0.3	8.7	22.0	<b>31.0</b>
Total retained earnings	0.8	5.5	15.5	<b>21.8</b>
Retained earnings attributable to FDI	0.8	2.4	9.5	<b>12.6</b>

Source: Reserve Bank of Malawi and MIPA, *Private Capital Stocks Survey*, 2002

**Annex 8: Malawi – Long-term Debt: Debt Outstanding and Debt Service**

Year	Debt Outstanding		Debt Service	
	Amount (US\$ m)	% of GNP	Amount (US\$ m)	% of Exports
1975	279	44.9	20	9.5
1980	746	65.6	69	22
1985	1021	94.6	-----	40
1990	1487	82	111	25
1991	1619	76	102	19
1992	1661	91	93	21
1993	1826	92	73	21
1994	2127	172	69	18
1995	2242	156	-----	-----
1996	2312	105	-----	-----
1997	2287	104	89	12.4
1998	2507	-----	-----	-----

Source: UNCTAD, *Handbook of International Trade and Development Statistics*, 1998.

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## **Annex 9: Extract from the Malawi Investment Promotion Act 1991**

(For details of the complete Act see [www.tradeport.com](http://www.tradeport.com))

### **PART III - The Malawi Investment Promotion Agency**

#### **Establishment of the Agency**

5. There is hereby established a body to be known as the Malawi Investment Promotion Agency (in this Act otherwise referred to as the "Agency") which shall be a body corporate by the name, having perpetual succession and a common seal and which shall, by that name, be capable of suing and being sued and of acquiring, holding and alienating moveable or immovable property and, subject to the provisions of the Act, of doing or performing all such acts or things as bodies corporate may by law do or perform.

#### **General authority of the Agency**

6. In addition to any other powers, duties and functions conferred on the Agency by or under this Act, it shall be the principal object of the Agency to ensure the giving of practical and prompt effect to the commitment of the Government on investment in Malawi as declared in the Statement of Investment Policies and the Investors Guide and, for that purpose, the Agency shall have power--

(a) to receive queries and complaints by, or on behalf of, an investor against any public officer or any authority in dealing with any matter submitted to the public officer or to the authority by, or on behalf of, the investor:

(b) to summon or call upon any public officer or any authority to promptly decide, in accordance with the relevant written law, on any matter submitted to the public officer or authority by, or on behalf of, an investor and to communicate the decision to the investor or to show cause, satisfactory to the Agency, why a decision on the matter cannot be promptly made or communicated to the investor, and further to request for an indication as to when a decision or the communication will be made;

(c) to inquire into the reasons for any negative decision by any public officer or any authority on any matter submitted by, or on behalf of, an investor to the public officer or authority and, where the Agency is not satisfied with the reasons given, to make representations to the public officer or authority or to the appropriate Minister on behalf of the affected investor;



(d) to report to the Minister cases of inefficiency, laxity and ineptitude by any public officer or any authority in the exercise of his or its powers or the performance of his or its duties and functions bearing upon the purposes and objects of this Act, the Statement of Investment Policies or the Investors Guide; and

(e) to do all such things as the Agency considers to be necessary for its objectives and functions and conducive to the fulfillment of the purposes of this Act, the Statement and the Investors Guide.

#### **PART IV - Objectives and Functions of the Agency**

##### **General objectives and functions of the Agency**

8. (1) The general objective of the Agency shall be to promote, attract, encourage and facilitate local and foreign investment in Malawi and, without prejudice to the generality of that objective, the Agency shall have the following functions--

(a) to facilitate all aspects of the investment process in Malawi including, but not limited to, the timely receipt of Government approvals, permits, licenses, registrations and the fulfillment of any other regulatory authorizations;

(b) to provide courtesy services to investors;

(c) to provide information relating to investment in Malawi;

(d) to identify partners in or outside Malawi for joint venture business opportunities in Malawi;

(e) to liaise and generally interact with local and international financial institutions for the benefit of investors;

(f) encourage expansions and new investments by existing investors in Malawi;

(g) to develop a favourable investment image of Malawi regionally and outside the region;

(h) to undertake investment promotion missions within the region and outside the region;

(i) to recommend to the Government changes in the statutory and administrative framework relevant to the investment climate of Malawi and to make representations against or regarding any changes to any such statutory or administrative framework; and

(j) to consult with private sector entities with a view to enabling the Agency to make recommendations to the Government for the improvement of the investment climate of Malawi.

(2) For purposes of this Act, the Agency shall accord priority to investment in-

(a) manufacturing;

(b) agriculture;

(c) mining;

(d) fisheries;

(e) tourism; and

(f) such other productive sectors as the Agency may, from time to time, determine with the approval of the Minister.

### **Statement of Investment Policies**

1. This policy statement sets forth the Malawi Government's principal policies for encouraging and assisting private investment. The Government is fully committed to enacting these policies and will take whatever measures may be necessary to ensure their prompt implementation. This statement is supplemented by the Investors Guide containing detailed information of importance to investors.

2. The Government seeks to encourage the private sector to assume the leading role in developing the national economy. The thrust of the Government's efforts will be to facilitate, rather than to regulate, private investment. This is consistent with the Statement of Development Policies issued by the Government in 1987.

3. To create a more conducive investment climate, the Government will continue to pursue stable macro-economic policies by exercising fiscal and monetary discipline and maintaining a realistic exchange rate of Malawi Kwacha (MK), the country's currency. Specific measures to deregulate the private sector and create new investment opportunities have already been enacted, including elimination of price controls, termination of import restrictions and of the accompanying need import licences, divestiture of state-owned companies and steps to rectify the external transport situation.

4. To further encourage and assist private investment, the Government announces the following new initiatives:

### **Freedom to Invest**

5. Investors, both domestic and foreign, may invest in any sector of the economy, with no restriction on ownership. Further there are no restrictions on the size of investment, the source of funds or whether products are destined for export or for the domestic market. Domestic investors are encouraged to join with foreign investors to pursue investment opportunities in Malawi.

### **Industrial Licensing and Company Formation**

6. The industrial licence is to be eliminated, except for investments in such industries as the Government may place on a short negative list. Procedures for company formation and business registration will be simplified to permit prompt establishment. Investors will only be required to provide the Registrar of Companies with basic information on proposed business activities.

### **Transfer of Land**

7. The Government is committed to ensure that land for industrial and commercial uses is readily available to investors. Accordingly, the Government will accelerate land transfer procedures to expedite granting approvals and consents. To better provide serviced land to investors, the Government will develop new industrial sites. In addition, the Government will provide the necessary framework to enable private investors to develop industrial sites, including sub-leasing to other investors.

### **Taxes And Duties**

8. To further enhance Malawi's investment climate and international competitiveness, the Government is committed to continue the process of reducing rate of taxes and duties. This is to be achieved throughout the ongoing tax and trade reform programmes.

### **External Transport Routes**

9. The Government is aware that access to efficient and secure transport routes, both within the country and to foreign markets, is of vital importance. To ensure such access, the Government is undertaking a number of initiatives, including the expansion of the domestic transportation network, the development of the Northern Corridor route to the port of Dar-es-Salaam in Tanzania and the rehabilitation of the Nacala Railway Line to the port of Nacala in Mozambique.

### **Availability**

10. The Government recognizes that the availability of foreign exchange is critical to investors. The Government will, therefore, ensure that foreign exchange is available for business transactions and remittances. The Reserve Bank of Malawi has granted, and will continue to grant, commercial banks the authority, as foreign exchange dealers, to approve such transactions and remittances according to set procedures.

### **Labour Practices**

12. The Government has embarked on a reform programme to modernize and liberalize the financial sector. With the enactment of the Capital Market Development Act, 1990, both foreign and domestic investors will have greater access to sources of local financing. The Government is committed to foster competition in the banking sector, including the establishment of new banking institutions.

### **Encouragement of Small-scale and Medium-scale Enterprises**

13. Malawi's small-scale and medium-scale enterprises hold great potential for rapid economic growth and employment creation. The Government is, therefore, dedicated to continuing with various programmes to assist these enterprises, including entrepreneurship training and technical and financial assistance.

### **Encouragement of Export-Oriented Investments**

14. To encourage export-oriented investments, the Government will offer incentives competitive to those found in other countries. At present, these incentives include-

- . an income tax allowance based on export sales of non-traditional products (i.e. products other than tobacco, tea, sugar and coffee);
- . rebates of import duties, surtaxes, and local taxes on most inputs used in production for export.

15. In addition, the Government is considering establishing other incentives, including export financing and guarantee schemes. Further developing a manufacturing-in-bond programme, creating export processing zones, and introducing measures to eliminate the payment of duties at the time of importation.

## **Investment Assistance and Promotion**

### **16. Investment Protection**

17. The Government recognizes that the security of assets is of primary importance to investors. The Malawi Constitution and existing laws and regulations provide further assurance that investors' assets are protected. In addition, the Government will actively pursue the process of concluding bilateral investment treaties with other Governments. Malawi is also a member of the Multilateral Investment Guarantee Agency (MIGA), and is an eligible country under a number of other investment insurance programmes.

### **Access To International Arbitration**

18. The Government acknowledges that investors must have an acceptable forum to resolve disputes that cannot be settled amicably. Parties to disputes may agree to pursue arbitration and to choose an appropriate forum, including international arbitration. The Government is a member of the International Centre for the Settlement of Investment Disputes (ICSID).

## **Annex 10: MALAWI'S INVESTMENT CLIMATE STATEMENT**

### **Openness to Foreign Investment**

The Government encourages both domestic and foreign investment in most sectors of the economy, without restrictions on ownership, size of investment, source of funds, and destination of final product. Currently, there are no explicit laws/rules on acquisitions, mergers and takeovers, but such laws may be introduced in the future to discourage private monopolies that may arise from Malawi's privatisation of public monopolies. Once introduced, the rules are likely to apply to both domestic and foreign investors.

There is no screening of foreign investment in Malawi. Because industrial licensing in Malawi applies to both domestic and foreign investment, and is only restricted to a short list of products, it does not impede investment, limit competition, protect domestic interests, or discriminate against foreign investors at an stage of investment. Restrictions are based on environmental, health, and national security concerns. Affected items are firearms; ammunition and chemical and biological weapons; explosives; and manufacturing involving hazardous waste treatment/disposal or radioactive material. All regulations affecting trade (foreign exchange, taxes etc.) apply equally to both domestic and foreign investors.

All investors, irrespective of ethnic group or source of capital (foreign or local) may participate in the privatisation programme. However, nationals are offered preferential treatment e.g. discounted share prices and access to subsidized credit. These concessions carry a precondition that the shares or assets be retained for at least two years.

### **Right to Private Ownership and Establishment**

The Government encourages both domestic and foreign investors to establish and own business enterprises in most sectors of the economy. All investors have the right to establish, acquire, and dispose of interests in business enterprises. Public enterprises compete equally with private entities with respect to access to markets, credit and other business operations.



### **Protection of Property Rights**

Both foreign and domestic investors have access to Malawi's legal system, which functions fairly well, albeit slowly, and is non-discriminatory. It governs the acquisition, disposition, recording and protection of property rights (land, buildings etc.) as well as intellectual property rights (copyrights, trademarks, and patents etc.). The Government has signed and adheres to bilateral and multilateral investment guarantee treaties and key agreements on intellectual property rights.

Malawi is a member of the Convention Establishing the Multilateral Investment Guarantee Agency, the World Intellectual Property Organisation (WIPO), the Berne Convention, and the Universal Copyright Convention. The Copyright Society of Malawi administers the Copyright Act which protects copyright and "neighbouring" rights in Malawi. The Registrar General administers the Patent and Trademarks Act which protects industrial intellectual property rights in Malawi.

### **Performance Requirements/Incentives**

In general, there are no performance requirements for establishing, maintaining, or expanding an investment. No requirements are placed on ownership, source of financing, or geographical location. However, while both local and foreign investors are eligible for EPZ status, it is limited to companies producing exclusively for export.

Foreign investors are generally treated on a national treatment basis. US and other foreign firms are able to participate in government/donor-financed and/or subsidized research and development programmes. The following information is required to register and incorporate an investment or company: name of company, authorized share capital, registered office, location of books of accounts, address of the company secretary, and names of directors and shareholders.

Visas do not inhibit foreign investors, but employment permits do. Under the Immigration Act, foreign nationals who work or invest in Malawi must have either a visitor's permit, business visitor's permit, temporary residence permit, temporary employment permit (TEP), or a business residence permit. TEPs have become a major

impediment to foreign investment. The processing is slow and inconsistent, and the government's long-standing commitment to streamline the process has yet to produce noticeable results. TEPs are not issued if the government determines local expertise is available. Private companies can claim that qualified Malawians are not available to fill all the positions for which the Government has denied TEPs.

### **Investment Guarantees**

As a further protection for foreign investments and the settlement of investment disputes, Malawi is a signatory to several international treaties. These include:

- International Centre for Settlement of Investment Disputes (ICSID);
- Multilateral Investment Guarantee Agency (MIGA); and
- Bilateral Investment Protection and Promotion Agreements with several countries including Malaysia, the Republic of China and Mauritius.

### **Transparency of the Regulatory System**

Malawi's industrial and trade reform program – including rationalization of the tax system, liberalization of the foreign exchange regime, and elimination of trade and industrial licenses on several items and businesses – has produced written policies intended to increase government use of transparent and effective policies to foster competition and establish clear rules. However, procedural delays, red tape, and corrupt practices continue to impede the business and investment approval process. These include decision-making which is often neither transparent nor based purely on merit; land access approvals; and slow and arbitrary processing of expatriate work permits. While the government encourages investment in most sectors of the economy, there are no indications that it will relinquish its monopoly hold on telecommunications.

### **Corruption**

There are serious but unproven allegations of corruption, particularly in official circles. The Corrupt Practices Act provides the legal framework for combating corruption in Malawi, but has not yet been used to counter corruption.

The long-awaited Anti-Corruption Bureau, first promised in 1994, finally became operational in February 1997. It is constitutionally mandated to investigate and prosecute corruption. Given widespread disappointment that the Bureau has been slow in materializing, the government must prove that the Bureau will operate efficiently and transparently. Investigations must be completed; cases referred to court must be prosecuted in a timely manner; and, judicial decisions must be handed down expeditiously.

Malawi's Penal Code does not sanction bribery. According to Section 90, giving or receiving a bribe – whether to or from a Malawian or foreign official – is a crime. A bribe to a foreign official cannot be deducted from taxes. Bribery, however, is not uncommon.

### **Labour**

The Government of Malawi estimates that more than half of the population is of working age. Unskilled labour is plentiful, but skilled labour is scarce. Occupational categories with skills shortages include accountants and related personnel; economists; engineers; primary school teachers; and medical and health personnel. The University of Malawi provides Bachelors and Masters degrees in economics, engineering, medicine, education, agriculture, and administration.

As of June 1997, the Labour Relations Act (LRA) of 1996 had not entered into force. Thus, labour issues continued to be governed by an antiquated hodgepodge of legislation and regulations. As democracy and trade union rights have only existed for a few years, industrial relations are still evolving. Unionization is not widespread but is increasing.

### **Financial System**

Malawi's banking sector is overseen by its central bank, the Reserve Bank of Malawi (RBM). The RBM, which has been existence since independence, is responsible for implementing monetary policy, safeguarding the value of the national currency, registering new entrants into the financial sector, and modifying and improving the

regulatory framework. The Central Bank and the treasury consult on a regular basis with respect to the formulation of monetary policy.

There are four full-service commercial banks: the long-established National Bank of Malawi (NBM) and Commercial Bank of Malawi (CBM), which operate countrywide and are the dominant players in the market; and two banks established in 1995: the first Merchant Bank Limited and Finance Bank of Malawi. These banks offer a conventional range of services including cheque accounts, registration of foreign capital with the Reserve Bank, short and medium-term credit facilities, trade financing, foreign remittances, export credit guarantees, and the repatriation of capital.

The finance sector has other institutions co-owned by local and foreign investors, which were created with the aim of providing medium to long-term financing. These include: The Investment and Development Bank of Malawi (INDEBANK), Investment Development Fund of Malawi (INDEFUND), Leasing and Finance Company of Malawi (LFC), Malawi Savings Bank, The New Building Society (NBS), the Malawi Rural Finance Company (MRFC), and the Malawi Development Corporation (MDC).

According to the U.S. Department of State, "The Malawi government and the conglomerate Press Corporation Limited (PCL), in which the government holds a 49% stake, dominate the ownership of the Malawi banking sector." The government exercises a great deal of control over the financial system. According to the Economist Intelligence Unit, "Much bank lending is to the government and parastatals, usually on a short-term basis; there is little lending to private individuals." A foreign presence is allowed; for example, a subsidiary of a Mauritian bank opened in Malawi in 1999, and the Finance Corporation of Malawi (FINCOM), is partly owned by the South African bank, Nedbank. A U.S. investor, along with two Malawian companies, purchased over 60 percent of the National Insurance Company of Malawi (NICO) in 2000.

The Company's Act, the Capital Market Development Act (1990), and the Capital Market Development Regulations (1992), provide the legislative and regulatory framework for the encouragement and facilitation of portfolio investment in Malawi.

The Malawi Stock Exchange was established in 1994. Stockbrokers Malawi Limited (SML) is the only registered stockbroker in Malawi. SML has run a secondary market in government securities since March 1995. Both local and foreign investors have equal

access to purchasing these securities. SML also began trading shares of companies towards the end of 1996, following the listing of shares of the national Insurance Company of Malawi (NICO). Blantyre Hotels Limited (BHL) was the second company to list on the MSE. Through the SADC Stock Exchanges Cooperation Initiative, Malawi and other SADC markets are taking steps to harmonize listing requirements.

### **Conversion and Transfer Policies**

There are no restrictions on remittance of foreign investment funds (including capital, profits, loan repayments and lease repayments), as long as the capital and loans were obtained from foreign sources and registered with the Reserve Bank of Malawi (RBM). The terms and conditions of international loans, management contracts, licensing, royalty arrangements and similar transfers, require initial RBM approval. RBM grants initial approvals according to prevailing international standards; subsequent remittances do not require further RBM approval. All commercial banks are authorized by the RBM to approve remittances, and approvals are fairly automatic as long as the applicant's accounts have been audited and sufficient foreign exchange is available.

### **Expropriation and Compensation**

Malawi's Constitution prohibits deprivation of an individual's property without due compensation. There are also effective laws that protect both local and foreign investment. Since the repeal of the Forfeiture Act in 1992, there have not been any expropriatory actions, and the likelihood of such actions is extremely remote.

According to the land Acquisition Act (1971), the Government must justify its acquisition of land as being in the public interest and must pay fair market value for the land. Fair market value is assessed by adding the amount the owner originally paid for the land; the value of permanent improvements that increase the productive capacity, utility or amenity of the land; and any appreciation of the land value. If the private landowner objects to the level of compensation, s/he may obtain an independent assessment of the land value. However, according to the Act, such cases may not be challenged in court – the Ministry remains the final judge.



### **Dispute Settlement**

Malawi has a fairly independent but overburdened judiciary system which derives its procedures from English Common Law. There is generally no government interference in the court system. However, the US State Department reports that “although not part of the formal judicial system, traditional authorities often mediate in disputes/legal matters at the village level. Credible allegations of political interference in court cases occasionally arise.”

There have also been unproven but more frequent allegations of bribery in civil and criminal cases. It is commonly accepted that administration of the courts is weak, and due process can be very slow. The court system in Malawi accepts and enforces foreign court judgements, provided that these judgements are registered in accordance with legal procedure.

Malawi has legislation that offers adequate protection for property and contractual rights. Malawi has written commercial laws which codify common law. The Sale of Goods Act and the Hire-Purchase Act cover commercial practices. These laws have been consistently applied, and there is a track record of cases involving commercial law. There is also a written and consistently applied bankruptcy law based on common law. Under bankruptcy law, secured creditors – which are ranked depending on registration of their investments - have first priority in recovering money. Monetary judgements are usually made in the investor’s currency. However, the currency in which monetary judgements are made is less relevant now that the foreign exchange system has been significantly liberalized.

### **Political Violence**

Malawians are generally peaceful, and Malawi has been largely free of political violence since independence in 1964. The peaceful political reforms since 1992 have acted to enhance confidence in Malawi as an investment location. With the exception of the Malawi Army’s disarming of the paramilitary Malawi Young Pioneers, incidents of



violence during and after the 1993 referendum and 1994 elections were rare and minor in nature.

There are no nascent insurrections, belligerent neighbours or other politically motivated activities of major concern to investors.

### **Foreign Trade**

Malawi's central location makes it an important trade centre in the region of central and southern Africa, and it has strong existing links with regional and overseas trading partners.

### **Annex 11: Investment Incentives Offered in Malawi**

**General investment incentives** laid out in the Investment Promotion Act, include:

- A corporate tax rate of 38%;
- The following tax allowances:
  - 40% allowance for new buildings and machinery;
  - An additional 15% allowance for investments in designated areas;
  - Up to 20% for used buildings and machinery; and
  - 50% allowance for qualifying training costs;
- 100% deduction for manufacturing company operating expenses in the first 2 years.
- Duty-free importation of heavy commercial vehicles with capacity of 10 tonnes or more;
- No withholding tax on dividends;
- Duty-free importation of raw materials for the manufacturing industries;
- Tax holidays or reduced corporate tax for new investments; and
- A maximum import tariff rate of 35%;
- Indefinite loss carry forward to allow companies to take full advantage of tax allowances;
- New investments between US\$5 million and US\$10 million are given an option of paying 15% corporate tax indefinitely or five-year tax holiday, while those in

excess of US\$10 million are given an option of paying 15% corporate tax indefinitely or ten-year tax holiday.

**Fiscal incentives:** Investors have free access to foreign exchange in Malawi, both for paying for imports and transferring financial payments abroad. This free access includes:

- No licensing requirements for importing foreign exchange;
- Full repatriation of profits, dividends, investment capital and interest and principal payments for international loans;
- Local and foreign investors have unrestricted access to local financing facilities; and
- Interest rates are market-based and there are no direct government controls on credit.

**Export incentives:** An important aspect of the Investment Promotion Act was the establishment of procedures for setting up Export Processing Zones (EPZs) in 1995.

Incentives for establishing operations in an EPZ include:

- No corporate tax, value added tax, or withholding tax on dividends;
- No import duty on capital equipment and raw materials; and
- No excise taxes on purchases of raw materials and packaging materials made in Malawi; and
- Transport tax allowance of 25% for international transport costs.

For industries manufacturing in bond, incentives include:

- An allowance of 12% of export revenues for products other than tobacco, tea, sugar and coffee;
- Transport tax allowance of 25% of all international transport costs;
- No import duties on capital equipment, raw materials, and packaging material;
- No excise tax on local purchases of raw materials and packaging material;
- No value-added taxes;

- Timely refund of all duties (duty drawback) on imports of raw materials and packaging materials; and

Exporters of horticultural products receive 100% duty-free importation of equipment and raw materials.

## Annex 12a: Interview with Aretha Kamwendo - Publicist at MIPA

*What is the complete array of incentive instruments used to attract and channel FDI activities?*

Malawi has not developed a comprehensive incentive regime for each sector. The general incentives apply and investors in all sectors may apply to government to be considered.

*Has there been a proliferation of incentives recently?*

No.

*Are any incentives redundant? For example, countries offering tax holidays sometimes also have in place programmes for accelerated depreciation, which are ineffective when applied during the tax-holiday period.*

No, but government has suspended the granting of duty waivers to investors.

*What have been the results obtained from the use of incentives and at what cost for Malawi?*

Incentives have greatly reduced the operational costs and start up costs of doing business in Malawi. You may wish to know that apart from cheap labour, other costs of doing business (such as transport costs, utilities i.e. water, telephones, electricity) are expensive and sometimes not reliable and push up production costs. Incentives, therefore, enable investors to reduce their operational costs.

*Are incentives superfluous in the sense that they are being offered to foreign investors that would have made the investment without them?*

No, both foreign and local investors may access incentives. The Malawi government decides which sectors to promote and those sectors are given special incentives to attract investors both local and foreign.

*Are the various incentive instruments coordinated to achieve the desired impact at the least financial and administrative cost?*

To some extent. Although investors come to MIPA to access incentives, it is not MIPA that grants them. At least all known governments that promote FDI do have an Incentives Act. This stipulates which sectors are eligible, who gets them, how they can access such incentives, and the time limit involved. In Malawi, such a thing is not yet available, and it is still in the bill form awaiting Cabinet approval. Currently, the Minister of Finance makes the final decision to grant incentives to investors, although prior approval may be given by MIPA. In the absence of an Incentives Act, there is therefore a need for government to produce a set of criteria which will show who qualifies for incentives, which sectors are eligible for incentives, what incentives are available for investors, and how these incentives will be awarded.

*What are the administrative and other problems in implementing the incentives?*

The fact that MIPA may approve and not grant the incentives, or force the Malawi Revenue Authority to enforce the decision, is a problem. Some incentives are not clear, as such incentives are treated on a case by case basis and this is not fair and transparent for investors.

*Can some incentive instruments be eliminated, or a ceiling be placed on them, with no overall loss in the effectiveness of the incentives programme?*

It is difficult to say as thorough studies have not been done.

*Have countries that are viewed as direct competitors for FDI been increasing or reducing their incentive levels?*

The issue is about offering better incentives in relation to the overall investment climate. If the climate is good (i.e. a stable economy, low interest rates, good infrastructure, low transport costs, and a good/large domestic market) incentives may not be crucial since investors would still be able to make a profit. In the case of Malawi, the business environment is hostile for investors, hence, incentives are used mainly to help companies

reduce the cost of production. The nature of incentives offered by Malawi's competitors is sometimes different because the economies are different and the sectors being promoted are different. For example, Lesotho is able to offer investors free factory shells, whilst Malawi doesn't have that kind of infrastructure.



## **Annex 12b: Interview with Chancellor L. Kaferapanjira – Chief Executive, Malawi Confederation of Chambers of Commerce & Industry**

Mr. Kaferapanjira worked with MIPA from 1993 until December 1999. He worked at MIPA from the time it was established, and the Investment Promotion Act was enacted.

*Could you give me some information as to how MIPA and the Investment Promotion Act (1991) came into being?*

The integration of Malawi into the global economy began with colonialism just before the turn of the century. After independence, this relationship continued under numerous voluntary arrangements, such as the Lomé Convention.

The civil war in Mozambique during the 1980s heightened the need for the liberalization of Malawi's external sector through various structural adjustment programmes. Malawi has been engaged in extensive liberalization and reform programmes, embracing market-oriented economic policies with an export-oriented approach. Since the early 1990s, economic reforms aimed at, among other things, attracting foreign direct investment, have been implemented.

Following recommendations by the World Bank, the Malawi Investment Promotion Agency (MIPA) was established in 1991 to promote foreign investment into Malawi. The Investment Promotion Act was enacted in 1991, and came into full operation in 1993. The Act demonstrated Malawi's commitment to attracting foreign investment, and eliminated the need for general investment licenses.

MIPA was officially opened in September 1993, and serves to act as a "one stop shop window" for both domestic and foreign investors. MIPA is responsible for facilitating the investment process, providing investment-related information, making suggestions to government on how to improve the investment climate, and marketing Malawi (both regionally and abroad) as a favourable location for investment.

The services MIPA provides to investors include:

- Facilitating all aspects of the investment process in Malawi.
- Providing courtesy services to investors.

- Furnishing information relating to investment in Malawi.
- Identifying partners in or outside Malawi for joint venture business opportunities.
- Working with local and international financial institutions for the benefit of investors
- Consulting with private sector organizations so that better informed recommendations concerning the investment climate can be made.

*How much progress has the Malawi Investment Promotion Agency made since its establishment, in terms of foreign investment flows to the country? Has there been a notable increase in investment?*

Since Malawi gained its independence, there were virtually no new foreign investments into the country. Most the foreign companies that were established had been operating in the country during colonialism. Many of the companies that were present in Malawi, had strong ties and relationships with the previous president, Kamuzu Banda, for example, Lonrho.

Since the establishment of MIPA, lots of progress has been made with regards to foreign investment in Malawi. For example, in 1993, FDI inflows into Malawi were recorded as US\$9 million; whereas by 1995, the figure stood at US\$25 million.

*What would you say were the main factors that contributed to this increase in FDI flows to Malawi?*

The first multi-party elections were held in Malawi in 1994. The introduction of a democratic government enhanced investor perceptions of the country, and spurred inward FDI flows to the country.

*Has this upward trend in foreign investment continued since then? If not, why?*

No. Malawi has seen a steady decline in foreign investment figures since 1998. Mr. Muluzi and his United Democratic Front (UDF) party were re-elected in the country's second multi-party elections, in June 1999. There were many disputes surrounding the actual election process and the outcome. This adversely affected Malawi's image to foreign investors.

Furthermore, the Government of Malawi followed good economic policies from 1995 to

1997, but in more recent years the pace of reforms has decelerated. Poor economic conditions in terms of high annual inflation, high real interest rates, together with a sharp depreciation of the kwacha, has resulted in slow growth of the economy. This has been compounded by weak expenditure control and acute fiscal indiscipline i.e. funds are grossly misused and corruption is rife. Current perceptions surrounding the upcoming elections in 2004, have also contributed to low investment levels.

*Have Malawi's domestic problems been the only factors that have contributed to the low investment levels in the country?*

The current crisis in Zimbabwe has had somewhat of a negative impact, and Malawi has been affected especially with regards to the supply of raw materials. Investor attitudes towards the region as a whole are negative, with the perception that the same problems could arise in other neighbouring countries.

*What would you say are the main strengths and weaknesses of MIPA?*

The management of MIPA is well organized and have managed to create good ties with other government ministries, as a means of informing them of its activities without alienating them.

In terms of its weaknesses, although MIPA falls under the office of the President and Cabinet, it does not have overriding decision-making capabilities of the senior ministry. Although it is a one-stop window for investment, it does not have the abilities to make on the spot decisions. With an incoming investment, MIPA must get clearance from numerous departments and ministries, and ultimately it is found that self-interests play an important part in what investments are encouraged and allowed into Malawi. Decisions are based solely on self-interests and not to the benefit of the Malawian economy. Many of the people with authoritative powers either do not understand, or choose to ignore, the vast benefits that foreign investment has to offer for the country, in terms of growth and boosting the domestic economy. This is also evident in the lack of investment by the government in local infrastructure and other facilities which would attract more foreign investors.

*In light of these problems, what does the future hold for Malawi?*

The future of Malawi lies in the leadership. With the upcoming elections in 2004, and the introduction of a new government, I hope that there is greater commitment to promote, attract, and encourage foreign investment in Malawi. Only once there is a change of leadership, will Malawi see any improvement in its economic environment.

**Annex 13: Corruption Perceptions Index 2002: Malawi**

Country rank	CPI 2002 Score	Surveys used	Standard deviation	High-Low Range
68	2.9	4	0.9	2.0-4.0

*Source: Transparency International's Corruption Perceptions Index 2002.*

{<http://www.transparency.org/cpi/index.html>}

**Explanatory Notes:**

**CPI 2002 Score:** relates to perceptions of the degree of corruption as seen by business people, academics, and risk analysts, and ranges between 10 (highly clean) and 0 (highly corrupt).

**Surveys used:** refers to the number of surveys that assessed the country's performance.

**Standard deviation:** indicates differences in the values of the sources: the greater the standard deviation, the greater the differences of perceptions of a country among the sources.

**High-Low Range:** provides the highest and lowest values of the different sources.

## QUESTIONNAIRE

Company Name \_\_\_\_\_

Location of Headquarters \_\_\_\_\_

Address \_\_\_\_\_

Telephone Number \_\_\_\_\_

Name \_\_\_\_\_

Position Held \_\_\_\_\_

1. How long has your company been operating in Malawi?

\_\_\_\_\_

2. What sector of the economy does your company operate in i.e. manufacturing, retail, agriculture etc?

\_\_\_\_\_

3. Why did you decide to invest to Malawi?

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

4. Did you explore other countries in the region as investment locales for your business?

Yes

No

If so, which ones, and why did you NOT invest there?

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5. How does the investment climate in Malawi compare to other countries in Africa?

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6. Was your investment in Malawi facilitated through the Malawi Investment Promotion Agency (MIPA)?

- Yes
- No (specify)

7. Which of the following factors encouraged you to invest in Malawi? (Check all that apply).

- Availability of locally-made inputs and raw materials
- Labour costs and skills
- The domestic market
- General environment
- Availability of local business finance
- Access to the African market
- Tax incentives
- Access to the South African market
- Access to global markets
- Costs of production
- Other (specify) \_\_\_\_\_



8. How would you rate the following decision-making institutions pertaining to investment? (Please write a number from the scale next to each institution).

EFFICIENT      5      4      3      2      1      INEFFICIENT

Reserve Bank of Malawi \_\_\_\_\_

Malawi Investment Promotion Agency (MIPA) \_\_\_\_\_

Malawi revenue Authority \_\_\_\_\_

Immigration Department \_\_\_\_\_

9. As an existing local investor, what is your view on the investment incentives currently offered to foreign investors?

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10. Each of the following incentives have been detailed in Malawi's Investment Promotion Act (1991). Using your own experience, for each incentive please indicate whether the factor has had a "positive effect", a "moderate effect", or a "negative effect" on investments in Malawi.

	Positive effect	Moderate effect	Negative effect
Tax allowances			
Import duties			
Free access to foreign exchange			
No licence requirements for imports			
Full remittance of dividends			
Repatriation of profits			

11. Based on your own experience, what is your opinion of the Malawi Investment Promotion Agency (MIPA)?

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12. The Malawi Investment Promotion Agency (MIPA) is charged with providing investor services in order to encourage and facilitate investment in Malawi. Below is a list of the services that MIPA is charged with. Using your experience, please indicate how effective or ineffective MIPA has been with regards to each service. (Please circle your response).

	EFFECTIVE					INEFFECTIVE	
Facilitating all aspects of the investment process	7	6	5	4	3	2	1
Providing courtesy services to investors	7	6	5	4	3	2	1
Furnishing information related to investment in Malawi	7	6	5	4	3	2	1
Working with existing investors to expand or start new investments	7	6	5	4	3	2	1
Developing a favourable investment image of Malawi	7	6	5	4	3	2	1

13. How would you rate the performance and service provided by MIPA? (Please tick your response).

	HIGHLY				
OUTSTANDING	SATISFACTORY	SATISFACTORY	UNSATISFACTORY	POOR	
(5)	(4)	(3)	(2)	(1)	

14. According to a statement given by Ted Kalebe, the head of MIPA, efforts to attract foreign direct investment are often hampered by red tape and unnecessary delays. Did you experience any of the above problems when deciding to invest in Malawi?

- Yes
- No

If yes, please describe the problems experienced.

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15. What macroeconomic factors have had the most negative effect on your business operations in Malawi? Use 1 to indicate that factor that had the most negative impact on your business, 2 the next most negative etc.

- \_\_\_\_\_ Interest rates
- \_\_\_\_\_ Inflation rates
- \_\_\_\_\_ Domestic political situation
- \_\_\_\_\_ Corruption and bribery
- \_\_\_\_\_ Exchange rate of the Kwacha
- \_\_\_\_\_ Other (specify) \_\_\_\_\_

16. How much of an impact has HIV/AIDS had on your business? Please tick your response.

- |                          |                          |                          |
|--------------------------|--------------------------|--------------------------|
| Major impact             | Moderate impact          | Negligible impact        |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |

17. With regards to the economic infrastructure in Malawi, how would you rate the following: (Please write a number from the scale next to each item).

EXTREMELY FAVOURABLE	5	4	3	2	1	0	EXTREMELY UNFAVOURABLE
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Roads	_____
Railways	_____
Telecommunications	_____
Water	_____
Electricity	_____
Availability of land	_____

18. Do you feel the policy environment in Malawi i.e. economic policies pertaining to trade, commerce etc., are conducive to investment and business development?

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19. What effect has the fiscal policy had on the current operations of your business?

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20. What effect has the monetary policy had on the current operations of your business?

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21. Has the recent political crisis in Zimbabwe had any impact on your business in Malawi? Please comment.

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22. What effect, if any, does the domestic political environment have on doing business in Malawi?

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23. Many reports cite corruption as being a major problem in Malawi. What effect, if any, does it have on your business?

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24. Would you say the opening up of the economy in the context of SADC and COMESA has positively or negatively affected industries in Malawi? Please comment.

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25. In your view, is the outlook for Malawi's investment climate favourable or unfavourable?

- Favourable
- Unfavourable

Regardless of your answer above, please state your reasons why.

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26. Do you plan to continue to operate in Malawi in the future?

- Yes
- No

Regardless of your answer to the above, please state your reasons why.

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If so, would you regard your plans as being short, medium, or long-term?

Short-term

Medium-term

Long-term

27. What do you think are the specific measures that need to be taken by the Government and its support institutions to attract more investment to Malawi, and also to ensure that those investors already here, will stay and expand their businesses?

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