FOREIGN DIRECT INVESTMENT AND ITS IMPORTANCE TO THE ECONOMY OF SOUTH AFRICA

by

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ABSTRACT

This study focuses on foreign direct investment ("FDI") and its importance to the economy of South Africa. Recognising that FDI, notwithstanding the type, can contribute to economic growth and development, most countries including South Africa are constantly working to attract it, and hence its demand has become highly competitive. However, FDI does not go without some negative effects, such as conflicts between host and investor country, and the creation of damaging competition to local firms. These negative effects could be minimised if policies and strategies for the promotion and attraction of FDI is part of, and integrated into, general economic development and economic reform policies, and not seen in isolation. Although South Africa has implemented strategies to attract more FDI, a refinement of some of these policies is needed if the country is to be successful in this regard.

Key terms:

Foreign Direct Investment; multinationals; balance of payment; FDI models; foreign inflows; FDI policies; exchange rate; host country; South Africa; economic growth

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CHAPTER 1: INTRODUCTION

This research relies mainly on secondary information and data collection. Data collection will involve an indirect approach, such as the gathering of information from academic publications. Credible internet sources on Foreign Direct Investment ("FDI") issues in South Africa and across the world are considered. A review of relevant literature on the subject by previous writers on FDI is also used extensively.

The aims and scope of this dissertation are discussed below, chapter by chapter:

In Chapter 2, various definitions of FDI by various disciplines are studied and an attempt is made to define FDI in a broader sense by considering the elements of FDI, namely long-term investment, control, foreign investors and the host country. Foreign investment may take another form which is not classified as FDI, but as portfolio flows. In this chapter, the distinguishing feature of FDI and portfolio flows is highlighted. The chapter also considers global trends with regard to FDI flows to host countries as well as attempts to gauge the bias in the flow of such investment by comparing the flows to both developed and developing nations. A look at the bias in the flow of FDI to different economies necessitates the study of the determinants of FDI in order to understand some of the factors that determine this type of investment. Hence the next chapter is dedicated to a discussion on the determinants of FDI in the form of economic models.

In Chapter 3, the various determinants of FDI are discussed in the form of the following FDI models:

Under the theoretical model, interest rate is described as a dependent variable and hence FDI is expressed as a function of interest rates. Interest rates represent return on capital, and where capital is in abundance, especially in developed countries, interest rates tend to be lower, compared to developing countries where capital is inadequate and hence the cost of capital has to be raised in order to attract it.

The eclectic model is based on the principle that an investor will have a competitive edge in the form of trademarks, production techniques, entrepreneurial skills and returns to scale, and speculates that the intended investment location has specific advantages in the

form of the existence of raw materials, low wages, special taxes or tariffs. The investing firm prefers to internalise these advantages without selling licences or entering into joint ventures by producing in the receiving or host country.

The gravity model explains the fact that trade flows/investments between countries is dependent on the size of the economies, the population difference and, most importantly, the distance between countries, which is measured by the transportation costs. The limitations, complexities and sophistication of the models discussed above are comprehensively observed (Twomey, 1997; Baldwin, 1999; Dunning, 1988). These models are also applied to discussions in other chapters. The determinants of FDI that are examined in Chapter 3 may lead to inflow of FDI in different forms and in order to understand these forms, the next chapter discusses and offers a motivation for each type in an economy.

Chapter 4 examines the main types of FDI, namely export-oriented investment, market-development investment, government-initiated investment, acquisition and greenfield investments. Export-oriented investment is described by Reuber (1973: 73) as the type of investment that reflects a wide range of considerations such as the desire to develop secondary and more diversified sources of supply by way of obtaining lower-cost products to be used either as inputs or for sale elsewhere.

The distinguishing features of market-development investment are as follows:

(i) The output of the project is intended primarily for sale in the host country.

(ii) The investment is made primarily in response to underlying economic considerations such as the size of the market and its long-term potential, local production costs and so on (Reuber, 1973; Bosworth, 1999; Collins, 1999).

The general effectiveness of the market-development investment on economic management policies is directly influenced by a country's policies on tariffs, trade controls, taxes, subsidies and trade barrier tools.

The third type of investment that is discussed in this chapter is the government-initiated investment. Albuquerque (2000) maintains that the distinguishing feature of this type of

investment is that it occurs at the initiative of the host country's government, and it is attracted from the sending or source countries primarily in response to government subsidies of one kind or another. On balance these subsidies are large enough to make the investment attractive to investors despite unfavourable underlying demand and cost conditions that may exist in host countries (Borensztein, 1998). Acquisition type investment occurs when foreign investors acquire interest in or merges with firms in a host country, which results in the foreign investor having significant influence or control over the investee firm. Greenfield investment is a type of FDI where foreign investors extend their operations into a host country in order to take advantage of a specific resource that gives it a competitive edge. It normally results in the forming of new businesses. Although these types of FDI may appear to be similar in nature by definition, their multiplier effects are different in nature. With this in mind, the focus of the study in the next chapter is on the effects of FDI on an economy.

Chapter 5 discusses the cyclical effects of FDI on macroeconomic variables such as balance of payments – receipts and payments, foreign exchange rates, interest rates and employment levels. A question may arise as to whether the effects of balance of payments should be clearly distinguished from the effects of real income, because balance of payments is determined by macroeconomic relationships and therefore can be controlled by macroeconomic variables such as the exchange rates and monetary and fiscal policy. However, in practice, there happens to be a serious constraint in the use of various adjustment mechanisms and this makes balance of payment effects very important.

If financed from outside the host country, initial inflow of FDI may positively impact on the foreign exchange reserve of a host country through its provision of foreign exchange. By producing goods that were previously imported, and by producing exportable goods, it also earns foreign exchange. As a result of this, on initial entry, the receipts column of the balance of account tends to exceed the payments column, all things being equal, and this has many numerous advantages for host countries. On the other hand, this form of foreign exchange reserve build-up may be eradicated by way of repatriation of capital, interest and profits. Also, transfer pricing may be resorted to.

Increase in FDI results in increases in demand for the host country's currency. This increase helps the host country to expand its foreign exchange reserve by which imports are funded. Assuming a floating exchange rate regime (this chapter also discusses the effects of FDI on the different types of exchange rate regime), an increase in demand for a host country's currency through FDI strengthens the currency of the host country and, given a constant supply of the currency, the following ensues: A strong currency may lead to cheap imports and makes exports expensive and where the host country supplies elastic commodities, this will have a negative influence on the foreign exchange reserve of the country, FDI, production, and ultimately unemployment.

The direct effects of FDI on employment are also examined in this chapter. In a nutshell, the chapter looks at the financial and trade effects of FDI on host countries and concludes by assessing the intensity of the impact of FDI on host countries (Kahn, 1999: 167). An evaluation of the effects of FDI on host countries confirms the existence of both positive and negative effects; however, there appears to be a more positive net effect, justifying the cause for studying the need for this type of investment. Chapter 6 is therefore dedicated to looking at the need for FDI in an economy.

FDI does not go without risk and disadvantages (Feldstein, 2002:3). In this respect, Chapter 6 focuses on discussing the main advantages and disadvantages. FDI has become an important source of finance for many countries. It also represents investments in production facilities, and its significance for developing countries is much greater. FDI does add to investible resources and provides capital for a host country. More importantly, it also provides a means of transferring production technology, skills, innovative capacity, organizational and managerial practices.

The advantages that are discussed include the following:

(1) Growth, higher income and reduction of poverty in a country
(2) Incentive structures resulting from FDI that lead to productive investment
(3) The low volatility of FDI flows than other capital flows
(4) Increased tax revenue
(5) Technology and management skill transfer
(6) Improvement in the skills and wages of the labour force

(7) An increase in access to export markets
(8) The provision of additional demand for output of local producers
(9) Provision of lower cost input for local suppliers
(10) Improvement of balance of payment and capital accounts
(Mallampally & Sauvant ,1999; Bevan & Estrin, 2000).

Some of the main drawbacks of FDI that are discussed in this chapter will include the following:

(1) Damaging competition for local firms
(2) Market dominance by multinational corporations
(3) Social protest and disorder
(4) Environmental degradation
(5) The creation of a volatile economy
(World Bank, 2001; Mallampally & Sauvant, 1999).

Given the potential role that FDI can play in accelerating growth and economic transformation, developing countries are strongly interested in attracting it. In view of this, Chapter 7 discusses the means by which FDI can be attracted into a country.

Tailoring of economic policies to suit FDI is an approach that a potential host country can consider to support its vision of FDI attraction. The policies discussed in this chapter can be broadly categorised into three types: firstly, overall economic policies that increase locational advantages; secondly, national FDI policies that reduce the transaction costs of investors; and thirdly, international FDI policies that deal with agreements (whether bilateral, regional or multilateral) on foreign investments. Other general policies in addition to the above are also discussed. The overall economic policies work at the macro level and aim to improve the fundamentals of the economy, such as the market size, availability of skilled labour, infrastructure, etc., which in turn aid in attracting FDI flows into an economy. The national FDI policies work at the domestic level and regulate entry and exit of FDI along with the creation of incentives and restrictions on operations of foreign firms in different sectors of the economy. The international FDI policies work at the international level and deal with agreement issues relating to the treatment of FDI from a particular region. These investment agreements may ensure that FDI from a particular region is either treated or not treated under most-favoured nation standards and

national treatment standards (Banga, 2003; Chakrabarti, 2001). The next chapter looks at all the literature reviews from chapters 2 to 7 in the context of the importance of FDI to the economy of the Republic of South Africa.

In addition to the discussion of the importance of FDI to the South African economy, Chapter 8 will also elaborate on innovative strategies that can be used or strategies that have to be enhanced by South Africa in order for it to attract more of it. FDI is key to the growth of the South African economy and hence attempts by the South African government to step up this form of investment should be encouraged. The direct effect of FDI on the growth of the economy is discussed. Jauch (2002:4) maintains that South Africa is keen on attracting FDI in order to overcome scarcities of resources such as capital, entrepreneurship, access to foreign markets, efficient managerial techniques, technology transfers, innovation, employment creation and ultimately economic growth. However, as a result of the level of demand for it in Africa, higher prices in the form of innovative strategies have to be paid in order to attract such investment into host countries.

Chapter 9 will conclude on the discussions in prior chapters and by so doing, assess whether the objective of the overall dissertation has been achieved.

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CHAPTER 2: HISTORICAL BACKGROUND TO FDI

2.1 INTRODUCTION

FDI has grown at a phenomenal rate since the early 1980s, and the world market for it has become more competitive. In this chapter, various definitions of FDI by different writers will be studied and an attempt will be made to define FDI in a broader sense. In addition, a historical background as well as global trends of this type of investment will be discussed.

2.2 HISTORICAL BACKGROUND TO FDI: EMPIRICAL EVIDENCE AND TRENDS

The term "foreign direct investment" usually brings to mind the significant contribution of foreign investment to domestic investment. FDI has been defined by different writers and authorities as follows: FDI is an investment made to acquire a long-term interest in a foreign enterprise with the purpose of having an effective voice in its management (Bjorvatn, 2000:16). As noted by Albuquerque (2000), FDI requires neither capital flows nor investment in capacity. Conceptually, it is an extension of corporate control over international boundaries other than that of a source/home country. According to Pugel (1999:23), FDI is the process whereby residents of one country (the home country) acquire ownership of foreign assets for the purpose of controlling the production, distribution and other activities of a firm in another country (the host country).

Eatwell, Milgate and Newman (1987:403) define FDI as the act of acquiring assets outside one's home country. These assets may be financial, such as bonds, bank deposits, real estate and equity shares, or they may involve the ownership of a means of production, such as factories and land. FDI is defined by Hines (1999) as occurring when a firm invests directly in production facilities in a country and maintains control over that investment. Selby (1999:3) defines FDI as the purchase or construction of productive capacity in a country by an individual or company based outside the country. The investment comprises a bundle of assets, some proprietary to the investor (technology, brand names, specialised skills, the ability to establish marketing networks, etc.), and some non-proprietary (finance, many capital goods, intermediate inputs, etc.).

Strictly speaking, FDI is any flow of lending to or purchase of ownership in a foreign enterprise that is largely owned and controlled by residents of the investing country

(Lizonda, 1990). According to Helleiner (1989), the most frequently used statistics for FDI are those of the International Monetary Fund (IMF), which defines FDI as investment made to acquire a lasting interest in a foreign enterprise with the purpose of having an effective voice in its management (IMF, 1995:25). In principle, it includes all flows, whether direct or indirect (through affiliates of the investor), as well as reinvested earnings and net borrowings as well as equity capital.

The South African Reserve Bank (2000) makes a clear distinction between FDI and portfolio investment as follows: both portfolio investment and FDI entail investment of foreign capital in South Africa; however, the difference between them is that, in the case of FDI, the purchaser/investor acquires an ownership stake of 10% or more, which is big enough to ensure significant influence, while portfolio investment flow constitutes a purchase of ownership of less than 10%. Salvatore (2007:418) defines and distinguishes between both portfolio investment and FDI as follows: portfolio flows are in the form of financial assets like bonds (lending capital to receive the face value of the bond at a date specified on the purchase date, as well as fixed returns in the form of interest at regular intervals). A distinguishing feature of FDI is that the investor retains control or has significant influence over the asset purchased. Some of the assets the foreign investors purchase are real investment in factories, capital goods, land and inventories, or they may take the form of starting a subsidiary or taking control of another firm.

In view of the above different definitions, FDI in a broader sense can be referred to as an investment involving a long-term relationship and control or significant influence by a resident enterprise of one economy (direct investor) in another enterprise resident in an economy (direct investee) other than that of the investor.

FDIs are mostly made by multinational enterprises (MNEs), also referred to as trans-national corporations (TNCs) or simply as multinationals. FDI takes place as part of the parent corporation's effort to defend or extend its ability to extract profits from quasi-oligopolistic control over intangible assets, in the face of ongoing competitive challenges at home and abroad. FDI is motivated by the ability to earn higher profits on activities in the foreign country. The financial returns from FDI are normally paid out in the form of profits (dividends, retained earnings, royalty payments and management fees).

FDI can be either vertical or horizontal. Vertical FDI refers to those multinationals that fragment production processes geographically. It is called 'vertical' because multinational enterprises separate the production process by outsourcing some stages abroad. The basic idea involved in vertical FDI is that if input prices of a certain stage of production are lower in a country other than investor's country, it then becomes more profitable to split the production chain. Horizontal FDI implies the production of roughly the same goods or services in the host country that multinational corporations (MNEs) produce in their home country. Such FDI is called 'horizontal' because it involves the duplication of similar activities across national boundaries. Horizontal FDI arises when it is less costly to serve the foreign market by investments instead of exports due to high tariffs or transportation costs.

FDI is measured either as a flow (the amount of investment made in one year) or stock (the total investment accumulated at the end of a year). Whilst FDI and foreign production is not one and the same thing, FDI has historically been closely bound up with the development of international business and still remains the backbone of MNE, and is the most frequently used proxy for the extent of MNE (Banga, 2003).

FDI has been one of the most fascinating and intriguing topics among researchers in international business. It is one significant form of rapid international expansion to increase ownership of assets, derive location-specific advantages and acquire additional knowledge. By 1991, FDI was one of the fastest-growing strategic activities that corporations were pursuing around the world, with over $7 trillion in global sales in 1995. The value of goods and services produced by some 280 000 foreign affiliates outweigh exports as the dominant mode of servicing foreign markets. Between 1982 and 1994, the global FDI stock – a measure of the investment underlying international production, had increased fourfold. It had doubled as a percentage of world gross domestic production to 9%. By 1996, FDI reached a record high of $350 billion from the boom which started in 1995. The two previous booms between 1979 and 1981, and 1987 and 1990 (the first being led by petroleum investment in oil-producing countries, and the second being concentrated in the developed world), may pale in comparison to this third boom, which is characterised by considerable developing country participation. Two

countries, the United States and the United Kingdom, were the primary drivers of the third boom, but developing countries are not far behind (World Investment Report, 1997).

During the 1990s, FDI accounted for an increasing share of private capital flows to developing countries. According to the World Investment Report (2002), developing countries received 28% of the world FDI inflow in 2001. Global FDI inflows, however, declined by 51% in 2001, which also affected the flow to developing countries. Developing countries witnessed a 14% decline in FDI inflows in 2001 compared to the US. A few developing countries like China and India, however, registered increased FDI inflows in 2001, which is indicative of their attractiveness for international investment. Several independent surveys have rated developing countries among the favourite destinations for FDI. FDI data released by the Reserve Bank comprises equity and preference share capital only and does not include reinvested earnings and other direct capital flow which otherwise form part of FDI as per IMF classification.

The rising prominence of inflows of FDI into most developing countries is a significant element of several overall changes taking place in international capital flows. At one level, the increasing dominance of FDI in international capital flows since the mid-1980s and its trade linkages have led to substantial policy changes and harmonisation efforts across the globe at national, regional and multilateral levels, aimed at capturing the expected benefits of these trends. It is widely acknowledged that one of the dominant changes in the global structure of FDI flows has been the increasing role of brownfield investment compared to greenfield investment. Among other factors, this increasing dominance of cross-border mergers and acquisitions has been an outcome of the worldwide reorganisation and consolidation across various highly competitive and increasingly deregulated technology-intensive manufacturing and service-sector industries (World Investment Report, 2002).

FDI is an important form of private external funding for developing countries. Today, FDI is regarded a major source of foreign capital for developing countries as opposed to portfolio flows or foreign aid. Unlike other major types of private capital flows, FDI is largely motivated by a firm's long-term prospects for making profits in production

activities that it directly controls. Developing countries' share of total FDI inflows rose significantly, from 26% in 1980 to 37% in 1997. However, the distribution of these inflows was uneven. In 1997, for example, Asia received a 22% share of total FDI inflows, Latin America and the Caribbean received 14%, and Africa received 1%. This uneven dispersion of FDI is a cause of concern since FDI is an important source of growth for developing countries. Not only can FDI add to investment resources and capital formation, but it can also serve as an engine of technological development with much of the benefits arising from positive spill-over effects (Jayaratnam, 2003).

Nunnenkamp (2002) concurs with the view above that, traditionally, FDI was a phenomenon that primarily concerned highly developed economies and as such developed countries still attract a higher share of worldwide FDI than developing countries do. This view is confirmed by the two graphic representations below, sourced from UNTCAD – World Investment Report:

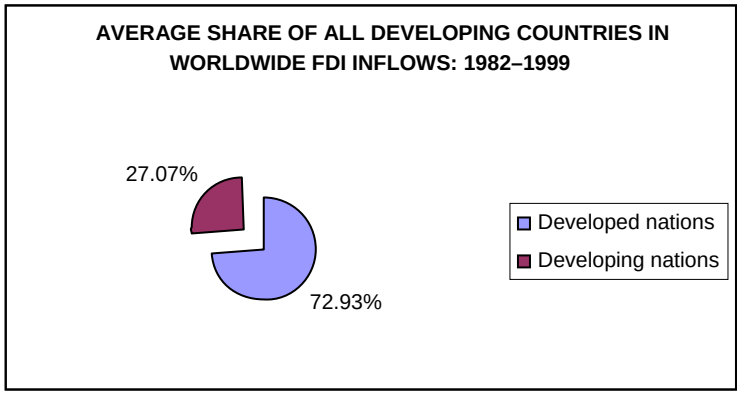

Figure 2.1

(From UNCTAD – World Investment Report, 2000)

From Figure 2.1 above, it can be seen that a greater amount of FDI between 1982 and 1999 has been directed to developed nations.

Table 2.1

AVERAGE SHARE OF ALL DEVELOPING COUNTRIES IN WORLDWIDE FDI INFLOWS: 1982–1999		
	Developed nations	Developing nations
1994–1999	68.90%	31.10%
1988–1993	75.40%	24.60%
1982–1987	74.50%	25.50%

(From UNCTAD – World Investment Report, 2000)

From Table 2.1 above it can be seen that growth in FDI in developing nations between 1982 and 1999 has been fairly consistent in that, although there was a 0.90% decrease between 1987 and 1993, there was a 6.90% increase between 1993 and 1999.

The split of foreign capital inflows into developing regions has been very biased. Represented below in Table 2.2 and Figure 2.2 is the split of FDI into the different regions that comprise developing countries.

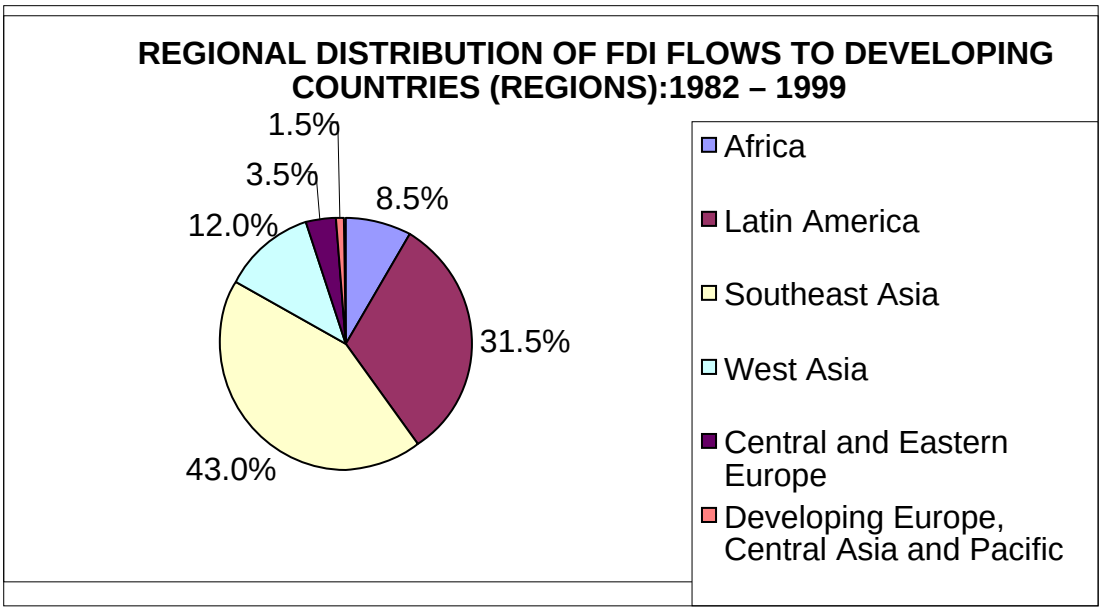

Figure 2.2

(From UNCTAD – World Investment Report, 2001)

It is clear from the above that, on average, a larger chunk of FDI inflow into developing countries is absorbed by Southeast Asia.

Table 2.2

REGIONAL DISTRIBUTION OF FDI FLOWS TO DEVELOPING COUNTRIES (REGIONS): 1982–1999

	Africa	Latin America	Southeast Asia	West Asia	Central and Eastern Europe	Developing Europe, Central Asia and Pacific
1994–1999	3.8%	33.5%	49.2%	2.2%	9.1%	2.1%
1988–1993	7.0%	26.0%	54.0%	4.0%	7.0%	2.0%
1982–1987	10.0%	37.0%	32.0%	20.0%	0.0%	1.0%

(From UNCTAD – World Investment Report, 2000)

It can be deduced from Table 2.2 above that Asia (Southeast, West and Central combined) emerged as the most important host region among developing countries, and

that FDI flow into West Asia decreased from 20% by 1987 to 2.2% by 1999. However, the group in aggregate absorbed about half of FDI flows into all developing countries in the 1990s. Although Latin America had experienced a decline in FDI between 1987 and 1993, there was significant increase of 7.5% between 1993 and 1999 after Southeast Asia in particular had shed almost 5.8% of its gains from 1987–1993 (Nunnenkamp, 2002).

Apart from Southeast Asia and Latin America, the third highest in terms of FDI shares is Central and Eastern Europe. This development is resulted from the eradication of the socialist regime in this region and its exposure to world markets. The emergence of Central and Eastern Europe as a new competitor for FDI raised concern in various developing countries that diversion of FDI inflow into developing countries would occur. From Table 2.2, although FDI in Africa decreased over the same period of emergence of the Central and Eastern Europe region, FDI by European investors in Latin America recovered, leading to the conclusion that there was rather more influx of FDI into developing nations than a diversion (Nunnenkamp, 2002).

A further deduction from Table 2.2 above is that Africa is often not chosen as a destination of foreign capital, as FDI into Africa consistently declined over the time period under review (Nunnenkamp, 2002).

2.3 SUMMARY

In view of the above different definitions, FDI in a broader sense can be referred to as an investment involving a long-term relationship and control or significant influence by a resident enterprise of one economy (direct investor) in another enterprise resident in an economy (direct investee) other than that of the investor.

FDI and portfolio investment are types of investments made by foreigners in a country; however, the difference between the two is the fact that with FDI, the purchaser/investor acquires a 10% (or higher) stake in a company, demonstrating a significant influence, while portfolio investment flow constitutes a purchase of ownership of less than 10%. FDI growth is not only limited to developed countries but also to developing countries and as a consequence the world market for it has become more competitive. FDI is an important form of private external funding for developing countries. Today, FDI is

regarded as the major source of foreign capital for developing countries as opposed to portfolio flows or foreign aid. In general, capital inflows will raise output and employment in an economy, from which it may be inferred that FDI improves potential levels of welfare in the country as long as it is not attracted by protectionist measures and as long as it does not create or exacerbate host country factors and capital market imperfections. It is with this realisation that many economies around the globe are putting up efforts to attract this type of investment. A study of global trends (figure 2.1 above) shows a bias of FDI flows into the developing economies – the world's developing nations have only attracted a total of 27.07% compared to the 72.93% that has gone to developed nations.

The bias in the flow of FDI to the different economies necessitates the study of the theoretical determinants in order to understand some of the factors considered by investors of this type of investment. Chapter 3 will therefore be dedicated to a discussion of these determinants.

CHAPTER 3: DETERMINANTS OF FDI

3.1 INTRODUCTION

Many developing countries today are trying to make their business environment more attractive to foreign investors through the establishment of a hospitable regulatory framework for FDI. Relaxing rules regarding market entry and foreign ownership, improving standards of treatment accorded to foreign firms and improvements in the functioning of markets are some of the means of achieving this aim. In addition to seeking a hospitable business climate, firms that invest abroad often factor in the size of local market and the cost of resources, such as labour and capital. To this extent, countries where labour costs are low relative to industrialised countries are successful in attracting FDI. While low labour costs and large markets are important determinants of FDI, the role of exchange rates in influencing FDI inflows has become a well-studied option since the 1990s. The level of exchange rate and exchange rate volatility are both thought to be determinants of FDI. However, the direction in which exchange rate levels and exchange rate volatility impact FDI is far from certain (Jayaratnam, 2003).

In view of the above, this chapter is dedicated to a discussion of some of the theoretical underpinnings to FDI, which will be done through the study of FDI models such as the eclectic, the theoretical and the gravity model.

3.2 DETERMINANTS

3.2.1 The theoretical model

The theoretical model describes interest rates as the key determinant to FDI and expresses interest rate as a function of FDI, i.e. FDI = f (I). The model operates on the principle that interest rates represent return on capital and that where capital is in abundance, especially in developed countries, interest rates tend to be lower, compared to developing countries where capital is inadequate and hence the cost of capital has to be raised in order to attract more of it. Furthermore, the theoretical model also looks at the effect of the exchange rate as a determinant of FDI, as explained later in this section.

The model presumes that one of the reasons why interest rate differentials exist is because of different controls in capital markets, and the relaxation of those controls may

lead to capital flow and foreign investment. Slightly more complex versions implicitly speak of potential interest rate differentials arising because of different rates of saving and investing in several countries. A standard example is the belief that young countries at the beginning of the 20th century had insufficient savings compared to their investment opportunities and therefore turned to the old world for savings at more attractive rates, which materialised as foreign investment (Twomey, 1997; Baldwin, 1999).

According to Bishop (1997), one reason for creating the theoretical model was to generate predictions of the effect of economic processes. Thus foreign capital flow which results from interest rate (normally higher in host countries) and exchange rate (relatively depreciated) differentials will raise income in the receiving or host country, and lower domestic income in the sending or source country. In addition, the distribution of income will be affected, and wages and/or employment will rise in the receiving country while the return to capital will fall with the opposite effects of lower wages and unemployment occurring in the sending country. The theoretical model can be made more complex, starting with allowing for repatriation of the earnings of investment through conversion of loans into consumption, the side effect of exchange rates and by explicitly giving the analysis an inter-temporal dimension. Such extensions inevitably multiply the range of possible outcomes of the theoretical model.

The theoretical model discussed by Alaba (2003) suggests that there is a sunk cost a firm must pay once it decides to invest and thus it constitutes a determining factor of FDI. The decision must, however, be made under uncertainty since the domestic value of output at that point will be uncertain. The following function ensues:

$$P = YD(Q)$$

where Y is the exchange rate and D (Q) is the firm's revenue in units of the numeraire or foreign currency. P is the output price, measured in domestic currency unit, while P/Y is the foreign currency price charged. For the purpose of this study, we assume that P is fixed, and therefore focus on the impact of the exchange rate uncertainty alone. Y represents the domestic currency price of foreign currency and D (Q) is fixed. This means that if Y varies so does P (the price received in foreign currency).

Broadly speaking, FDI is a transfer of capital and hence can be interpreted in the form of a comparison of expected returns on alternative decisions of investment. Accordingly, the impact of exchange rates on investment decisions is twofold: both the level and the volatility of the exchange rate. Level is defined based on the state of the exchange rate, i.e. whether it is generally considered as depreciated or not, and volatility refers to the gap in the trading range of the currency over a period of time. Firstly, the level of the real exchange rate affects FDI in various ways depending on the destination of the goods produced. If the investor aims at serving the local market, FDI and trade then become substitutes, and various mechanisms then can be considered. It is expected that an appreciation of the local currency increases FDI inflows (especially in the form of imports) due to the higher purchasing power of host countries' consumers. Conversely, with depreciation in the real exchange rate the recipient country increases FDI through reduced costs of capital. Finally, a depreciation of a country's currency increases the relative wealth of foreign firms hence their capacity to invest in the context of imperfections of the capital market (Domar, 1997).

Alternatively, according to Jayaratnam (2003), if FDI aims at producing for re-export, it complements the exchange rate, and appreciation of host countries' currency reduces FDI inflows through lower competitiveness. Exchange rate depreciation in real terms is generally shown to induce more FDI inflows. In the same way, Corden (1990), and Barrel and Pain (1998) highlight the negative impact of an appreciation of the real exchange rate on FDI. A foreign firm facing large exchange rate volatility will produce in the host country if it intends to sell on the local market, but will refrain from doing so if it intends to re-export. FDI occurs in a context of uncertainty as compared to domestic investment and hence is risky. In theory, risk aversion should lead firms to diversify across possible locations. Accordingly, investing abroad and bearing an exchange rate risk means, broadly speaking, buying the option to face alternative sets of production costs. It is as a result of this that countries whose exchange rates are negatively correlated with global returns to capital may actually benefit from their role as portfolio hedges. Depreciation in these countries' exchange rate may raise their FDI inflows on diversification grounds.

Having such perspective of capital transfer in mind, the second impact of exchange rates on FDI decisions is associated with its variability. Bell (2004) emphasises that the theoretical effect of exchange rate volatility is quite ambiguous in that, although it may have a negative/positive effect on the investor's net worth in the short term, the net effect may come to no effect in the longer term. Corden (1990), however, finds a positive impact of volatility on FDI as investors having knowledge of the level of the volatility of a currency will invest with the notion of ploughing back profits and repatriating funds when exchange rates are favourable. He posits that FDI decisions can also be referred to as location strategies. Interestingly, the location of multinational activities depends on comparative advantages but also on transportation/transaction costs and increasing returns. As a whole, the choice of locating abroad is motivated by lower costs, a decision again depending on the investor's structure of sales.

3.2.2 The eclectic model

The eclectic model (also known as the OLI model) enunciates that FDI comes about when an organisation in a sending country has a competitive edge in the form of a trademark, production technique or entrepreneurial skill, and returns to scale or speculates that the intended investment location has specification advantages in the form of the existence of raw materials, low wages, special taxes or tariffs. In such a case the firm prefers to internalise these advantages, without selling licences or entering into joint ventures, as a way of producing in the receiving or host country.

Dunning (1988) at the University of Reading (UK) and Rutgers University (US) developed the eclectic theory or OLI paradigm. The model combines other models of FDI in their practical application, especially the monopolistic advantages model. The paradigm is a blend of three different theories of FDI = O + L + I, each piece focusing on a different question. According to this model, the firm starts its production abroad (say directly invests abroad) because three different conditions take place at once:

Ownership advantages (O)

Ownership advantages address the WHY question (i.e. Why go abroad?) as well as elaborate on the core competencies that give competitive advantage over the firms already serving foreign markets. The WHY question hypothesises that a multinational

enterprise has one or more firm-specific advantages (FSAs) which allow it to overcome the costs of operating in a foreign country. Such an FSA is normally intangible and can be transferred within a multinational enterprise at low cost (e.g. brand name, benefits of economies of scale, and technology). The advantages generate higher revenue and/or lower costs that can offset the costs of operating at a distance in a foreign location. Some of these O advantages can be found with new firms (i.e. first-time overseas investors); others come from being an established affiliate in a large far-flung multinational enterprise. Economies of common governance clearly belong to the latter category. Therefore FSAs can change over time and will vary with the age and experience of the multinational (Dunning, 1988).

Location advantages (L)

Location advantages address the WHERE question (i.e. Locate where?) and location-specific factors which favour overseas production as firms use some production resources more effectively than in their home country. The motive to move offshore is to use the firm-specific advantages in conjunction with factors in a foreign country. Through these factors (e.g. labour, land), the multinational enterprise makes a profit and earns returns on its firm-specific advantages. The choice of investment location depends on a complex calculation that includes economic, social and political factors. The location advantages of various countries are keys in determining which countries become host to investments. Clearly the relative attractiveness of different locations can change over time so that a host country can to some extent engineer its competitive advantage as a location for FDI.

An attractive country-specific advantage package for a multinational enterprise would include a large and growing high-income market, low production costs, a large endowment of factors scarce in the host country, and an economy that is politically stable, welcomes FDI, and is culturally and geographically close to the home country.

Internalisation advantages (I)

Internalisation advantages address the HOW question (e.g. How go abroad?). This results from internalising foreign operations through control over supplies or market outlets. The multinational enterprise has various choices of entry mode, ranging from the vertical to the horizontal mode. The multinational chooses internalisation where the market does not

exist, or functions poorly so that transaction costs of the external route are high (Dunning, 1988).

According to Dunning (1981:32), in each case the possession of ownership advantage is a necessary prerequisite for foreign involvement. However, the presence of internationalisation advantages suggests that enterprises will exploit these advantages by way of exports or FDI rather than by contractual resources, exchange licensing where an equity investment route rather than exports will be chosen where locational advantages favour a foreign rather than a domestic production base. Dunning (2000) further explains that all of the above criteria in the paradigm must be satisfied in order for a firm to engage in international production. It should be noted that the internalisation advantage is merely an expression of the first two advantages, which is further specified by Dunning (1982) when expressing the correlation of the advantages as follows: the more the ownership-specific advantages possessed by an enterprise, the greater the inducement to internalise them; and the wider the attractions of a foreign rather than a home-country production base, the greater the likelihood that an enterprise, given the incentive (relative to home country) to do so, will engage in international production.

The OLI model was considered to be especially appropriate to the post–World War II foreign investment of US manufacturing corporations. The emphasis of competitive advantages having been created by technological superiority or a greater willingness to take entrepreneurial risk was also attractive to scholars. Furthermore, in contrast to the theoretical model, in this framework the market rate of interest would be relatively unimportant. The underlying assumption of the model is that FDI improves the overall welfare of both the sending and the recipient countries while still having distributional effects (Twomey, 1997).

The eclectic model is based upon several propositions. Consider a firm that has some competitive advantage that seeks to earn profit from a foreign country. It faces three basic choices: export its product to the foreign country, license a firm in the foreign country to produce and sell locally, or undertake FDI to establish local production.

The first two alternatives involve arm's-length transactions and thus operate through a market. FDI, however, internalises the international transactions within the firm, and the firm achieves administrative control over the foreign operations. FDI in that instance has an inherent disadvantage as it lacks local information on social, legal, cultural and economic conditions in the foreign country that the local firm takes for granted or knows how to acquire at a low cost. Thus the firm must have some offsetting advantage *vis-à-vis* local competitors if FDI is to be successful. The eclectic theory recognises that each decision on the mode of foreign operations involves a balancing of advantages and disadvantages, and it seeks to identify the factors that together delineate the necessary and sufficient conditions for each FDI decision (Pugel, 1999:83).

According to Cargill and Segal (2003), the eclectic theory can be viewed as comprising two choices: firstly, the decision between licensing and FDI to establish the preferred mode of foreign local production, and secondly, the decision between exporting and FDI, assuming that licensing has been ruled out. The firm faces the decision between licensing and FDI if its competitive advantage is an intangible asset such as proprietary technology or marketing know-how. Such ownership-specific advantages have characteristics of public goods and can be transferred to foreign production at low opportunity costs. Cargill and Segal (2003) further explain that licensing of such an asset has a variety of advantages and disadvantages. The former include the avoidance of local information and low capital commitment, and the latter the costs of negotiating the terms of the licence, including pricing and restrictions, the cost of monitoring and enforcing the contract, and the risk of developing a future rival. These disadvantages can be viewed as imperfections in the market largely because of transaction cost. These imperfections create internalisation advantages as the firm has an incentive to avoid them by internalising the international transfer of the intangible asset, using FDI to establish control over foreign operations.

Several factors can be added to the basic eclectic theory. First, the dynamics of oligopolistic behaviour may affect the FDI decision. Second, the role of traditional multi-plant economies may influence FDI decisions, especially those involving geographically contiguous countries. Third, the role of FDI used to establish international vertical integration can be added. Of relevance to the earlier discussion, FDI can be forwarded

into distribution of products exported by the parent firm. A sales subsidiary provides the firm with control over the local marketing of its products (Pugel, 1999:83).

Buckley (1987) mentions that a multinational enterprise operating a plant in a foreign country is faced with additional costs compared to a local competitor. These could be due to (i) cultural, legal, institutional and language differences; (ii) a lack of knowledge about local market conditions; and/or (iii) the increased expense of communicating and operating at a distance. Therefore, if a foreign firm is to be successful in another country it must have some kind of an advantage that overcomes the costs of revenues or have lower costs for the same revenues than comparable domestic firms.

According to Ethier (1994), the eclectic model explains how external arm's-length markets are either imperfect or, in some cases, non-existent. As a result, multinational enterprises can substitute their own internal market and reap some efficiency savings. For example, a firm can go abroad by simply exporting its products to foreign markets; however, uncertainty, search costs and tariff barriers are additional costs that may deter such trade. Ethier (1996) further elaborates that the OLI model predicts that hierarchy (the vertically or horizontally integrated firm based on internal markets) is a superior method of organising transactions in a market (trade between unrelated firms) whenever external markets are non-existent or imperfect. The theory predicts that internalisation advantages will lead the MNE to prefer wholly owned subsidiaries over minority ownership or arm's-length transactions.

Hood and Young (1979) argue that the existence of country-specific advantages and the motivation to internalise are, however, still insufficient explanations for why a firm should choose foreign production over foreign licensing or exporting. It is in this sense that host country conditions exert influence. For example, an MNE may choose to service a foreign market via FDI because the possibility of licensing advanced technology does not exist in many host countries due to the unavailability of the necessary skills among indigenous firms. The relevant locational factors to be considered in host countries include, among others, labour costs, marketing factors, trade barriers and general government policy.

Critics of the OLI model allege that on close examination it does not appear to be a distinct theory at all but rather a loose association of the three main elements on which it is based (Chen, 1983; Cooper, 1992). Buckley (1987) maintains that the relationship between these elements and their development over time is unclear and that the existence of separate ownership advantages is doubtful and logically flawed because internalisation explains why firms exist even in the absence of such advantages. However, Buckley (1987) has elsewhere acknowledged that the absence of locational factors renders the transactions approach tautological. Furthermore, Dunning's OLI model is criticised for not sufficiently theorising the relations between the ownership, location and internalisation advantages, and particularly for not making a clear distinction between the internalisation and ownership-specific advantages.

In his work on the eclectic paradigm, Dunning (1988) clearly states that FDI occurs when its net present value is both positive, and greater than that of alternative modes of international production. This definitely provides a rationale for investment, but it presumes to reduce the decision-making process to one variable while ignoring other possible impacting conditions. This view is in contrast to current advances in investment theory.

Dunning (1988:41) has responded to these and other criticisms of the eclectic theory in the following manner: It is accepted that, precisely because of its generality, the eclectic paradigm has only limited power to explain or predict particular kinds of international production and even less, the behaviour of individual enterprises. However, this deficiency, which some critics have alleged, could no less be directed at attempts to formulate a general but operational testable paradigm of international trade. Moreover, the theory not only provides a rich framework for analysing and explaining the determinants of international production and how they vary between firms, industries and countries over time, but it also helps the understanding of a wide variety of other firm-related issues. In addition, Tahir and Lairmo (2002) support the above by claiming that the OLI model has proved to be the most comprehensive explanation of international production by providing a wide analytical framework for explaining the determinants of international production and how they differ between firms, industries and countries over time.

3.2.3 The gravity model

Originally, gravity models were used to explain bilateral trade flows between countries in an analogy of Newton's law of gravitation (Breuss & Egger, 1997:3). Basically, gravitation comes about by the attraction of two masses with distance reducing this effect. Applied to bilateral trade flows, the pull forces are represented by the size of the economies concerned and measured by geographical distance and preferential trade factor (DP) or population (N), while distance is represented either by kilometres, transportation costs or, more generally, transaction costs. The basic gravity equation as formulated by Breuss and Egger (1997:34) based on Linnemann (1966:34) is:

$$Xij = Yi^{B1}Ni^{-B2}Yj^{B3}Nj^{-B4}Dij^{-B5} <p_{kij}>$$

where:

Xij = trade flow from country i (country of origin) to country j (destination)

Y = the gross national product of the two countries involved

N = population

D = geographical distance

P = preferential trade factor

<> = summation

It can be deduced from the equation above that trade flows between country i and country j are dependent on the size of their economies, which is measured by Y, the population difference, which is represented by N, as well as the distance between country i and country j.

The Linnemann equation has been adjusted by various authors in line with theoretical advances, and the core gravity variables of size and distance were completed. Consequently, researchers have used various specifications of factor endowment of the countries concerned as well as transactional cost-related variables, such as common language, common border, general openness of destination, country of foreign competition, etc. What is called the gravity model, therefore, often goes beyond the core idea of such models mainly to take into account the size of the economies concerned and their distance. Using the gravity model in the analysis of FDI presumes that country size (markets) and distance can be considered important FDI determinants. Existing

theoretical approaches to explain FDI support Linnemann's view in principle. However, there seem to be significant differences in the mode of operation of these specific gravity-related factors (Linnemann, 1966).

There are two qualifications to be made regarding the market factor. On the one hand, in the case of FDI, the market concept should be wider than in the case of exports. The markets of foreign affiliates may often reach beyond the host country and extend at least to neighbouring countries. On the other hand, FDI is not necessarily only oriented towards the market of the host country concerned. It has therefore become common in the literature to distinguish horizontal FDI, which is indeed market-oriented, from vertical FDI, which is endowment-oriented. Qualifications have to be made especially with regard to the theoretical basis of the distance factor when using gravity model as an FDI determinant. While trade is clearly impeded by the distance of partner countries, for FDI distance can be an impediment as well as an incentive – an impediment since coordination and other transaction costs should normally increase with distance, and an incentive which would aim at avoiding transportation costs or overcoming other trade barriers by local production. Such investments would take place as long as the advantage of proximity to the respective market exceeds the costs of operating at a distance and also, as long as alternative exporting from the home country is profitable (Africano & Magalhaes, 2004).

Given the ambiguous character of distance as an FDI determinant, it is obvious that empirical testing is confronted with severe problems. If distance turns out to be insignificant, this does not necessarily mean that it is unimportant. Insignificance may simply result from a positive effect on some investors and a negative one on others. These problems are aggravated by unsatisfactory specification of the variables, which are similar problems faced when testing trade theories. According to various theoretical approaches to explain FDI, and more specifically the determinants of FDI, empirical studies based upon a gravity-type approach should include the following:

1. Market-related variables
    - GDP of the host country as an indicator of market volume
    - Development level representing the degree of demand differentiation
    - Population of the host country as an indicator of country size

2. Distance-related variables
    - Geographical distance between capitals of economic centres
    - Factors affecting the economic distance between countries concerned

3. Endowment-related variables
    - Skills variables of employees in the host country
    - Wages in host countries
    - GDP per head as an indicator of technology and general development levels (Tinbergen, 1962)

The tradition of the gravity model is to explain trade flows in relation to market size and geographic or economic distance as core variables. Both these variables can be important determinants of FDI. However, when such models are used to explain such determinants, there can be differences in the mode of operation of these variables so that the interpretation can become uncertain. Market size can reach beyond the host country, and distance can be an incentive as well as an impediment to FDI. This would be diametrically opposed to the idea of the gravity model assuming distance generally as an impediment rather than as an incentive.

3.3 SUMMARY

The theoretical model describes interest rates as the key determinant of FDI and expresses interest rate as a function of FDI, i.e. FDI = *f* (I). The model operates on the principle that interest rates represent return on capital and that where capital is in abundance, especially in developed countries, interest rates tend to be lower when compared to developing countries where capital is inadequate, and hence the cost of capital has to be raised in order to attract more of it.

The theoretical model also looks at the effect of the exchange rate as a determinant of FDI, and looks at the exchange rate from a level and volatility perspective. It assumes that when a potential host country's currency is relatively considered/seen to be depreciated, it attracts investors. All things being equal, it is expected that an appreciation of the local currency increases FDI inflows (especially in the form of imports) due to the higher purchasing power of host countries' consumers. Conversely, with depreciation in

the real exchange rate, the host country increases FDI through reduced costs of capital. Relative depreciation of a country's currency increases the relative wealth of foreign firms, hence their capacity to invest. With regard to volatility, where a potential host nation is facing considerable exchange rate volatility, a foreign firm may only invest to produce in the host country if it intends to sell on the local market, but will refrain from doing so if it intends to re-export, due to the risk of reduction in net worth over time.

The eclectic model is an advantage and question-based model. It addresses the questions of why, where and how investors go abroad. 'Why' is captured in locational advantages, 'where' is captured in ownership advantages and 'how' is captured in internalisation advantages. In accordance with the model, an investor will only invest if answers to these are positive for all three conditions, which means that the firm has a competitive edge at the potential destination and will succeed in its investments as a result. A glaring limitation with this model is that it does not consider other potent feasibility factors such as locational factors, labour costs, marketing factors, trade barriers and government policy.

The gravity model describes the variables of gravity, which are size (in this case the size of the investor and investee home markets) and distance (in this case the distance between the host's and the investor's economy) as the core determinants of FDI. In other words, theoretically, foreign investors will base their decision to invest on how big an economy is and also on the cost of the distance between the investor and investee countries.

FDI models, though, are not without limitations, provide useful ways of seeing how FDI inflows can be determined. However, no theory dominates the decision making of FDI, by reason of the fact that the opportunities that a country has to offer change with time. However, FDI models identify a number of opportunities in which real options can be applied to provide an alternative process for decision making. Also, it has been identified that none of the FDI models discussed attempts to value FDI.

The different economic models (FDI determinants) that have been discussed in this chapter may determine different forms of FDI and in order to understand them, the next chapter will focus on the types of FDI and the motivation for each in an economy.

CHAPTER 4: TYPES OF FDI

4.1 INTRODUCTION

FDI flows into an economy through many mediums, and the type of flow determines its multiplier effects on an economy. This chapter discusses the categorisation of FDI into five broad types, viz. export-oriented investment, market-development investment, government-initiated investment, acquisition investment and greenfield investment, and the motivation for such investments in an economy.

4.2 TYPES OF FDI

4.2.1 Export-oriented investment

Export-oriented investment is described by Reuber (1973) as the type of investment that reflects a wide range of considerations such as the desire to develop secondary and more diversified sources of supply by way of obtaining lower-cost products to be used either as inputs or for sale elsewhere.

Firms serving established markets at home or internationally frequently seek new sources of inputs, including raw materials, components and parts, as well as finished products. This reflects a wide range of considerations, such as the desire to develop secondary and more diversified sources of supply and the possibility of obtaining lower-cost products. Examples of this type of investment are found in the raw materials sector. Generally, such foreign investors are mainly interested in extracting products from the host country and selling them abroad through established market channels. In making such investments, firms sometimes also create a supporting infrastructure such as housing, hospitals and schools. This investment focuses on the needs of a particular market which is largely or entirely outside the host country (Reuber, 1973:73).

The World Investment Report (1999) advocates that this type of investment is made with the intention of the investor to improve its competitive position at home or internationally by taking advantage of the lower cost of production that host countries offer, where lower cost is indicated by some of the following, amongst others: incentives from the host country, abundance of skilled and semi-skilled labour with concurrent relatively lower wages, and political and monetary stability. With this type of investment, investors attach little significance to host countries' markets. The major factors with regard to the

determination of the location of the investments are cost, as explained above, and the reliability of production.

This investment is geared towards the production of component parts. After production, the components are normally exported to a central location or to a country other than the host country for assembly into finished goods, confirming the fact that this investment is made with the object of taking advantage of the lower-cost environment in a host country (Giles & Williams, 2000).

Export-oriented investment tends to be highly profitable even in the short term. The investing company's control over the market and the rapid depreciation of its investment is made possible by high cash throw-off and is sometimes enhanced by technological obsolescence. If competitive conditions become less favourable in the host country relative to somewhere else then the firm can move its investment quite quickly. Moreover, because of this high mobility, countries can easily find themselves competing with each other in making concessions to such investors in order to make their investment platforms more attractive, which in turn reduces the risk of this type of investment and hence an advantage to both the host country and the investor (Golberg & Klein, 1999).

Reuber (1973:74) states that this type of investment is less commonly found producing final products for sale directly to consumers abroad. One may speculate on a variety of reasons for this, such as the difference in comparative advantage associated with different parts of the production process, handling and transportation costs, the reluctance of investors to assume the risk of relying entirely on any country for the production of a full product line, and the advantages from the standpoint of sale and the service of having final assembly take place in the major markets where the product is sold, as in most cases the host country's markets are more oriented to raw materials.

There are many ways by which export-oriented FDI can help to enhance a host country's manufacturing and export competitiveness. In order to attract this type of investment and to ensure that the investment translates into development gains, a host country needs to find the most effective ways of making the choice of locations as well as the target segments conducive to the kind of export activities the host country aims to foster. In today's rapidly globalising world, successful exporting needs not only competitive

products, but also marketing expertise and access to international markets. Giving greater access to export-oriented FDI can provide major benefits to the host country in this respect, especially in markets in which established brand names and large distribution networks are important assets. This type of investment can also be an effective means of providing resources such as skills, training, technology, capital goods and intermediate inputs needed to exploit a country's existing comparative advantages (Helpman & Kruman, 1995).

The most prominent role played by this type of FDI in the exports of developing countries is in the manufacturing sector. In this sector, foreign affiliates tend to be leaders in export-oriented investment and in marketing. The impact of foreign affiliates on the domestic entities' export activities can be both direct and indirect. Direct effects occur when exporting foreign affiliates establish backward linkages with local firms which then become indirect exporters. Indirect effects of the presence of export-oriented foreign affiliates occur when local firms manage to copy the operations of foreign affiliates, employ staff of foreign affiliates, and benefit from improvements in infrastructure and reduction in trade barriers undertaken in response to demand by the host country for foreign operations/investors.

Khan and Afia (1995) have a similar view to that of Helpman and Kruman (1995). However, they also point out that expanding exports is a means to an end of a country's economic development, thus promotion of export-oriented FDI should be an integral part of the overall development strategy. Moreover, FDI can help a host country in its efforts to raise exports in all kinds of industries by providing the missing elements that they need in order to compete or by improving locally based skills and capabilities.

Export-oriented FDI is generally considered to be an economic development and growth tool. Indeed, the positive role of export-oriented FDI, especially in the context of development, has been well documented (Lall, 2000). UNCTAD (2001:13) has therefore suggested that developing countries should actively seek to attract the right type of FDI to tap into the new international production system and that although FDI projects might not be export oriented at first, such an orientation can emerge as countries learn more about the performance of their initial investments and possibilities for expanding production in

particular markets. In effect, a question is raised concerning the feasibility of accurately identifying export-oriented FDI given that orientation can change over time.

Although the potential benefits of export-oriented FDI are widely acknowledged, this does not necessarily lend support for policies aimed at targeting and promoting it. One reason for this is that most countries tend to take an incremental approach to foreign markets, especially new ones, and that their commitment to this over time will be conditioned to a significant extent by observed performance. Policies that aim to attract export-oriented FDI may neglect or even discourage FDI that might initially be oriented towards the domestic market but which might become more export oriented over time.

4.2.2 Market-development investment

Unlike the export-oriented type of FDI, the objective of making a market-initiated type of FDI is to sell the final output in the host country's market. However, a common feature of both types is that they thrive on feasibility of reduction in production cost. Another key consideration by the investor is the potential growth in the size of the host country's market in the long term. Although in the short to medium term the investment may not yield the expected return, if the long-term view is that the host country's market will grow in size and hence become profitable, the investment may then be undertaken. The growth in the host country's market is, however, dependant on the general economic outlook of the host country and hence the macroeconomic variables and the effectiveness of the economic reform policies, other policy directives like tariffs, trade controls, taxes, subsidies and so forth, as well as various regulations imposed on foreign investors by the host country, become fundamental to the decision to invest (Reuber, 1973; Bosworth, 1999; Collins, 1999; Aschauer, 1999).

The policies referred to in the previous paragraph are for the most part general in scope. They apply to foreign investment generally or to broad sectors of the economy rather than to particular projects or industries. Moreover, many of these policies confer the same advantage on domestic industries. The initiative to undertake such investment is taken by the investor and although the incentives provided by the host country frequently have some influence on the decisions made, investors may view many of these incentives as

uncertain over time and marginal in importance by comparison with long-term market considerations.

Market-development investment is marked by many uncertainties of the most central kind from a business standpoint: How quickly will a market develop? Can the firm speed up the market-development process? What share of the market can the firm capture? Owing to these and other uncertainties regarding product acceptance and market development, many manufacturing firms are likely to prefer to explore the market initially by exporting. As the market develops and investors' knowledge and confidence grow, and they become more familiar with the risk involved, they may expand gradually into assembly activities (Reuber, 1973:75).

This type of investment may be illustrated by the following examples, as reported in Reuber (1973). A major manufacturer of tractors approached the Brazilian market by exporting initially and working directly with Brazil to establish a strong local distribution network. This required extensive training of Brazilian distributors, not only in how to sell tractors but also in how to use, service and repair them. In many cases certain business practices were also transferred, such as inventory control for parts and record keeping for internal control purposes. The Brazilian distributors were allowed to make attractive margins in return for their inputs. The distribution system added more value to the host country than did the company's eventual manufacturing activities. Furthermore, after the firm had developed a large-enough market to begin the integrated manufacture of tractors in Brazil, the distribution network proved effective in handling imported combines and other farm equipment as well. The firm's next step was to develop the integrated manufacture of combines in Brazil, and the gradual diversification of the product range is expected to continue into the future.

A second example in Reuber (1973) relates to a major US chemical company which bought out the only local plastics manufacturer in a small Latin American country and operated on a reasonably profitable basis. The American firm was not very interested in the modest return available from the existing firm, but was interested in the potential returns after market development and the related infusion of technology. Their long-term objective was to create a technologically advanced self-contained plastics industry in the

host country as they knew that the existing manufacturer was operating with old technology and that the inferior quality of the output limited the number of possible end users. Furthermore, the size of the market as it stood was less than half that required to justify building the new facilities using new technology needed to bring about market growth. The American firm's strategy in the light of these conditions was three-fold: (i) to develop the country's market potential; (ii) to export more sophisticated products from other countries to the host country; and (iii) to build a new plant with advanced modern technology in the host country after the market had developed to a sufficient level (Reuber, 1973). An important feature of such a strategy is that it is very long term in its conception. This strategy also looks more creative and will benefit both the investor and host country (Kumar, 2003; Reuber, 1973).

Market-development FDI takes many different forms. A major aluminium company began its operations in India by selling aluminium pans and utensils door to door. Over time this led to fabricating activities, bauxite mining and smelting within India, thus forming a well-integrated local industry. The key feature to be noted in this process is that the building of production facilities followed the development of demand, and that the development of demand was a risky and time-consuming activity requiring extensive transfers of managerial and technological skills (Reuber, 1973).

With this type of investment, host countries have considerable bargaining power in their relationship with the investors seeking to establish a foothold in their domestic markets.
As the economy expands, new investors are attracted, creating some competition among investors for available market opportunities. In these circumstances, it may be possible not only to reduce any concessions that may have been extended to foreign investors initially but also to insist on certain concessions from these investors relating to such matters as local ownership, local content in products and reinvestment without interfering significantly with the inflow of investment (Reuber, 1973).

4.2.3 Government-initiated investment

In comparison with the export-oriented and market-development types of FDI, government-initiated type of FDI occurs through the provision of substantial incentive structures to investors by a host country's government. These are accepted by investors

whereas market as well as cost conditions may have precluded them from investing in the host country under normal or "no-incentive" circumstances. For example, in South Africa the incentive takes the following forms: relaxed foreign exchange controls, tax concessions to investors who partake in national development projects such as Coega in Port Elizabeth, indirect subsidies through the provision of specific infrastructural requirements by investors, ease of repatriation of investments and many other kinds of government support services (Department of Trade and Industry, 2006).

To protect the host country and also to make the option of providing incentives to foreign investors efficient, such incentives are directed at specific projects or industries. Additionally, incentives are given by host country governments in order to attract foreign investors to either less-developed regions or regions which require improvement in certain sectors. For example in South Africa, it is understood that the Industrial Development Corporation of South Africa has allocated investment opportunities to each of the nine provinces (Department of Trade and Industry, 2006)

The following illustration from Reuber (1973) seems typical of this kind of investment. A country decided that the time had come to displace imports of synthetic rubber with those produced locally. The country was short of hard currency and lacked the technological skills to produce competitive products. To overcome these problems, it sought a joint venture arrangement with another country which held only a small share of the host country's market as an exporter to the country. This country considered it worthwhile to supply funds and technology in order to obtain a substantial minority interest in the venture and thereby increase its market share. The participating country continued to maintain its own independent distributors, although subsequently the host country decided to set up its own distributor to handle a portion of the output under a market-sharing arrangement. The plan was to produce specialised grades locally as sales volumes rose to the point where production costs became internationally competitive. The host country, however, pressed for local manufacture much earlier than the participating country felt justified in doing by economic considerations. Import-displacement investment of this kind accelerated the transfer of production and technology but at the cost of considerably higher prices for the domestic economy. This cost was justified by the government on the grounds that it yielded a variety of intangible non-quantifiable

external effects, such as the development of local management and technical skills, improved technology and series of beneficial spill-over effects on the local industries (Reuber, 1973).

Host-country governments have historically played an important role in attracting or excluding FDI through subsidies, which is one of the most effective ways of stimulating the flow of FDI. Subsidies take a number of different forms. They serve to reduce the risk premium of locating abroad and so they may directly influence a firm's cost structure. One example of a subsidy which affects the firm's risk premium would be the provision of public education to increase literacy within the country. All firms benefit from a more educated populace. In contrast, a subsidy could be aimed at reducing a particular firm's or industry's costs of providing on-the-job training. A risk-reducing subsidy, such as the provision of social overhead capital, has direct economy-wide benefits while a cost-reducing subsidy benefits a select firm or group of firms (Jones, 1998; Caves, 1982).

Given the framework of analysis presented above, a government-sponsored subsidy would have the unequivocal effect of increasing the probability of a firm's move to an investment location. Under the cases presented above, the view by investors is that a subsidy does not in itself reduce or compensate firms for locational risk, but does increase the risk premium for investors, i.e. a subsidy is not seen as a positive factor in a firm's cost structure or the "riskiness of a foreign location" decision making. However, this does not necessarily imply that a subsidy is independent of the firm's profit-maximising level of output (Davidson, 1980).

As an incentive to FDI, a host government can tailor subsidies to reflect the relative importance of the cost or risk factor in a firm's decision to locate in the host country. Krueger (1990) indicates that the objective of this type of investment is generally rooted in the desire of a country to increase employment and output, to encourage certain kinds of activities, to promote regional development within the host country, to improve the balance of payments and to alleviate the scarcity of hard currency. Tyler (1997) argues that although such policies do not necessarily imply investment in import-displacing industries, this in fact has been the most common practice in the past.

Government-initiated investment, despite its benefits, inevitably creates a high degree of interdependence between the investor and the host-country government, and an uncertain environment for both parties. Home-country government may also be drawn into the arrangements directly or indirectly. Given that the success of the incentive depends largely on the continuation of the host country's subsidies in various forms, the investor loses much of his bargaining power once the investment is committed. The investor is therefore likely to demand excessively favourable terms at the outset as a condition for making the investment to compensate for the possible erosion of these terms once a commitment is made. The host government for its part tends to be excessively generous in the first instance in the hope of being able to change the terms of its support once investments have been committed. On this basis, the stage is set for relatively difficult relationships to develop between investors and governments. Owing to their interdependence and in order to minimise conflict, investment of this kind tends to give greater emphasis to joint ventures, minority interests for foreign investors and other conditional forms of FDI (Reuber, 1973).

4.2.4 Acquisitions and greenfield investments

FDI flows to developing countries surged in the 1990s to become the leading source of external finance. This rise in FDI volume was accompanied by a marked change in its composition: investment taking the form of acquisition of existing assets (M&A) grew much more rapidly than investment in mainly new assets (greenfield FDI), particularly in countries undertaking extensive privatisation of public enterprises. For example in 2000, South Africa attracted FDI of US$152 million compared to US$877 million in 1999. The poor FDI figures for 2000 are partly a reflection of the decrease in government activity, such as privatisation, which attracts foreign inflows. Approximately 60% of FDI into South Africa takes the form of mergers and acquisitions, largely as a result of state-leveraged deals and the privatisation of state assets (World Investment Report, 2001).

Are greenfield investments better than M&As?

The UNCTAD report (2001:17) asks to what extent FDI entry through the acquisition of domestic firms is different – in terms of its developmental impact – from entry through the establishment of a new facility (greenfield investments). There is a perception that M&As do not necessarily add productive assets or new jobs to a country. At the heart of

the concern in this regard is the notion that M&As are generally perceived as resulting mainly in a change of ownership and a shift in control from domestic to foreign hands, thereby increasing the risk of foreign domination of segments of the economy. Moreover, M&As often lead to employment loss and can be used to reduce competition and strengthen market power. They may also lead to the breaking up of the acquired firm and divestment of its individual parts. Such concerns exist in all countries.

The World Bank (2000) suggests that, especially at the time of entry and in the short term, M&As (as compared to greenfield investments) may involve, in some respects, smaller benefits or larger negative impacts from the perspective of host-country development. The UNCTAD report (2000:7) summarises the impact as follows:

The financial resources provided through M&As do not always add to the capital stock. Hence, a given amount of FDI through M&As may correspond to a smaller productive investment than the same amount of greenfield FDI, or to none at all. However, when the only realistic alternative for a local firm is closure, cross-border merger or acquisition can serve as a "life preserver".

FDI through M&As is less likely to transfer new or better technologies or skills than greenfield FDI, at least at the time of entry. M&As may lead directly to the downgrading or closure of local production, or functional activities in line with the acquirer's corporate strategy.

FDI through M&As does not usually generate employment when it enters a country. It may even lead to layoffs, although in the case of a firm which would have gone bankrupt had it not been acquired, it can also maintain employment. Greenfield FDI, by contrast, necessarily creates new employment at entry.

FDI through M&As can increase concentration and lead to anti-competitive results. However, it may prevent concentration from increasing when takeovers help preserve local firms that might otherwise have gone under. Greenfield FDI, by definition, increases the number of firms in existence and does not increase market concentration upon entry. The UNCTAD report (2000) notes that most of the shortcomings of FDI

through M&As, as opposed to greenfield FDI, relate to effects at entry or soon thereafter. In the longer term, when both direct and indirect effects are taken into account, many differences between the impacts of the two modes diminish or disappear. For example, cross-border M&As are often followed by subsequent investments by the foreign acquirers; thus, over time, FDI through M&As can lead to enhanced investment in production just as greenfield FDI does. Similarly, cross-border M&As can be followed by transfers of new or better technology, especially when acquired firms are restructured to increase the efficiency of their operations.

4.3 SUMMARY

A host country's decision on which type of investment to pursue is made within a wide range of interests and a variety of complex objectives. Such decisions are necessarily characterised by considerable uncertainty and risk as each type of FDI comes with its own benefits and drawbacks although the net result appears to be that FDI does have a positive effect on an economy's growth and development.

Five different types of FDI were discussed, namely: export oriented, market development, government initiated, greenfield, and mergers and acquisitions. Distinguishing government-initiated investment projects from other types of investment projects is difficult and necessarily imprecise because virtually all foreign investment projects in less-developed countries (LDCs), including export-oriented and market-development projects, receive government encouragement through subsidies in one form or another. However, the distinction becomes difficult to draw when other forms of FDI are supplemented with other government investment incentives. The distinction between export-oriented investments and those oriented to local sales (i.e. market development) is more firmly based than that between market-development and government-initiated investment. Thus the distinction between these types of investments is more hazy and difficult to interpret. The differences in the origin and determinants of these two types of investment suggest that the distinction is of some value even though the statistical differences between these two categories are open to greater question and must be interpreted with considerably more caution than the difference between export- and locally oriented projects.

In summary, the UNCTAD report (2000:2–18) concludes that it is difficult to distinguish between the impact of greenfield and acquisition types of FDI on a host country. UNCTAD also observes that there are broader policy concerns regarding the weakening of the national enterprise sector, loss of control over the direction of economic development, and the pursuit of social, cultural and political goals resulting from the activities of MNEs. The basic question here is what role foreign firms should play in an economy, regardless of whether they enter through greenfield investment or cross-border M&As. In light of potential host-country consideration of the need for a specific type of FDI, Wei (2000:3–6) states that: Each country needs to make its own judgement in the light of its conditions and needs and in the framework of its broader development objectives. It also needs to be aware of – and to assess – the trade-offs involved, whether related to efficiency, output growth, the distribution of income, access to markets or various non-economic objectives.

With this in mind, the focus of the study in the next chapter will be on the effects of FDI on an economy.

CHAPTER 5: THE EFFECTS OF FDI ON AN ECONOMY

5.1 INTRODUCTION

This chapter examines the cyclical effects of FDI on an economy in terms of macroeconomic variables like balance of payments (BOP), foreign exchange rates, interest rates and employment. It should be noted that the overall objective of this dissertation is to consider the impact of foreign investment flows on the South African economy. In light of this, the literature review in this chapter will only address the impact on the host country and not on the investor/source country. Similarly, the discussion of the effects on the balance of payments will only consider the net inflows in relation to host countries.

5.2 THE EFFECT OF FDI ON THE BALANCE OF PAYMENTS, INTEREST RATES AND EXCHANGE RATES

The balance of payments is a statistical statement that systematically summarises, for a specific period, the economic transactions of an economy with the rest of the world. The balance of payments is also regarded as the difference between international receipts and payments (Duce, 2003:2).

The balance of payments is an account that measures the sum of all receipts from outside an economy against the payments to sources outside the same economy (Cooper, 1992). Table 5.1 represents a generic balance of payments account.

Table 5.1 Sample of a balance of payments account

BALANCE OF PAYMENTS ACCOUNT			
RECEIPTS	R' billion	PAYMENTS	R' billion
Exports (X)	364.4	Imports (M)	384.1
Transfers from foreigners (TRs+1)*	-	Transfers to foreigners (TRs–1)	53.2*
Income payments to foreigners (IP+1) & Asset sales to foreigners (AS+1)	31.3	Income payments to foreigners (IP–1) & Asset purchases from foreigners (AS–1)	41.4
Negative net reserves (deficit)	83	Positive net reserves (surplus)	-
	478.7		478.7
SUMMARY			
1. Net transfers surplus (deficit) = TRs+1 – TRs–1 (* = Net transfers is reflected as a net figure in the bulletin) 2. Net income (expenditure) = IP+1 – IP–1 3. Net exports (imports) = X – M 4. Current account surplus (deficit) = net transfers + net income + net exports 5. Financial account surplus (deficit) = AS+1 – AS–1 6. BOP = financial account surplus (deficit) + current account surplus (deficit)			

(*From the South African Reserve Bank, Quarterly Bulletin, December, 2005: 1- 24*)

In Table 5.1, the initial transfer of assets by foreign nationals is first recorded in the financial account, which is used to record all asset flows. However, it should be noted that subsequent transfers in the form of royalties, interest, dividends and all other forms of income from the host country are recorded in the current account, which is used to record all income flows. It becomes very crucial, therefore, to look at the balance of payments account as whole when assessing the impact of FDI, since every international transaction has a different impact on the components of the BOP accounts and an ultimate impact on BOP balance or net reserves of a host country (Bartlett & Sumantra, 1998; South African Reserve Bank, *Quarterly Bulletin*, 2005:1–24).

Before considering the issues above, it is worthwhile looking at the relationship between BOP and the exchange rate, especially since the effects of FDI on BOP depend on the type of exchange rate regime observed by a host country. An exchange rate is the rate at which one currency can be exchanged for another. In other words, it is the value of one country's currency compared to that of another. Theoretically, identical assets should sell at the same price in different countries, because the exchange rate must maintain the inherent value of one currency against the other. There are four types of exchange rate regime that a country can adopt: fully fixed, floating, managed floating and semi-fixed.

- A fully fixed exchange rate regime is where a government sets and maintains the official exchange rate. A set price is determined against a major world currency.
- A floating exchange rate regime is where a country's exchange rate is determined by the private market through supply and demand.
- A managed floating exchange rate is where the value of a currency is determined by market demand for and supply of the currency with no predetermined target set for the exchange rate by the government. Host countries' governments at one time or another "manage" the value of their currency through changes in interest rates and other controls.
- A semi-fixed exchange rate is where the value of a country's currency is set by its government to move between permitted bands of fluctuation, and its central bank intervenes to ensure that the exchange rate stays within those bands (Froot & Stein, 1991: 191–217).

It should be noted that most countries in the 21st century have resorted to the adoption of the managed floating exchange rate since it has been found to reduce volatility in the exchange rate. If a host country's government follows a fixed exchange rate regime, initial FDI inflows will only affect the balance of payments account (specifically the financial account, as explained above) and not the value of its currency, since the effect on a country's currency will be contained and/or controlled by the government in accordance with the said monetary policy. When a flexible exchange rate is adopted by a country, initial FDI inflow affects the host country's balance of payments (increased receipts and reserves) and exchange rate (appreciation of its currency, all things being

equal). Under a managed exchange rate regime, the effects on both the exchange rate and the currency lie in between the two effects explained under flexible and fixed above. However, the extent depends on how heavy the intervention of the authorities is in the markets. If a high amount of FDI is received by a host country under the fixed exchange rate regime, foreign exchange reserves increase with a corresponding increase in money supply. This creates a problem in that the host country would immediately have to tailor monetary policies to curb such anomalies (South African Reserve Bank, *Quarterly Bulletin*, 2005: 24).

From the discussions above, it can also be deduced that the effect of FDI on the balance of payments and/or the exchange rate of a country depends on how FDI is financed. If it is financed by a host country on initiation of the transaction, for example by way of a loan (especially with regard to acquisition-type FDI), then both the balance of payments account as well as the value of the host country's currency may not be affected.

According to Reuber (1973), three issues are particularly prominent in discussions of the effects of foreign investment on the balance of payments of host countries:
(a) Is it meaningful to consider balance of payments in isolation from other macroeconomic variables?
(b) What transfer difficulties are likely to be associated with foreign investment?
(c) Related to this, is foreign investment likely to result over time in either a chronically weak balance of payments position or an ever-increasing non-resident share of the ownership and control of domestic industry, or both?

(a) In relation to other macroeconomic variables, it may be asked whether the balance of payments effects should be considered separately from real income effects because the balance of payments is determined by macroeconomic relationships and can be influenced by macroeconomic policy instruments such as the exchange rate, and monetary and fiscal policy (Johnson, 1970). However, in practice, countries often feel seriously constrained by the use of various adjustment mechanisms, and the balance of payments effects become important in resolving problems concerning FDI (Chenery & Strout, 1966). This is especially true of developing countries where supply rigidities,

economic dualism and high external dependence often curtail the efficacy of macroeconomic policy instruments.

(b) Two questions arise with regard to transfer of FDI. The first concerns the terms of trade effects – the effects on the receipts and payments column of the BOP account as explained above. However, these are likely to be negligible when the initial transfers, probably consisting mainly of capital goods, are made. Subsequent transfers from the host to the investing countries as a reverse flow of interest, dividend and principal repayments may conceivably give rise to adverse terms of trade effects which need to be recognised. (These effects were discussed in detail earlier in this chapter.)

The second question about the transfer mechanism is the inflationary effects it may have on an economy. Conceivably, foreign capital inflows can have an inflationary effect on domestic expenditure, depending on their influence on domestic investment. If the level of total investment is fixed independent of the capital inflow, then any capital inflow will be a substitute for domestic investment and such inflows will be inflationary. Normally, though not necessarily, direct investment, depending on whether it is acquisition or greenfield, will be linked to a decision to undertake capital expenditures in the country equivalent to at least the amount of investment. It has generally been assumed that capital inflows enhance expenditure and employment, and the available evidence tends to support this presumption (Reuber, 1973:32).

(c) With regard to reverse flows and foreign ownership bias, Reuber (1973:37) suggests that one can adequately assess the contribution of foreign investment to the balance of payments of the host country by simply subtracting the annual outflow of interest and dividend payments from the annual inflow of capital into the host country. For any given investment yielding a positive return after depreciation, the outflow in time will exceed the inflow, i.e. the net flow will become negative in that the total sum of returns repatriated over time tends to exceed the original investment. Thus in its simplest form, it is suggested that although foreign capital inflows may initially serve to ease balance of payments problems, the acceptance of such capital implies a built-in chronic balance of payments problem for the future as reverse flows develop. The fundamental flaw in these arguments is that they neglect the effects of foreign investment on domestic savings,

output, employment, exports and imports or, alternatively, rest on very special and highly implausible assumptions.

The operations of MNCs on the balance of payments may be divided into two parts: a financial effect on the capital and factor income accounts, and a trade effect on the current account. As far as the financial effect is concerned, the net outcome will depend on the rate of capital inflows relative to the rate of interest and amortisation repayments on foreign liabilities. There exists a foreign investment or debt cycle in which, for any given investment, the inflow will initially exceed the outflow but, all things being equal, over time the flow of capital may become negative due to repatriation of returns, thus creating potential problems on the balance of payments. This cycle is particularly noticeable in the case of direct investment, which, though not necessarily associated with the need for repayment as such, represents a single initial injection and there is no control in place to reduce future repatriation of profits and dividends. As long as a host country is borrowing capital at a positive rate of interest it must eventually expect the basic transfer to be negative unless the rate of growth of the debt exceeds the rate of return on it (Cooper, 1992:215).

Generally speaking, the inflow from the MNC's parent represents only a part of the total foreign investment. The remainder is financed through local borrowing and by the reinvestments of profits. However, profit is determined by the total investment in the affiliate and whilst reinvestment of profits reduces the current burden on the balance of payments, it increases the base on which profits are repatriated, thus increasing the burden on the balance of payments in the longer term. Following Hirschman (1969), it is likely that dividend remittances may be a multiple of the capital originally bought into the country, especially in situations where returns are re-invested in that the power of compound interest takes effect.

According to Parris (1981), the means by which a net positive FDI balance of payments effect can be achieved is expressed as follows:

$N > (1 - J)\, Bi + T$……...…….. (1)

where

N = the annual new direct investment from abroad, net of capital repatriated overseas
B = the value of foreign-owned local enterprises at the beginning of each year
J = the proportion of total foreign profits that is not repatriated but reinvested locally
i = the after-tax rates of return on FDI
T = annual disguised profits through transfer pricing

Moreover, to keep the share of foreign-controlled capital constant or decreasing, the following condition must hold:

$A > N/B\ Ji$ ……. (2)

where
A = the rate of growth of locally owed firms

In that sense, then, A is the determining factor. However, in the long run N/B must remain positive and grow cumulatively. In addition to the financial effects of FDI on the balance of payments, one should also include its trade effects via its contribution towards export promotion and import substitution. The net impact of FDI in this case will be all additional sales made possible by the investment projects minus imported inputs, subject to the fact that all resources employed in the project were previously unemployed, that all sales were either exports or imports substitutes, and that all additional income generated was saved.

Taking both the financial and trade effects into consideration, we can show the impact of FDI on a host country's balance of payments by using the following model employed by Parris (1981). The initial impact on the balance of payments of a given investment project is as follows:

$Bo = Io = EGo + MSGo – MIo – LFo – PRo – Do$…… (3)

where
B = the balance of payments for a given year owing to the specific investment project
I = the initial inflow of foreign exchange owing to this investment
EG = exports of the product yielding foreign exchange
MSG = reduction in imports of substituted goods

MI = imports of raw materials and intermediate inputs used in production of outputs (if this is non-existent in the host country)
LF = foreign labour and royalty payments
PR = repatriated profits
D = the annual amortisation of the initial investment that is annually repatriated
o = initial time period

The effect of FDI on the balance of payments depends on the magnitude of these variables. If the initial inflow (I) is small and exports (EG) are minimal, while the remaining items are all considerable, the effect may be negative. In this case we may have the following:

$B_t = I_t - MI_t - LF_t - PR_t - D_t$ …….....(4)
$B_t < o$ ……... (5)

After the initial inflow in year one, the impact of FDI is as follows:
$B_t = EG_t + MSG_t - M_{it} - LF_t - PR_t - D_t$…… (6)
where t is the time period.

The effect will be positive or negative depending on whether the sum of exports (EG_t) and import substitution (MSG_t) is greater or smaller than the sum of imported inputs (MI_t), foreign factor payments (LF_t and D_t) and repatriated profits (PR_t). The total impact of the investment over the life of the project will be as follows:

$$\sum_{t=1} B_t = I_o + \sum (EG_t + MSG_t - M_{it} - LF_t - PR_t - D_t) \quad \text{…… (7)}$$

In the long run:

$$\sum_{t=1} I_t < \sum (D_t + PR + LF_t) \quad \text{……(8)}$$

The burden of ensuring that FDI has a positive impact on the host country's balance of payments falls entirely on its net contribution to exports and import substitution. In other

words, in this partial equilibrium model, the trade effect must exceed the financial effect to ensure net benefits in the long run. Expressed algebraically:

$$\sum_{t=1} (EGt + MSGt) > \sum MIt - LFt - PRt - (Dt - It) \quad \text{.....(9)}$$

The limitation of this formula is that it is assumed that FDI activities run at a loss in host countries, i.e. B_o (on the initial time period, balance of payments for a given year owing to the specific investment project) is less than all other variables (MI = imports of raw materials and intermediate inputs used in production of outputs (if this non-existent in the host country); LF = foreign labour and royalty payments; D = annual amortisation of the initial investment that is annually repatriated; PR = repatriated profits).

Initially, FDI increases the influx of capital flows relative to outflows. By providing foreign exchange, FDI may fill the foreign exchange gap in the short run. Also, by producing goods that were previously imported it saves foreign exchange, and by producing exportable goods it also earns foreign exchange. As a result of this, the receipts column of the balance of payments account tends to exceed the payments column, all things being equal, and this has advantages and disadvantages for host countries, especially under a managed flexible exchange rate regime. On the other hand, the foreign exchange reserve built-up through FDI inflow may be eradicated by way of repatriation of capital, interest and profits, and transfer pricing may also be resorted to.

Moreover, an increase in FDI results in increases in demand for the host country's currency (and a corresponding increase in foreign exchange in the foreign exchange market). The effect of the increase in demand for the host country's currency is as follows: under a fixed exchange rate regime, there will not be much effect on the host country's currency (an increase in reserves is the only effect). In the case of managed exchanged rate regime, the effect on the exchange rate is dependent on the policy decisions of the host country. However, it is noted that under a flexible exchange rate regime, an increase in demand for the host country's currency through FDI strengthens the currency of the host country through the market forces. Assuming a constant supply of the host country's currency, the following ensues: a strong currency may lead to cheap

imports and uncompetitive exports, where the host country supplies elastic commodities (i.e. commodities that easily respond to prices changes), this will result in a negative influence on the foreign exchange reserves of the country, FDI, production and ultimately unemployment. By the same token, an increase in FDI leads to future outflows in the form of royalties, dividends and interest. These outflows create the reverse of the above. A high-value currency resulting from an increase in FDI, all things being equal, allows the government of a host country to reduce interest rates in line with its policy objectives, while remittances in the form of payments to foreign investors, all things being equal, allow the government of a host country to increase rates in line with its policy objectives. In other words, the mere occurrence of currency appreciation or depreciation does not necessarily require the increase/decrease in rates, but supports the decision of the government to alter rates. However, temporary strength in the local currency would, all things being equal, erode over time as various outflows associated with the initial inflow occur (Kahn, 1999).

5.3 FDI AND EMPLOYMENT

Cooper (1992:188) explains employment as follows: an act where a service is rendered by a person (including legal persons) to another person in return for compensation (monetary or non-monetary).

FDI may contribute to economic growth directly by creating employment opportunities and indirectly through the creation of employment opportunities in other organisations.

Indirect employment created by foreign affiliates in host countries, according to Nanak (2000), can be large, probably larger than that created directly. With the growth of international production, the share of employment creation by foreign affiliates is growing. Employment creation in host countries has been partly attributed to the labour-intensive nature of the economic activities established by foreign companies (World Bank, 2000).

There is a wide divergence of views concerning the effect of FDI on host countries' employment levels. The initial assumption in most host countries is that there is an increase in the level of employment when foreign investors enter a country. This view is shared by US multinationals, who contend that they are only able to maintain domestic

employment in high-skill activities by transferring their labour-intensive activities abroad. This suggests that although employment levels increase, this is only at a semi-skilled level. However, this is still an advantage to host countries, who are better off with this increase in employment levels than if there were no FDI at all (Glickman & Woodward, 1989). Another side to this divergent view is that due to the sophisticated technology and the level of knowledge of foreign investors, host countries are not able to compete with regard to this knowledge, which eventually leads to downsizing of the labour force (Reuber, 1973).

Reuber (1973) further elaborates that most resident firms bear most of the cost of training employees, and the degree to which investing firms finance training is extremely difficult to determine. In most cases, employees are hired at going rates for the category in question rather than at some lower rates which increase in line with their training. In addition to FDI's effect on the level and composition of employment there is also the question of its effect on labour income. This is because more work is created, increasing the demand for labour and thus leading to increases in salaries generally. At a broad macro level it follows from general theoretical principles that an increase in capital stock enhances labour income.

Focusing on wages and salaries, one would expect that as foreign investment creates more jobs it would also tend to raise wage and salary levels. This effect, according Michael and Gugerty (1997), seems most likely to show up in the market for skilled and semi-skilled workers as well as for highly trained professional categories where the elasticity of local labour supply is likely to be the lowest. It remains to consider what, if any, effect FDI may have on the stability of employment. One possibility is that FDI, by increasing the integration of the local economy into the international economy, leaves the local economy more vulnerable to fluctuations in the international economy. While this may be so, cyclical savings in the economies of developed countries in recent years have probably been more moderate than in the LDCs. In this situation increased integration serves as a stabilising factor to employment in the LDCs

Kyong-ae (2006) supports the fact that FDI creates employment. He avers that foreign investors added a total of $66.4 billion to Korea's reserves in 2005, which helped create

about 530 000 new jobs, or 87 000 per year. FDI created 302 000 jobs in the service industry (which accounted for 58% of the total new jobs); 198 000 jobs in manufacturing; and 31 000 jobs in other areas such as gas and construction. In addition, Kyong-ae (2006) states that attracting foreign investments is one of the options to creating jobs amid soaring unemployment in South Korea, particularly in manufacturing and service sectors.

Of concern with regard to the negative effects of FDI on employment is the following: it has long been a concern of policymakers that greenfield FDI may cause job losses in investor countries (in line with the objective of the dissertation, investor countries being examined here to determine the effect on host countries below); indeed, labour unions generally consider FDI to be the equivalent of job exporting. The logic is simple: as production lines are relocated overseas, with them go the workers that served the domestic lines. This serves to confirm that host countries will see an influx of foreign staff/labour (especially skilled staff) with increases in FDI. This leads to increasingly less use of skilled staff in the host country. Skilled staff are sometimes laid off or become redundant, resulting in a halt in knowledge transfer and ultimately in productivity and economic growth. A counter-argument is that the entrance of foreign investors expands the economy through competition, which creates vacancies which "surplus" skilled labour in an economy can fill, and productivity increases, which, when sustained, results in economic growth (Bartlett & Sumantra, 1998). This reasoning is, of course, over-simplistic, because there could never be any guarantees that if the production lines that were relocated overseas would have been able to survive the competition had they remained at investor country. If these production lines were to be eliminated (or in the process of being eliminated), then their relocation would not result in any job losses. Moreover, acquisition-type FDI results in just a transfer of ownership and does not in itself create jobs; in fact foreign investors seek ways to reduce costs, increase revenue and generate more profits, and may go to the extent of shedding jobs.

5.4 GENERAL EFFECTS OF FDI ON AN ECONOMY

Recently, it has been claimed, based on empirical evidence, that the presence of multinational corporations (MNCs) in developing countries does not bring the expected positive spill-over effects to domestic firms in the same industry. In fact, their effects are often negative because domestic firm productivity decreases as MNEs (multinational

enterprises) move into the market – the fall in domestic productivity is attributed to domestic firms having to compete with more efficient MNEs. Going by such evidence it might seem that FDI is unimportant and even an obstacle for economic growth. Further studies have argued that while there might not be evidence for positive intra-industry spill-over – i.e. spill-over for domestic firms operating in the same industry as MNCs – there is evidence for positive inter-industry spill-over, i.e. that which accrues to domestic firms in different industries. Such inter-industry spill-over is often attributed to the cross-fertilisation of ideas through knowledge sharing. Empirical evidence in manufacturing in Colombia can be used to illustrate this point. Producers in other sectors may experience positive spill-over, especially when MNCs outsource from local upstream suppliers. Therefore, some studies suggest that FDI has the potential to boost the economies of host countries through knowledge sharing and technology transfer between industries (Kugler, 2001)

5.5 SUMMARY

The importance of exchange rate policy is usually emphasised in trade-balance or balance-of-payments debates, since it mostly determines the state of the BOP account. Initial receipt of FDI leads to a positive financial account and consequently a balance of payments surplus. Subsequent to the initial investment, income transfers in the form of interest, dividends and royalties which are remitted to investor countries result. These remittances affect the current account and ultimately the BOP account negatively. However, the effect of FDI on the value of the host country's currency depends on the exchange rate policy in place at the host country. Under a fixed or managed exchange rate policy, the influx of FDI has no effect on the exchange rate of the host country, but causes an increase in reserves. However, an increase in reserves leaves host countries' government with a decision as to whether to carry on buying the surplus foreign exchange indefinitely or whether to sterilise such intervention by offsetting sales of securities in the domestic money market. On the other hand, the effect under a flexible/managed flexible exchange policy may be that the value of the currency increases. A high-value currency resulting from an increase in FDI, all things being equal, may encourage the government of a host country to reduce interest rates in line with its policy objectives, while remittances in the form of payments to foreign investors, all things being equal, may encourage a host countries' government to increase interest

rates in line with its policy objectives. In other words, the mere occurrence of currency appreciation or depreciation does not necessarily require the increase/decrease in rates, but may support the decision of the government to alter rates accordingly.

In the case of employment, it is argued that greenfield FDI creates employment in that newly formed businesses employs in order to carry on with its objects. Wage and salary levels may be increased due to increase in demand for labour. Productive training may also be given in that foreign investors go to host countries with innovative and more efficient ways of production. However, a concern is that foreign investors, in order to implement their innovative strategies, tend to employ skilled workers from their country of origin. This leads to unemployment and also leaves the host country's skilled workers redundant – this applies to both greenfield as well acquisition-type FDI.

In this chapter, the effects of FDI on host economies have been examined and, aside some negative effects, there appears to be a more positive net effect, justifying the cause for studying the need for this type of investment. Chapter 6 will therefore be dedicated to looking at the need for FDI in an economy.

CHAPTER 6: THE NEED FOR FDI IN AN ECONOMY

6.1 INTRODUCTION

It has long been recognised that the benefits of FDI for the host country can be significant. Some of the benefits include knowledge and technology transfers to domestic firms and the labour force, productivity spill-overs, enhanced competition and improved access for exports abroad, notably in source countries. Moreover, since FDI flows are non-debt creating, they are a preferred method of financing external current account deficits, especially in developing countries where these can be large and sustained. Also, FDI represents investments in production facilities, and its significance for developing countries is much greater. Not only can FDI add to investible resources and capital formation but, more importantly, it is also a means of transferring organisational and managerial practices between locations, as well as accessing international marketing networks.

The main beneficiaries are enterprises that are part of transnational systems (consisting of parent firms and affiliates) or that are directly linked to such systems through non-equity arrangements, but these investments can also be transferred to domestic firms and to the wider economies of host countries if the environment is conducive to this. The greater the supply and distribution links between foreign affiliates and domestic firms, and the stronger the capabilities of domestic firms to capture spill-overs (i.e. indirect effects) from the presence of and competition from foreign firms, the more likely it is that the attributes of FDI that enhance productivity and competition will spread.

This chapter is not limited to discussing the benefits of FDI alone, but also looks into possible drawbacks of FDI, which take the form of unintended side effects on host countries; hence they should not be seen in isolation. The drawbacks have been found to include the distributional consequences of enterprise restructuring, competing effects where foreign entry results in greater market concentration, and balance of payments volatility in response to the import and export patterns of foreign-owned enterprises. In small economies, large foreign companies can, and often do, abuse their dominant market positions and may attempt to influence the domestic political process. In addition, large investors are sometimes able to coax concessions from governments in return for locating investment there and aggressively use transfer pricing to minimise their tax obligations.

6.2 THE BENEFITS OF FDI

6.2.1 FDI and macroeconomic growth

When one undertakes a survey study on FDI for development, a question immediately springs to mind: why FDI and why should investment have to be foreign investment? The answer to this question explains one of the key benefits of FDI: it is known that foreign investment (given the level of inward investment) is good for productivity growth, technological progress as explained under 6.2.3, income and so on. The most one could hope for in any economic activity in a developing country is that it contributes to economic growth. However, as with many economic phenomena, there is no conclusive evidence one way or another, but the empirical evidence is that FDI often, though definitely not always, contributes to economic growth, and the evidence is indeed good that economic growth usually leads to reduced poverty, though not necessarily to a more equitable distribution of income (Bevan & Estrin, 2000).

Estrin (1994:90) maintains that poverty reduction resulting from economic growth arising from FDI may not necessary benefit the poor directly; however, because FDI contributes to export growth, productivity growth and finance for balance of payments, it supports increases in national income that offer the potential to benefit the poor indirectly. Also, even though FDI may not reduce poverty directly, it helps to create an enabling economic environment and increases employment, which may help many to move out of poverty. The beneficial effects of FDI on poverty reduction are potentially stronger when FDI is employed as a tool to develop labour-intensive industries and where it is anchored in the adherence to MNEs' national labour law and internationally accepted labour standards.

According to Hausmann and Fernandez-Arias (2000:3), the advantages of FDI in contributing to economic growth are threefold:

First, some developing countries have domestic savings that are too low to finance an optimal rate of capital building. If, at the same time, they have problems tapping into international financial markets, FDI may be their best chance of alleviating financing constraints. A similar effect occurs where domestic savings may be ample, but a deficient banking system is unable to funnel the available funds to domestic investors.

Second, FDI is a more stable source of external finance than portfolio investment and borrowed funds. For example, in the case of a financial crisis, loans and short-term

securities investment are usually withdrawn very swiftly. Investors with a direct stake in enterprises are less likely to disinvest due to short-term considerations.

Finally, Hausmann and Fernandez-Arias (2000:6) further explain that perhaps, and most importantly, countries at all levels of development may benefit from a foreign corporate presence in their business sector in that FDI has direct effects on the performance of the host country business sector. The entry of foreign enterprises generally leads to productivity growth and enterprise development. This in turn can lead to enhanced competition, particularly in previously shielded market segments.

Lipsey (2001) argues in a similar way to Hausmann and Fernandez-Arias (2000) in that FDI has become an important source of private external finance for developing and developed nations. It is different from other major types of external private capital flows as it is motivated largely by the investors' long-term prospects for making profits in production activities that they directly control. Foreign bank lending and portfolio investment in contrast are often motivated by short-term profit considerations that can be influenced by a variety of factors and are prone to herd behaviour. Lipsey (2001) illustrates that these differences by referring to the pattern of bank lending and portfolio equity investments and FDI to the Asian countries stricken by financial turmoil in 1997. FDI flows in 1997 to the five most affected countries remained positive in all cases and declined only slightly for the group, whereas bank lending and portfolio equity investment flows declined sharply and even turned negative in 1997.

According to the World Bank Report (1997), there is empirical evidence to suggest that a dollar of FDI raises the sum of domestic and foreign investment by more than a dollar, thus FDI complements rather than substitutes for domestic investment. In addition, especially in less-developed countries, FDI has been shown to be a more efficient, stable and worthwhile type of investment to attract than domestic investment only. The efficiency and the stability of FDI was evidenced by the fact that FDI remained high despite growing investor concerns over emerging market risk as well as the deterioration of the global economic environment. FDI flows to developing countries totalled $155 billion in 1998, down by $8 billion from its peak in 1997. FDI increased in some of the

East Asian crisis countries despite severe recessions, as it continued to be attractive through the collapse in domestic asset prices, massive exchange rate depreciation, and the continuous/new reception of FDI in certain economies. In the wake of the crises, M&As increased as domestic companies sought accessibility to financing through restructuring. FDI is said to be worthwhile due to the economic growth potential it creates when it complements domestic investment.

6.2.2 FDI and trade integration

As developing countries industrialise, FDI contributes to their further integration into the global economy by engendering foreign trade flows. Several factors are considered, including the development of international networks of related enterprises and an increasing importance of foreign subsidiaries in MNE's, strategies for distribution, sales and marketing. In both cases, this leads to an important policy conclusion, namely that a country's ability to attract FDI depends on investors' subsequent access to importing and exporting. Some countries have attempted to use FDI in a more targeted manner to either boost exports or curb imports. As for the first of these points, FDI may clearly boost exports where FDI helps host countries that had been financially constrained to exploit of their resource endowments or their geographical location.

6.2.3 FDI and technology transfers

FDI allows the transfer of technology, particularly in the form of new varieties of capital inputs that cannot be achieved through financial investments or trade in goods and services. Baldwin and Portes (1997) report that the spill-overs (or positive externalities) generated by FDI fall into two categories: technology diffusion and human capital building. FDI brings new technologies into host countries, which are eventually diffused to the broader domestic business sector. The channels through which this may take place are many but the report concludes that the most important source of technology spill-overs is vertical linkages between MNEs and local suppliers. Foreign-owned enterprises usually provide their suppliers with technical assistance, training and other information to improve the quality of their products. Also, through FDI, many MNEs assist local suppliers in purchasing raw materials and intermediate goods, and in modernising or upgrading production facilities.

An important issue is the actual uses that host countries are able to make of the technologies thus transferred. Crucially, the technologies need to be relevant to the host country's business sector beyond the specific company that receives them. In this respect, the general technological level of the host country's business sector is of great importance. 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 MNEs (Bevan & Estrin, 2000; Mallampally & Sauvant, 1999:12).

The above notion is supported by Meyer (1998:46), who explains that FDI can lead to beneficial technology and management skills transfer to local firms. Owing to the fact that MNEs typically have greater technological and management expertise than local firms, such expertise can be transferred to other parts of the economy. This appears to happen most clearly when the MNE has close ties with local partners, suppliers and customers, but even in cases where the MNE is not tightly integrated with local firms, there is evidence that technology and skills transfer takes place most likely through labour mobility, professional contacts or a general rise in competitive pressure.

Information and communication technology is a very important ingredient for growth. It helps in developing a country's productive capacity in all sectors of an economy, and provides a link between economies, thereby leading to competition. It stimulates invention, innovation and wealth creation. It contributes to poverty reduction by increasing productivity and providing new opportunities, and it sharpens the effectiveness, efficiency and transparency of human capital in a society. It is comprised of indicators such as Internet hosts and the number of computers, telephone mainlines, creation of bandwidths, fax machines, TV sets, radios, users of mobile phones and subscribers to newspapers (Bevan & Estrin, 2000). In the face of global competition for FDI, potential host countries are disadvantaged if information infrastructure and information technology are inadequate.

6.2.4 FDI and human capital enhancement

Recipients of FDI often contribute to employee training in the course of operating the new business, which assists in human capital development in the host country. Investment in general education is of the utmost importance in creating an environment in which foreign enterprises wish to invest. Achieving a certain minimum level is paramount to a country's ability, not only to attract FDI but also to maximise the human capital spill-overs that may arise from foreign enterprise presence, since the magnitude of MNE-sponsored training is necessarily smaller than that of general education. The direct impact on human capital from FDI derives mainly from the fact that MNEs tend to provide more training and other upgrading of human capital than domestic enterprises.

The beneficial effects of training provided by FDI can supplement but not replace a generic increase in skill levels. The presence of MNEs may, however, provide a useful demonstration effect as the demand for skilled labour by these enterprises provides host-country authorities with an early indication of what skills are in demand (Smith, 1991).

Grabbe (2001) shares a similar view that FDI can improve the skills and wages of the labour force in that, MNEs provide training and better employment opportunities for development of labour. Evidence is strong that MNEs pay better and train employees more thoroughly than domestic firms in developing economies. Grabbe (2001) further explains that the presence of MNEs in the labour market provides an incentive to local firms to improve the conditions and wages of workers. However, this creates a drawback in the sense that local firms, in order to control labour costs, may adopt a negative stance with regard to the reception of FDI.

Human capital levels and spill-overs are closely interrelated with technological transfers. Technologically advanced sectors in host countries are more likely to see human capital spill-overs and conversely, economies with a high capital component lend themselves more easily to technology spill-over, since technological development varies with the capital levels of a country. Consequently, efforts to reap the benefits of technology and human capital spill-overs could gain effectiveness when policies of technological, educational and training improvements are undertaken conjointly.

6.2.5 FDI and competition

FDI can also promote competition in the domestic input market. The European Commission Report (2004:5) identifies two main categories of efficiency gains from FDI, namely the effects on competition and the effect on enterprise restructuring and development. As for competition, since the early 1990s, a wave of mergers and acquisitions has reshaped the global corporate landscape. At the same time, a surge in the number of strategic alliances has changed the way in which formerly independent corporate entities interact. There has also been a wave of privatisations that has attracted considerable FDI (mainly in developing and emerging countries). This adds up to an increasing degree of concentration in national markets, which could have important effects on competition. Furthermore, the report suggests that the effect of FDI on host-country concentration is, if anything, stronger in developing countries than in more mature economies.

However, foreign entry also has the potential to increase competitive pressures in a previously cosy national market. This argument is underpinned by the fact that MNE entry is generally found to raise productivity levels among host-country incumbents (albeit more consistently so in developed than in developing countries). Unsurprisingly, this effect is strongest in markets where there appears to have been little competition prior to the foreign entry (European Commission Report, 2004).

Foreign market entry may lead to the closure of weaker enterprises, which may lead to increasing market concentration thus removing competition. Hence, while it is desirable that strongly performing entrants be allowed to replace less productive domestic enterprises, policies to safeguard a healthy degree of competition must be in place. The best way of achieving this is by expanding the relevant market by increasing the host economy's openness to international trade. In addition, efficiency-enhancing national competition laws and enforcement agencies are needed to minimise the anti-competitive effects of weaker firms exiting the market.

6.2.6 FDI and enterprise development

Foreign-orchestrated takeovers lead to changes in management and corporate governance. MNEs mostly impose their own company policies, internal reporting systems and principles of information disclosure on acquired enterprises, and a number of

foreign managers are normally appointed with the takeover. Where foreign corporate practices are superior to the ones prevailing in the host economy, this boosts corporate efficiency. However, in some cases country-specific competences are an asset for managers in subsidiaries; therefore MNEs need to strive towards an optimal mix of local and foreign management.

Foreign participation in the privatisation of government-owned enterprises is a case in point. Experiences from the transition economies in Eastern and Central Europe have been largely positive. Participation by MNEs in privatisations has consistently improved the efficiency of the acquired enterprises. Some political controversies have, however, occurred because the efficiency gains were often associated with sizeable job losses (in the short run, at least). Moreover, it has been argued by some that the good experiences with MNE participation in the privatisation process of transition economies could simply reflect the fact that few domestic strategic investors have access to sufficient finance and in those (few) cases where domestic private investors were brought into previously publicly owned enterprises, important efficiency gains also occurred (Breuss & Egger, 1997:94).

The privatisation of utilities is often particularly sensitive as these enterprises often enjoy monopolistic market power within segments of the local economy. The first-best privatisation strategy is to link privatisation with an opening of markets to greater competition. Where the privatised entity remains largely unreconstructed prior to privatisation, local authorities often try to attract foreign investors by promising them protection from competition for a designated period. In this case there is a heightened need for strong, independent, domestic regulatory oversight (World Bank Report, 2000).

6.2.7 FDI and environmental and social issues

Di Mauro (2000:11) posits that it is important to stress that not only does FDI affect the economy of the host country, but the foreign corporate presence also, in many cases, has important effects on social conditions and the environment. Taking the latter point first, Di Mauro explains that FDI has the potential to greatly benefit the environment in developing countries. However, for this potential to turn into tangible benefits, host-country authorities need to pursue adequate environmental policies. The technologies that

are normally transferred to developing countries in connection with FDI tend to be more modern and environmentally cleaner.

The World Bank Report (2000) also finds little support for the assertion that efforts to attract FDI may lead to "pollution havens" or a "race to the bottom" Apparently, the cost of environmental compliance is limited and, unsurprisingly, this is particularly the case where investors' home countries are wealthy or very environmentally concerned. The report finds little evidence that foreign corporate presence in developing countries leads to a general deterioration of basic social values, such as core labour standards. On the contrary, the report finds a positive relationship between FDI and workers' rights. Low labour standards may in some cases even act as a deterrent to FDI due to investors' concerns about their reputation elsewhere in the world and fears of social unrest in the host country.

6.2.8 Other advantages of FDI

Lall (1980) indicates that FDI is generally done by MNEs which are usually concerned with making profits; therefore the investments are usually well targeted towards setting up a business that will make money and create jobs. This contrasts sharply with aid and loans to governments which are often squandered through corruption or spent inefficiently on unneeded infrastructure or other vanity projects. Profits generated by FDI contribute to corporate tax revenues. A successful foreign-owned firm will generate profits and hence tax revenue for the host country. Those taxes can then be spent on necessary infrastructure, social programmes and education, etc. This is a strong incentive for government encouragement of FDI. However, in some cases the tax benefits can be disappointing. One risk is that the government may provide too great a tax amnesty as an incentive. For instance, a sharp decline in corporate tax in some of the member countries of the Organization for Economic Cooperation and Development (OECD) may result in transfer pricing. This occurs when a foreign-owned entity produces an intermediate good that is purchased by its parent company (such as car parts that are shipped to an assembly plant in another country). When the subsidiary sells its products at an artificially cheap price to the parent company so that it can pay lower taxes, this has a negative effect on the host country's tax revenue.

Furthermore, FDI may improve access to export markets. This is because MNEs almost by definition require substantial skills in importing and exporting. Many economists and policymakers believe that a key benefit of FDI is that the presence of export-oriented foreign firms in a country can help improve efforts by local firms to sell overseas. One way this happens is through improvements in shipping and logistics infrastructure, e.g. increased presence of international shipping firms and agents. There is probably also some knowledge transfer in this regard where managers of local firms learn from the example of the MNE on how to open new export markets (Mallampally & Sauvant, 1999:13).

Jayaratnam (2003) argues that FDI does not only improve skills and wages of labour and lead to technology transfer, but it can also provide additional demand for output of local producers. Another key component of positive spill-over is the increased demand for inputs from local suppliers that new MNEs can create, leading to increased profits and higher tax revenues for the state. A key determinant of the benefits to national income from FDI is the extent to which the foreign enterprise sources locally rather than importing its inputs. Similarly to the above, if an MNE creates a product previously imported by local producers or otherwise in short supply, FDI can lead to a decrease in production costs for local firms and correspondingly higher productivity and profits.

Since exports will typically earn foreign currency, an export-oriented foreign-owned entity can improve the current account of the balance of payments of a nation. The balance of payments benefit is reduced, however, by the extent to which the firm imports its production inputs. In addition, the initial FDI investment itself can also be an important source of foreign currency since the MNEs will typically need to use local currency to either purchase a local entity or to contract for work and equipment in setting up a new entity. This will be regarded as an inflow on the financial accounts of the BOP. However, MNEs will also eventually repatriate profits and retained earnings periodically, which causes an outflow of foreign currency (Christie, 2003).

FDI is also viewed as “good cholesterol” because it is thought to be bolted down and cannot leave so easily at the first sign of trouble. Unlike short-term debt, direct investment in a country is immediately re-priced in the event of a crisis (Christie, 2003).

Lim (2001) argues similarly to Christie (2003) by elaborating on the fact that FDI is thought to be more useful to a country than investment in the equity of its companies because equity investments are potentially "hot money" which can leave at the first sign of trouble, whereas FDI is durable. Also, since FDI is usually in the form of a factory or some other fixed object, it is very illiquid and thus a long-term investment. Moreover, MNEs are less apt to leave the country during speculative periods. This is one reason why FDI is so important to a country. Alfaro (2003:14) also concurs that because FDI is generally spent on real assets such as plant and equipment, the capital embodied in FDI cannot flee a country in times of crisis as easily as debt capital can. Even in instances where the FDI is a service-related effort, time is spent on developing an ongoing business, and owners will be reluctant to sacrifice this investment in human capital. Thus FDI is said to be much less likely than debt capital to exacerbate a crisis situation, as occurred in the Asian crisis in the late 1990s – these instances proved FDI to be much less variable than debt flows.

The presence of foreign firms may improve access of the host country to international markets, since many are well connected globally in terms of access to financial markets, consumer outlets and transportation networks. Foreign firms can act as catalysts for domestic exporters by providing externalities that augment the exporting prospects of domestic firms. Foreign firms may be seen as natural conduits for information about foreign markets, foreign consumers and foreign technology, and they provide channels through which domestic firms can distribute their goods (Aitken, Hanson & Harrison, 1997: 3-40). This raises a country's potential to increase foreign-exchange earnings from exports for purchasing imports and servicing debt.

6.3 DRAWBACKS OF FDI

In spite of the various advantages/benefits of FDI listed above, FDI is not without drawbacks and disadvantages to a host nation. The following drawbacks, amongst others, are discussed in detail below: FDI may lead to decapitalisation; damaging competition; creation of monopolistic power and social disorder; generation of undue influence on the shaping of policy; environmental degradation; exploitation of natural resources; strain in international relations; dissipation of potential gains; information bias between host and investor countries; and excessive borrowing in domestic credit market. Furthermore it

may be instable, exacerbate or create misallocation of resources and indicate economic weakness.

6.3.1 Decapitalisation

If foreign ownership becomes too extensive, decapitalisation can occur. As foreign-owned firms become established and profitable, they begin to repatriate earnings to their home country. In so doing, the local currency is converted to their home-country currency and capital leaves the country. If the base of foreign-owned companies is large enough, this can lead to a serious capital drain. This is especially a concern if in times of crisis all foreign-owned companies repatriate retained earnings simultaneously. The effect of this can be similar to the effect of foreign lenders refusing to roll over short-term loans. The country can be starved of capital, and a bad economic situation can be made dramatically worse. This is sometimes cited as one of the primary risks of a country becoming too reliant on FDI (Rasmini, 2000; Mallampally & Sauvant, 1999:13).

6.3.2 Damaging competition

Singh and Jun (1996), and Mallampally and Sauvant (1999:15) indicate that, because MNEs often have skills, technology and capital that local firms cannot match, FDI may create damaging competition to local firms, and that this is often cited as a primary negative spill-over from FDI. This is a significant and complex risk to evaluate. Lehman and Mody (2002) note that it is certainly true that local firms can be damaged or even put out of business and that unemployment can result. But it is also true that in many instances competition from more efficient foreign-owned producers can be seen as a benefit to the economy as a whole, improving overall productivity and forcing local firms to modernise and improve efficiency. The question to ask here may be whether local firms will be able to improve to compete or just be decimated by competition from MNEs. If it is the latter, then FDI deserves additional scrutiny.

6.3.3 Monopolistic power

Lankes and Venables (1996) clarify the fact that by their access to finance and advanced technical and management expertise, MNEs can possibly force all local competitors out of business, which can lead to market dominance by MNEs. Once such monopolistic power is obtained, MNEs can then raise prices and extract excessive profits, potentially

eliminating any overall benefit of FDI. Lankes and Venables (1996) further warn that monopolistic power gained by MNEs is a risk associated with FDI that should be closely monitored by host countries.

6.3.4 Social disorder

When MNEs are seen as exerting too much power, especially monopolistic power over something considered a public good, e.g. water, electricity and telephone services, then public resentment and protest can occur. This can lead to a hostile business environment, social disorder and, in the worst case, political instability. This happened dramatically in Cochabamba, Bolivia in 2000, when the local water service was taken over by a multinational conglomerate led by Bechtel, which immediately doubled prices, precipitating a general strike and transportation shutdown. In this case the Bolivian government reversed the privatisation and Bechtel was forced to exit the country (World Bank Report, 2003). A counter example is the telephone service in several countries around the world including Mexico, Brazil and India where foreign entry into the industry previously controlled by the government dramatically reduced costs and improved service. However, in each of these cases it is probably the introduction of competition rather than the introduction of foreign capital per se that led to such dramatic service improvements (World Bank Report, 2003; Mallampally & Sauvant, 1999:15).

6.3.5 Undue influence on the shaping of policy

In a similar way to the above, Mills (1995) explains that large-scale flows of FDI will tend to create reliance on them, so that policy is constrained by the need to avoid any moves that discourage continued FDI. Foreign investors in general and multinationals in particular may come to have undue influence on the shaping of policy. The danger of abuse of market power will be particularly strong when the entry of large MNEs raises concentration levels within an economy. Then, if the bargaining and regulatory capabilities of the host country are also weak, democracy, indigenous development and the welfare of population may all be undermined.

6.3.6 Environmental degradation

New production facilities may lead to environmental degradation. A frequent argument is that MNEs attempt to locate polluting facilities where environmental controls are the weakest. It is true that most developing countries have fewer environmental regulations

and less ability to enforce regulations, which may result in terrible accidents and great environmental harm being caused by MNEs (e.g. the Bhopal chemical disaster oil pollution in India in 1984). However, there is no good evidence of MNEs being more likely to pollute than domestic firms. Evidence may actually point the other way because MNEs, due to their higher profile, are seen to be more sensitive to environmental issues than local firms are (Mallampally & Sauvant, 1999:16).

6.3.7 Exploitation of natural resources

Graham (1995:95) adds that environmental and natural resources costs may also be involved, requiring careful consideration of the short-term advantages to be gained from FDI and the longer-term implications for the country's resource base and general state of the environment. The large-scale exploration and exploitation of natural resources is often associated with large-scale environmental damage. Graham (1995) further argues that sometimes, and even more importantly, politico-strategic interests could also be at stake when FDI comprises a large component of the total investment and involves a loss of control over strategic sectors of the economy, vital infrastructure and natural resources. Moreover, in some circumstances, the country's sovereignty may be at stake.

6.3.8 Strain on international relations

It is argued that FDI often creates conflicts between the host and the source country. This is because FDI in the host country diminishes the market share of the domestic firms in the source country, which in turn has adverse effects on the level of employment and profits in the source country. The host country does not lose out if there are no major domestic firms there and in fact it encourages FDI in order to reduce the level of unemployment. However, foreign firms often import inputs from source countries and therefore the host country does not benefit fully from the FDI. In order to reap the full benefit of FDI, host countries tend to impose local content requirements on foreign firms. The source country, in reverse, also imposes content restrictions on the products of the investor, which effectively reduces the expected advantage of both the source and host countries (Grosse, 1989).

Similar to the above, Woodward (1997) mentions that FDI can generate unfair discrimination between source and host countries, and this raises serious political and

economic implications, especially in middle-income countries, with some affected groups asking why foreigners should enjoy better treatment than domestic investors.

6.3.9 Dissipation of potential gains

Special treatment for some projects or sectors may also reduce the net benefits from FDI. In attempting to foster particular sectors or specific investment projects, authorities may negotiate special conditions for foreign investors on a case-by-case basis. This is risky. In a competitive world, if many countries bid against each other to attract the same foreign investment, they may end up dissipating all the potential gains from such investment (World Investment Report, 1999).

6.3.10 Information bias between host and investor countries

FDI may not necessarily benefit the host country, as demonstrated by Lahiri and Ono (2005). Through FDI, foreign investors gain crucial inside information about the productivity of the firms under their control. This gives them an information advantage over uninformed domestic investors whose buying of shares in domestic firms does not entail control. Taking advantage of this superior information, foreign direct investors will tend to retain high-productivity firms under their ownership and control, and sell low-productivity firms to the uninformed investors. As with other adverse selection problems of this kind, this process may lead to over-investment by foreign direct investors.

6.3.11 Excessive borrowing in the domestic credit market

Excessive leverage can also limit the benefits of FDI. The domestic investment undertaken by FDI establishments may be heavily leveraged owing to finance that may be obtained from the domestic credit market. As a result, the fraction of domestic investment actually financed by foreign savings through FDI flows may not be as large as it seems (because foreign investors can repatriate funds borrowed in the domestic market), and the size of the gains from FDI may be reduced by the domestic borrowing done by the foreign-owned firms.

6.3.12 The somewhat instable nature of FDI

Recent work has also cast the evidence on the stability of FDI in a new light. Though it is true it can be difficult to move out of a host country on short notice, financial transactions can sometimes accomplish a reversal of FDI. For instance, the foreign subsidiary can

borrow against its collateral domestically and then lend the money back to the parent company. Likewise, because a significant portion of FDI is inter-company debt, the parent company can quickly recall it (Winham, 1996).

6.3.13 Exacerbating or creating the misallocation of resources

According to Winham (1996), there are some other cases in which FDI might not be beneficial to the recipient country, for instance when such investment is geared toward serving domestic markets protected by high-tariff or non-tariff barriers. Under these circumstances, FDI may strengthen lobbying efforts to perpetuate the existing misallocation of resources. There could also be a loss of domestic competition arising from foreign acquisitions leading to a consolidation of domestic producers, through either takeovers or corporate failures.

6.3.14 FDI as an indication of weakness in an economy

Hausmann and Fernandez (2000:7) point to reasons why a high share of total capital inflows may be a sign of a host country's weakness rather than its strength. One striking feature of FDI flows is that their share in total inflows is higher in riskier countries, with risk measured either by countries' credit rating for sovereign (government) debt or by other indicators of country risk. There is also some evidence that their share is higher in countries where the quality of institutions is lower. What can explain these seemingly paradoxical findings? One explanation is that FDI is more likely than other forms of capital flows to take place in countries with missing or inefficient markets. In such settings, foreign investors prefer to operate directly instead of relying on local financial markets, suppliers or legal arrangements. The policy implications of this view, according to Albuquerque (2000), are that countries trying to improve their access to international capital markets should concentrate on developing credible enforcement mechanisms instead of trying to obtain more FDI.

In a similar vein, Hausmann and Fernandez (2000) suggest that countries should concentrate on improving the environment for investment and functioning of markets. By so doing, they are likely to be rewarded with increasingly efficient overall investment as well as with more capital inflows. Although FDI may be higher where domestic policies and institutions are weak, this should not be regarded as a criticism of FDI per se since without it the host countries could well be much poorer.

6.4 SUMMARY

FDI is usually preferred over other forms of external finance because it does not create debt and is less volatile. Returns depend on the performance of projects financed by the investors. FDI benefits domestic industry as well as consumers by providing opportunities for technological upgrading; allowing access to global managerial skills and practices; affording optimal utilisation of natural and human resources; making the industries in the host economy more competitive; opening up export markets; providing backward and forward linkages; and giving access to international quality goods and services. Thus FDI can be used to diversify the economy thereby reducing over-dependence on a few sectors.

On the negative side, foreign firms with subscale operations and protection from competition generate inefficiencies and misallocation of resources in the host economy. In such cases, they leave the recipient country worse off than if it had never received the investment in the first place. Moreover, such protected FDI, however small, creates a vicious dynamic of adverse signals and perverse incentives (both economic and political) for all parties. Instead of providing a path for growth, dynamic learning and development, this type of FDI tends to produce conflict-generating constituents that are likely to use their influence to maintain their privileged position and undermine the impetus to economic reform.

Another commonly heard objection against the importance of FDI for development is that developing countries receive only a small share of global FDI flows. The beneficial effects of FDI for development has also been cast in doubt by some on the grounds that those funds that do flow to developing economies are concentrated in a few countries

From the discussions above, it can be seen that FDI has numerous advantages, which appears to outweigh the disadvantages brought about by this type of investment, therefore it is justifiable for countries to attract this type of investment through structured national efforts. It is for this reason that the next chapter has been dedicated to the discussion of policies that can be implemented by host countries in their pursuit of this investment.

CHAPTER 7: POLICIES TO ATTRACT FDI INTO AN ECONOMY

7.1 INTRODUCTION

Attracting FDI is at the top of the agenda for most countries as many studies show that it has become the most important source of development and economic growth. By and large, governments are recognising that FDI can contribute to economic growth and development and, as a result, most have given the attraction of FDI high priority, especially on the African continent. The high level of demand for this type of investment has made the world market for it highly competitive.

The growth of FDI in the world has been significant in recent years. Between 1990 and 2000, the world's FDI inflow increased more than five times, and after reaching a peak in that year it has experienced a decline. One fascinating feature of this growth phase was that most FDI transactions were between developed countries. This stands to confirm that although FDI is important to developing countries; its distribution has been biased in favour of developed countries. The problem of biased distribution of FDI into developing countries has been exacerbated by the decline in world FDI transactions and as a result of the scarcity, both developed and less-developed countries are now competing for it, especially due to the positive multiplier effects this type of investment has on an economy (the advantages of FDI are discussed in Chapter 6). It is for this reason that policies to attract this type of investment have become of critical importance (Addison & Heshmati, 2003).

FDI flows are basically the result of investment decisions taken by transnational corporations (TNCs) in response to certain pull factors. Whether a TNC will undertake FDI in a foreign country or not depends on the existence of a number of factors that influence such a decision.

In view of the above, this chapter will discuss the policies that a country can consider to attract FDI. These can be broadly categorised into three types: first, general economic policies that increase locational advantages; second, national FDI policies that reduce the transaction costs of investors; and third, international FDI policies that deal with agreements (whether bilateral, regional or multilateral) on foreign investments. Other general policies in addition to the above will also be discussed. The overall economic

policies work at the macro level and aim to improve the fundamentals of the economy such as the market size, availability of skilled labour, infrastructure, etc., which in turn aid in attracting FDI flows into an economy. The national FDI policies work at the domestic level, and regulate entry and exit of FDI along with the creation of incentives and restrictions on operations of foreign firms in different sectors of the economy. The international FDI policies work at the international level and deal with agreement issues relating to the treatment of FDI from a particular region. These investment agreements may ensure that FDI from a particular region is either treated or not treated under most-favoured-national standards and national treatment standards.

7.2 GENERAL ECONOMIC POLICIES

The general economic policies should help to strengthen the economic fundamentals. Though not limited to the following, the economic fundamentals that the policies should address include the market size, cost factors (these include cost of labour, cost of capital and infrastructure costs), the exchange rate, the rate of inflation and macroeconomic stability factors (e.g. political, economic and financial stability).

7.2.1 Market size

Economic policies aimed at developing the market of a country should ensure that FDI is attracted into that country. Market size may be measured not only by the population of the host country – other factors might also prove significant. Specifically, these are policies directed at assessing and improving the purchasing power of the local population, policies regarding the proximity and connections with other relevant countries, or policies to effect healthy competition already present in the host country.

Large markets, due to their large resource base, are often given more consideration than smaller markets. Firms usually invest in large markets to capitalise on their own specific assets by entering the market first or by following a lead in the new market. It should also be emphasised that large firms, which mostly operate in large markets, are more willing to undertake the risk and cost associated with FDI projects due to their large resource base. The market potential of host countries has a significant and positive effect on attracting FDI. Lunn (1980:54) found the market size of Eastern European countries (EEC) to be a significant variable for US direct investment in Europe. In addition, Lunn

(1980:62) states that for developing countries, previous studies found market size to be a significant indicator that attracts FDI. In either case, future share of new markets is the driving force behind expansion in foreign markets and hence the importance of policies that result in or are directed at expanding host-country markets.

According to Dunning and Narula (1998), countries that possess small domestic market size are likely to have not just limited natural resources such as primary commodities but also limited attraction in terms of FDI. Thus, lack of economies of scale inhibits foreign investment – a small population is not just indicative of small aggregate consumption, but also that domestic firms would need to seek overseas markets in order to achieve economies of scale.

Furthermore, it has been argued that firms expect to experience greater long-term profits through economies of scale and lower marginal cost of production in countries with larger market potential as a large market size generates economic of scale and a growing market improves the prospects of market potential, resulting in attracting FDI flow (World Bank Report, 1995).

Chakrabarti's (2001) view, although similar to the above, is argued from another perspective. According to him, most FDI attraction policies have focused on the size of the host markets, measured by GDP. The size of the market has been widely found to be a significant incentive for FDI and in some cases it has proven to be the most important one, in that a larger market brings in higher returns on investment by allowing a more efficient utilisation of resources and the exploitation of economies of scale, but this does not go without disadvantages. Chakrabarti (2001) further argues that production units are thought to be located where the marginal cost of production is lowest. Traditionally it is considered much easier for a large market to organise its production structure in a way that can exploit the benefits of economies of scale in production, which could then lead to higher efficiency gains, a lower marginal cost of production and a larger market share.

Wang and Swain (1995) have identified the size of a market as an area for development in order for both developed and developing economies to attract FDI. However, Wang and Swain point out that the size of the market may be less influential or even

insignificant when FDI is invested to exploit the host country solely as a production base; i.e. to reap profits from the cost advantage of the host economy by exporting the production more competitively to markets in home countries of investors or other countries.

7.2.2 Cost factors

Policies to attract FDI should be directed at addressing factors that cause investment cost differentials across countries and are thus categorised as cost factors. These include labour, capital and infrastructure costs. Cost factors may significantly influence the attraction of FDI into an economy.

To assess the cost of labour and the availability of skilled labour, according to Dunning (2003), real wage rates are used – lower real wages in a host country are expected to attract FDI. According to neoclassical theories, labour cost differential is considered an important determinant of FDI. The new international division of labour theories also focus on the cost minimisation strategies of firms. It can be argued that locational advantage induced by the low wages, increases the prospects of low production costs and could stimulate a firm to establish itself in a new market (London & Ross, 1995; Banga, 2003:13).

Dunning (2000) argues that the main focus is not solely on inexpensive labour but also takes into consideration productivity, flexibility and the adaptability of the labour force in the host country, which effectively reduces cost. Therefore, in order to attract FDI, the country must offer a relatively skilled and educated labour force.

The impact of the cost of capital (i.e. lending interest rates) on FDI inflows is found to be ambiguous. On the one hand, it can be argued that higher lending rates may have a positive impact on FDI, i.e. the higher the cost of capital in the host country, the more capital is bought in by foreign firms. On the other hand, it can be argued that a host

country's cost of capital impacts directly on domestic consumption, which positively affects the market. Thus the lower the interest rate, the higher the domestic consumption

and hence the higher the FDI inflows, and therefore economic policies of host/potential host countries should include cost factors (Bende-Nabende et al, 2000:16).

Satisfactory infrastructure is a prerequisite for investors making long-term investments. With regard to infrastructural costs, it is found that, all things being equal, the availability of appropriate infrastructure means a lower infrastructural cost and an increase in the ability of the host country to attract FDI. Efficient communications systems in particular and transportation links within and outside the country are essential to making a country attractive to foreign investors. Some of the variables involved are land and property rents, fuel costs, and infrastructure and transport costs.

Developed infrastructure must cover both physical (transport, communications, etc.) and financial (developed financial markets, insurance, accounting and legal skills) facilities. An advancement of financial infrastructures like capital markets, money markets and property markets in a host country creates a perception in investors that the host country is more organised and has the platform to manage inflows. The more highways, railways and interior transport waterways that are adjusted according to the size of a host country, the more the attraction of FDI inflows. Another important variable is the level of telecommunications services. Higher levels of telecommunication services will save time and reduce the costs of communication and information gathering, thus facilitating business activities. Therefore, countries with more developed infrastructure are likely to succeed in attracting FDI, which is something that economic policy reforms should take cognisance of, especially in developing countries (Greene, 2000; Banga, 2003:13).

7.2.3 Exchange rates

The volatility of exchange rates is also important. Profits from foreign investment in an economy are often used to supplement the profits of firms in host countries and also, in home countries of foreign investors. As a result less volatile exchange rates are necessary for an investor to repatriate its profits to the home country.

The economic policy of a country may favour a depreciating or appreciating currency, depending on the country's objective. Exchange rate may be real or nominal. The nominal exchange rate is the rate at which an organisation can trade the currency of one country for the currency of another. Real exchange rate (RER) is the rate at which an

organisation can trade goods and services of one economy (e.g. country) for those of another. For example, if the price of a good increase by 10% in South African currency, and the Zimbabwean currency simultaneously appreciates 10% against the South African currency, then the price of the good remains constant for someone in Zimbabwe. The people in South Africa, however, would still have to deal with the 10% increase in domestic prices. Trevino (2002) argues that even though there is mixed evidence on the impact of real depreciation on the host country with regard to FDI inflows, foreign investors, who may either gain or lose from a devalued currency, may in fact gain due to the larger buying power in host countries. They can also produce more cheaply and therefore export more easily. This may attract resource- and efficiency-seeking FDI. Trevino further argues that foreign firms may not invest in a host country if they believe that depreciation may continue after they enter it as this would imply higher costs. Nunnenkamp (2002) has a similar view, in that a devalued currency is expected to encourage inflow of FDI into host countries as this reduces the initial cost of investment to foreign investors.

According to Asiedu (2002:67), a depreciation of a host country's currency might attract FDI for two reasons. Firstly, a real depreciation of the host country's currency renders that country's assets relatively cheap, motivating FDI. Secondly, in cases where FDI is invested for re-exports to markets at home or in other countries, a real depreciation of a host country's currency enhances the competitiveness of producing in a host country, thereby raising the investors' wealth.

The volatility of a host country's real exchange rate may attract or deter FDI. Instability of a currency has often been identified as a significant impediment for the inflow of FDI. The instability of a host country's currency tends to reduce FDI inflow by discouraging the repatriation of investment returns (Chakrabarti, 2001; Banga, 2003:14).

Analysts argue that caution must be exercised when examining currency fluctuations between host and home countries, because the importance of changes in exchange rates to countries can vary based on country-specific objectives and strategies. It is commonly held that exchange-rate fluctuations increase risks and uncertainties, thereby affecting

incentives to attract investment. Kwon and Konopa (1993) further argue that an unfavourable shift in foreign exchange rates also poses a danger to FDI.

7.2.4 Rate of inflation

When policies are geared towards the control of inflation in an economy, investors perceive this as a sign of internal economic stability in the host country. High inflation, on the other hand, indicates the inability of a government to balance its budget and failure of a country's central bank to conduct appropriate monetary policy and hence may reflect instability of the macroeconomic policy of the host country. This type of instability creates uncertainty in the investment environment, which discourages FDI, and the reduction of FDI is worsened by the fact that the relative costs of production in host countries rise, unless this is compensated by a proportionate depreciation of the currency (Schneider & Frey, 1985; Banga, 2003:15).

Pedroni (2001:730) holds a contrary view that overly tightened inflation policies lead to falling price levels, and the resulting contraction in economic activities might trigger a deflationary spiral and eventually bankrupt a host country's firms. This can induce local investors to sell off their interests in host countries' companies to foreign investors at low prices, thereby expanding the inflow of FDI.

Foreign capital fled countries such as Russia, Brazil, Yugoslavia and Thailand during periods of high inflation. According to Schneider and Frey (1985), the rate of inflation in host countries negatively affects FDI attraction. Hyun and Whitemore (1989) find that high inflation rates in Latin America, Asia and Africa deter investments by Japanese firms.

It can therefore be argued that, if foreign investors are risk averse or even risk neutral, uncertainty about the potential for high inflation rates may lead to a reduction in FDI, because investors do not want to risk their expected profits. As long as there is uncertainty about the future level of inflation, foreign investors will demand a higher price to cover their exposure to inflation risks and this in turn will decrease the volume of investment. Hence economic policies must address the stability of inflation over time, which is vital to the attraction of FDI.

7.2.5 Political, economic and financial stability

Generally, a country with sound economic policies that promote macroeconomic stability, have an established and practised rule of law, enforce contracts and encourage private-sector development can be expected to attract FDI. Investors will have more confidence that a nation that has done well in the past will also be likely to do well in the future (Tallman, 2002).

The lack of policies to promote these economic fundamentals has diverted FDI from many of the former Soviet Republics and several Balkan countries. Schneider and Frey (1985) re-examined the issues and concluded that moderate changes to policies are crucial for FDI flows to developing countries. Casson (2003:67) argues similarly to the above by explaining that a basic level of overall economic, political and financial stability is a prerequisite for FDI in a country. He further argues that the basic institutions of an economy must allow the inflow and repatriation of foreign private capital.

7.3 NATIONAL FDI POLICIES

As observed by Globerman and Shapiro (1999), it is difficult to statistically examine the impact of specific policies regarding FDI, such as incentives offered and the removal of restrictions on the operations of foreign firms, since they are hard to isolate from other factors by reason of the fact that they are more implicit than explicit. Another difficulty in examining the impact of these policies is the difficulty in quantifying them.

According to Kumar (2002), FDI may flow into a country not only because the host country provides certain investment incentives but also because these incentives, when compared to those provided by other competing host countries, appear to be more attractive. Also, an important fact that needs to be addressed is that, when considered individually, different incentives offered by a host country may have significant influence on FDI when considered as a package. In view of the above, policies such as tariffs, investment incentives, removal of restrictions and tax structure will be discussed in this section.

7.3.1 Tariffs

Trade policies and, more broadly, trade costs (tariffs, non-tariff barriers and transportation costs) are generally found to have a significant impact on FDI flows.

With the decline in the barriers to trade and an increase in the importance of networks, foreign investors find barriers to entry and non-competitive environments less appealing. In more recent studies it has been found that foreign investment is deterred by high tariffs or non-tariff barriers on imported inputs and is attracted to more open economies. On the other hand, all things being equal, high amount of tariffs induces investors to set up operations in host countries (especially those with larger markets or larger potential markets) in order to avoid the cost imposed by such barriers. In reviewing cross-country regressions on the determinants of FDI, Chakrabarti (2001) argues that after market size, openness to trade regarding tariffs has been the most reliable indicator of attracting FDI.

7.3.2 Investment incentives

National policies should consider two main categories of FDI incentives offered by host countries to attract FDI inflows. The first is fiscal incentives, i.e. policies that are designed to reduce the tax burden of a firm (tax incentives are discussed under section 7.3.4), and the second is financial incentive such as direct contributions to the firm from the government (including direct capital subsidies or subsidised loans). Financial incentives include grants, subsidised loans and loan guarantees, publicly funded venture capital participating in investments involving high risks, and government insurance at preferential rates. Fiscal incentives are, however, preferred by the host countries partly because these can be easily granted without incurring any significant financial costs at the time of their provision (Smith, 1991; Banga, 2003:13).

Fiscal incentives may affect location decisions, especially for export-oriented FDI, although other incentives seem to play a secondary role. However, fiscal incentives appear unimportant for FDI that is geared primarily towards the domestic market; instead such FDI appears more sensitive to the extent to which it will benefit from import protection (World Bank Report, 2003).

7.3.3 Removal of restrictions

National FDI policy directives should give consideration to the removal of FDI restrictions. Rugman (1981) and Banga (2003) posit that various forms of restrictions have been applied to FDI in host countries in the pre-liberalised era, the nature of which either attracts or deters FDI. Rugman (1981) and Banga (2003) further explain that these restrictions relate to admission and establishment, ownership and control, and other operational measures. Admission and establishment restrictions include closing certain sectors, industries or activities of FDI; screening, authorisation and registration of investment; and minimum capital requirements. Ownership and control restrictions exist in various forms, for example allowing only a fixed percentage of foreign-owned capital in an enterprise; compulsory joint ventures; mandatory transfer of ownership to local private firms, usually over a period of time; and restrictions on reimbursement of capital upon liquidation.

Developing countries have during the past decade begun liberalising their national policies to establish a hospitable regulatory framework for FDI by relaxing rules regarding market entry and foreign ownership, improving the standards of treatment accorded to foreign firms and improving the functioning of markets. These core 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, i.e. changes in the direction of greater openness allow firms to establish themselves in the direction of less openness (e.g. nationalisation or closure to entry) will ensure a reduction in FDI (Cunningham, 2000 ; Banga, 2003:20).

Even after entry, foreign firms could face certain restrictions on their operations, such as employment of foreign key personnel and performance requirements, such as sourcing or local content requirements, and export targets. Owing to the enforcement of trade-related investment measures (TRIMS), many of these restrictions have now been withdrawn and the types of restrictions relating to FDI have been greatly relaxed in a large number of countries. Many of these restrictions now do not require investment approvals or licensing except for few sectors that are closed to FDI (mainly for security reasons). The impact of the removal of some restrictions has a positive effect on attracting FDI and hence causes a higher flow of FDI into an economy (World Bank Report, 2003).

7.3.4 Tax structure

The evidence on the impact of tax policies on FDI is evolving. Hines (1999) shows increasing evidence that a low tax burden attracts FDI. He further argues that the rate of taxation should not be prohibitive or unduly punitive, and must not be different to the marginal rate of personal income tax. However, special concessions such as tax holidays, relatively low corporate tax rates, simplicity, consistency, predictability, exemption from certain import duties and prevention of double taxation should be offered as incentives for large-scale investment projects deemed to be in host country's interest (but too general a use should not be made of this, since investors may use the opportunity for speculation, which may negatively affect investment flows by encouraging short-term investments).

A country's tax regime is a key policy instrument that may negatively or positively influence FDI. Imposing a tax burden that is high relative to benefits realised from public programmes in support of business and relative to tax burdens levied in other competing locations may discourage investment, particularly where location-specific profit opportunities are limited or profit margins are thin, with the host country's tax burden a function of not only statutory tax provisions but also of compliance cost (Nigh, 1998).

Owen (1992) argues similarly to the above by noting that a poorly designed tax system (covering laws, regulations and administration) may discourage capital where the rules and their applications are non-transparent, overly complex or unpredictable, adding to an investor's project cost and uncertainty over net profitability. Systems that leave excessive administrative discretion in the hands of officials in assigning tax relief tend to invite corruption and undermine good governance objectives fundamental to securing an attractive investment. Policymakers of host or potential host countries are therefore encouraged to ensure that their tax system is one that imposes an acceptable tax burden, keeps tax compliance and tax administration costs under control, and addresses FDI attraction rather than contributing to deterring FDI.

Navaretti and Venables (2004) indicate that the responsiveness to tax policies is mainly driven by the relative cost of production, which is becoming more prominent. Moreover, they mentioned that the evidence on tax incentives is not conclusive but that there are

some indications that transparent and simple tax systems tend to be most attractive for FDI.

7.4 INTERNATIONAL FDI POLICIES

International FDI policies are those that deal with agreements on the treatment of FDI from a particular region.

7.4.1 Bilateral investment treaties

There has been a substantial increase in the number of bilateral investment treaties (BITs) that have been signed and brought to force in the last two decades, and particularly in the 1990s. BITs deal exclusively with investments and lay down specific standards of investment protection and transfer of funds (Eaton & Tamura, 1994; Banga, 2003:21).

Root and Ahmed (1979) show that these treaties contain provisions for settlement of disputes between the treaty partner, investors and the host state. BITs also cover a number of other areas in particular: non-discrimination in treatment and, in some cases, the entry of foreign-controlled enterprises and other related fields. Bilateral agreements shape FDI frameworks. Over 2 100 BITs were in effect by end of 2002. These generally contain binding commitments on expropriation, fund transfers and compensation due to armed conflict or political instability on a national treatment (UNCTAD, 2003).

Bilateral investment treaties are one of the rare ways in which rich countries can try to increase FDI flow to developing countries by reducing *ex ante* the risks associated with opportunistic behaviour by host governments and providing some rights to investors once they are settled in a country.

An important characteristic of BITs is a considerable uniformity in broad principles underlying the agreements, coupled with numerous variations in the specific formulations employed. BITs generally recognise the effect of national law on FDI and accept the right of governments to regulate its entry. BITs were initially addressed exclusively between developed and developing countries. A major reason for this is that developed countries were the major source of investment; however, the 1990s witnessed an increasing number of BITs between developing countries. BITs are popular because they provide host

economies with the flexibility to screen and channel foreign investment to desired sectors or locations while extending protection to foreign investors. By providing protection, BITs are expected to promote and attract FDI (UNCTAD, 1999:1; Banga, 2003:24).

7.4.2 Regional investment agreements

With regard to regional investment agreements, following negotiations during the Uruguay round of multilateral trade that reached an agreement on prohibiting trade-related investment measures (TRIMS), some of the regional trade bodies in various countries have taken the initiative to improve the investment environment to make it more conducive to the free flow of FDI. An example of such an agreement among the Association of Southeast Asian Nations (ASEAN) is the non-binding investment principles reached in 1999. The ASEAN investment agreement, which was signed by all the member countries, commits them to opening up industries and granting national treatment to all ASEAN investors (Banga, 2003:24).

7.5 OTHER POLICIES

7.5.1 Resource structure

FDI policies should address the resource structure of a country and the rights of foreign investors with regard to these resources. A country may possess a significant comparative advantage or an absolute advantage in primary commodities. Such a country is likely to spawn domestic firms that possess advantages in the exploitation of such assets. However, especially if such an advantage is a near absolute one, it is likely to be the recipient of considerable investment. These advantages associated with the host country include the availability of skilled labour and other infrastructural facilities, and may lead to sequential investment by both domestic and international firms. As a result, a comparative advantage in a natural resource-based industry may be sustained.

The lack of a natural resource base (which is a comparative disadvantage in primary commodities) would, all things being equal, result in the opposite effect. Such a country is also more likely to begin strategic asset-seeking investment at an earlier stage (e.g. Japan and more recently China). Over all, these countries would become net outward investors at a considerably earlier stage of development than those well endowed with natural resources that will attract FDI (Dunning & Narula, 1998).

7.5.2 Cultural distance

Economic policies geared towards strengthening ties with other countries that share similar cultures to that of a host country is ideal for FDI attraction. Culture can be described as an accepted way of doing things by social groups that differentiates one group from another. Investment decisions are partially influenced by cultural factors. In investigating FDI flows to Central and Eastern Europe, Mikalak (1992:1575) suggests that inherent variations in language and culture dissuade potential investors, except in countries that have traditional ties.

Grosse and Trevino (1996:155) conclude that those countries culturally dissimilar to the US or further away tend to have less investment in the US. Davidson (1980) finds that US firms have usually made their first foreign investments in countries like Canada and the UK due to similarity in culture. Root (1990) argues that uncertainty due to cultural distance may also cause executives to undervalue foreign investments. Furthermore, the cultural familiarity of the host country offers a whole range of efficiency-enhancing measures including the procurement of inputs, marketing and distribution of output, thereby making the economy more habitable for FDI.

7.5.3 The economic system

The economic policies of a host/potential host country should define the orientation of an economy, which will substantially affect both economic development and the extent and pattern of FDI flow into it. The economic orientation of a country may either be outward looking, export oriented or inward looking. An export-oriented regime is likely to achieve faster growth and structural upgrading.

Lizonda (1990:15) argues that an export-oriented regime is a necessary condition for attracting FDI and FDI-facilitated developments. Where a country's policies are more export oriented, the faster the process of structural adjustment and economic growth becomes, and the faster the country will attract FDI.

According to Porter (1990), although the kind of economic system associated with a country broadly determines the path it takes, the nature of government policy associated with a particular system can vary. The differences between the macro-organisational

strategies of countries at the same stage of development influence both the structure of markets and the extent to which economic activity is efficiently conducted, thereby affecting the specialisation and economic structure of the country as well as the extent of FDI activity associated with it.

Present economic indicators play a role in attracting FDI. Current economic performance represents the current governmental regime's ability to handle the state's economy as well as other social factors. Investors will seek out countries that have had recent economic success in the hope that the trend will continue in the long run.

7.5.4 A country's international experience

The economic policies of a host or potential host country should consider the international experience of the country as a basis, which can be considered an important factor in attracting FDI. Buckley and Casson (1985) aver that experience reduces the cost and uncertainty of serving and hosting a market. Similarly, Agarwal and Ramaswani (1992) show that countries without foreign market experience are likely to have more problems in managing foreign operations, as a country's knowledge base will increase with repeated experience and be embodied in personal and organisational memory.

Prior experience with a similar type of environment in a foreign country will become valuable to a firm when dealing with similar circumstances. Consequently the firm will prefer to use the same strategies, because these enhance the firm's value by reducing implementation costs in another country, since existing routines can be used. Furthermore, firms in highly experienced countries will also be motivated to undertake market-seeking FDIs by the advantages associated with staying close to their customers and thus protecting their ownership-specific advantages from deteriorating (Amemiya, 2001).

7.5.5 The human capital of a country

A country with sound educational and training policies should, all things being equal, attract FDI. The human capital of an economy should be an important factor when considering investing for a long term in another country, as the investor will use the labour in the host country. It would seem that the more educated a population is, the more

likely it is to attract FDI. However, Root and Ahmed (1979) found that although the theoretical literature on FDI presumes human capital to be among the key ingredients of FDI flow into an economy, among the 58 developing countries they studied, none of their proxies for human capital literacy, school enrolment and the availability of professional and technical workers were found to attract FDI.

Schneider and Frey (1985:22), using data for 54 developing countries, found that the share of an age group with secondary education to be a less significant determinant of FDI as compared with other economic and political influences. Hanson (1996), using a sample of 105 developing countries, showed that the adult literacy rate was not an important determinant of FDI as compared with other social-political variables. Finally, Narula (1996:12) demonstrated that the level of tertiary education in a population was not a statistically significant explanatory variable for FDI inflows among 22 developing countries.

All the above cross-country studies show that human capital is not necessarily an important input for FDI. This conclusion is, however, consistent with the fact that the period of the 1970s to 1990s was when FDI in developing countries was concentrated on market and resource seeking, and/or lower-end manufacturing types, and cheap labour and/or abundant natural resources were more important. This still holds true for recent times.

7.6 SUMMARY

The impact of FDI on the world economy has risen dramatically over the past decades. Between 1973 and 2000 worldwide annual FDI flow increased fifty-fold from $25 billon to $1.271 billion. The contribution of FDI to world welfare (the cumulative GDP of all countries) rose to 17% compared with a mere 6% in 1980. Developing countries, emerging economies and countries in transition increasingly see FDI as a source (and not a panacea) of economic development. Countries have liberalised their FDI regimes and pursued other policies to attract this type of investment. They have addressed the issue of how best to pursue domestic policies to maximise the benefits of foreign presence in the domestic economy (World Bank Report, 2001). In this regard, the resources gathered under this chapter looked at the many different policies that can be used to attract FDI as

well as the effectiveness of the policies. FDI is no longer only a strategic option of corporations – it also plays key role in the national economic development strategies. FDI can also transform a country's economic scenario within the shortest possible time as it is not merely access to funds but also provides transfer of technical know-how and management expertise, and is also a stabilising factor in an economy.

Attracting FDI involves policy measures that are not without economic or social costs. Tax breaks, subsidies and infrastructure improvements are examples of policy measures intended to raise the volume of FDI received that have direct and measurable costs, especially in poor countries. It is therefore a legitimate question to ask whether those costs are worth the prize, i.e. whether FDI received yields substantive net economic benefits and justifies this type of spending. Nevertheless, the policy environment in the host country still matters for FDI. We find that high unit costs, a high corporate tax burden and, to a lesser extent, a high level of import tariffs discourage FDI while a liberal foreign exchange and trade regimes and advanced reforms in the infrastructure sector encourage it.

Foreign firms will undertake FDI if they have an oligopolistic advantage over host countries' firms through supportive national policy directives. However, as in the past, a welcoming FDI regime remains fundamental to attracting FDI, but today's globalising investor has a wide choice of developing-country locations and desires those that are capable of enforcing competition, providing stable and transparent rules for private business and, over time, improving the quality of their local productive factors.

While there have been significant improvements in the policy regime for FDI in most African countries, these have not been significant enough to attract globalising FDI. Disappointingly, the region continues to suffer from a poor image as an investment location despite efforts to promote and market it. Most crucially, the economic disparities between Africa and other developing regions (with the exception of the natural resource sector) remain considerable. There is little or no policy governing infrastructure, human capital, supplier networks, technological capabilities and support institutions.

CHAPTER 7
POLICIES TO ATTRACT FDI INTO AN ECONOMY

It is important that less-developed countries work hard to address policies that are crucial to attracting FDI. It is evident that some countries can improve their international image if they can address negative factors such as conflicts, crime and government apathy that discourages the rule of law. Policies and strategies that are aimed at improving the image of the region need to be coordinated among member countries if the region is to increase its share of global FDI.

A transition from pre-apartheid South Africa into a post-apartheid era necessitated a re-consideration of some of the country's economic policy directives. As a result, in some aspects of the South African economy, economic policy reforms were embarked on. The challenge with these reforms is whether they consider some of the key policy areas described above. It is on the back of this that the next chapter will, in a general sense look at all the literature reviews from chapters 2 to 7 in the context of the importance of FDI to the economy of South Africa.

CHAPTER 8: FDI IN SOUTH AFRICA

8.1 INTRODUCTION

FDI, whether through transnational corporations or other forms, is being widely considered as an important vehicle for economic growth in less-developed countries, where it can play an important role. At a macroeconomic level, it brings new capital for investment, contributing to the balance of payments and potentially adding to future economic growth. Evidence suggests that FDI can also contribute to raising exports and integrating countries into global economic networks. At the microeconomic level there is a range of purported benefits from FDI.

South Africa's regulatory regime for FDI has undergone significant transformation and liberalisation since the country's successful transition to a democratic government in April 1994. This has been in line with global trends towards greater liberalisation of national FDI regimes. South Africa's macroeconomic policy – the growth, employment and redistribution (GEAR) strategy – is concerned within and oriented towards the competitive global economy, with strong emphasis on fiscal discipline, investor confidence and macroeconomic stability.

FDI is regarded as an essential source of savings needed to finance increased investment and therefore an important engine of economic growth. The South African government has been particularly keen to attract export-oriented FDI and in so doing, hopes to stimulate innovation and exports in local firms through the technology and skills transfers and competitive pressures associated with FDI. For this reason the government has established a national investment promotion agency, Trade and Investment SA (TISA), with the mandate to provide one-stop-shop services to potential investors. South Africa's investment credentials have also been promoted by president Thabo Mbeki's prestigious International Investment Advisory Council. The president hopes to attract FDI to the country through his direct interventions with international business leaders (UNCTAD, 2001).

South Africa dominates foreign investment in the SADC, receiving a substantial fraction of new FDI inflows into the region and hosting the greatest number of foreign

subsidiaries across a broad range of economic sectors. South Africa's capacity to act as a magnet for FDI in the region, particularly in the context of growing regional economic integration, is an important feature of investment flow. However, even though South Africa is a large emerging economy with great potential for growth, the country does not receive a significant amount of FDI, compared to other large emerging markets such as China and Brazil. There is a feeling in government as well as in civil society in the country that foreign investors are wrongly neglecting them. In view of the above this chapter will look at FDI in the context of the growth of the South African economy, and give recommendations on how South Africa can improve on its attractiveness to investors.

8.2 THE SOUTH AFRICAN ECONOMY

South Africa has the most sophisticated free-market economy on the African continent. The country represents only 3% of the continent's surface area, yet it accounts for 40% of all industrial output, 25% of gross domestic product, 64% of generated electricity and 45% of mineral production.

According to Botha (1999), about 75% of South Africa's economic activity occurs in the four main metropolitan areas which together represent about 3% of the total land area: the Pretoria/Witwatersrand/Vereeniging (PWV) area surrounding Johannesburg, the Durban/Pinetown area in KwaZulu-Natal, the Cape Peninsula in the Western Cape and the Port Elizabeth/Uitenhage area in the Eastern Cape. The Witwatersrand, where most of the South Africa's gold mines are situated, is the financial and industrial hub of the country and accounts for about 60% of all economic activity. Furthermore, Botha (1999) adds that the country's economic system has a marked duality – a sophisticated First-World economy has developed alongside an underdeveloped Third-World one – and that the solution to this problem is viewed as twofold: the opening up of the modern First-World sector to make it accessible to the vast majority of people and the continued development of the Third-World sector through increased employment opportunities.

Despite the duality of the economy, the mining industry has played a dominant role in the economic development of South Africa and is a major employer. Mining is carried out by the private sector under mineral rights owned outright or leased from the state. There are

major mining enterprises and a number of smaller specialised producers. Agriculture now accounts for only 7% of the country's economic activity, although only a century ago the country had an almost exclusively agrarian economy. Except for collective ownership in the Third-World sector, farming is characterised by private ownership encouraged by generous tax concessions. Significant agricultural products include wheat, maize, sugar, fruit, vegetables, wool, meat and dairy products. Manufacturing, construction, electricity and water now account for about one-third of the country's economic activity. The growth of the manufacturing sector since World War II has been significant and this sector is capable of further expansion. However, South Africa is still an exporter of primary and intermediate goods, and an importer of capital goods (Loots, 2002).

Loots (2002) further explain that many tax concessions and business incentives are available for industrial activities, particularly for those that produce exports or import substitutes. The contribution of the financial and business services sector has remained relatively stable for many years at about 14% of GDP. The country's British colonial heritage underlies much of its social and economic infrastructure, including sophisticated banking and commercial practices as well as a wide range of business-related professions.

Collier and Patillo (1999) explain that the South African economy is extremely open to imports and exports, and that each constitutes about 30% of GDP. A large proportion of exports consist of unprocessed raw materials, the mining industry as a whole contributing approximately 20% to this, showing a significant reduction over the past 20 years. South Africa is a major exporter of gold (an estimated 50% of total world production). The country is also an exporter of deciduous and citrus fruit as well as animal hides and skins. Exports of chemicals, metal products, machinery, transport equipment and manufactured goods have increased in recent years. Imports, however, include mainly capital goods, and raw and intermediate goods, as well as sophisticated consumer goods.

Edwards (2001:38) argues that, subject to certain exchange control restrictions, South Africa welcomes investment by non-resident persons and companies. FDI may be undertaken through a new or existing company incorporated in South Africa or through the establishment of a branch or a partnership. Foreign companies are subject to South

African income tax in respect of their South African income source only. The applicable tax rate is 34% (29% for companies resident in South Africa) irrespective of the level of involvement of the company, since foreign companies are not subject to tax on dividend distributions (Roelofse, 2007).

Edwards (2001) further adds that virtually all business activities are open to foreign investors. In a few sectors, however, ceilings have been placed on foreign shareholdings and government representatives have taken the position that strategic industries such as electronics should be firmly rooted in South Africa and not controlled entirely or mainly from abroad.

The JSE is the only stock exchange operating in South Africa. In addition to the main board listing, there is a Development Capital Market (DCM) and Venture Capital Market (VCM) sectors. The criteria for listing in the DCM and VCM sector are less restrictive than for other sectors. The Competition Commission is charged with preventing the creation or strengthening of monopolies but is less aggressive in its approach than, for example, its counterpart in the US. There are regulations governing the conduct of business in various sectors of the economy, such as finance, manufacturing and mining, in which safety and other working conditions are subject to inspection by government bodies. The registration of patents, designs and trademarks is provided for by statute and is administered by the patents office of the Department of Trade and Industry in Pretoria. A patent may be registered for any product or process involving an inventive step that may be used in trade, industry or agriculture. New designs may be registered if they have not previously been used in South Africa or any other country, or described in any publication (National Treasury, 1997–2001).

The Minister of Trade and Industry is empowered by statute to regulate, prohibit or ration imports to or exports from South Africa in the national interest. Such powers are exercised within the boundaries of the General Agreement on Tariffs and Trade (GATT) to which South Africa is a signatory, and consist of import tariffs and direct controls. Export controls are imposed to prevent a local shortage of goods, but in view of the country's policy on export promotion, these are kept to a minimum. Custom tariffs are set forth in accordance with the Brussels system of terminology. There is also a free and

virtually unimpeded exchange of goods between the member states of the customs union (which includes Botswana, Lesotho, Namibia, South Africa and Swaziland) and the independent lands that were formerly a part of South Africa.

According to the South African Reserve Bank's *Quarterly Bulletin* (2005), a feature of industrial development in South Africa to date has been the concentration of some 75% of industrial activities. There is a need to encourage industries to relocate to areas characterised by substantial pools of labour and a shortage of jobs, a situation that in the past has compelled a large number of people to search for employment in the metropolitan areas. Major reforms in the area of labour legislation included the removal of discriminating statutes, which opened the way for all workers to participate in organised labour. Furthermore, the *Quarterly Bulletin* (2005) indicates that under the Labour Relations Act, employers and employees in a particular industry may form employer and employee organisations. Furthermore, in contrast with the provisions governing organised labour in the Labour Relations Act, provision is made in the Wage Act for establishing minimum wages and conditions of service for particular industries and trades.

Resident companies are subject to income tax on income from any source, subject to the Organisation for Economic Cooperation and Development (OECD) rules (income of a company taxed in one of the member countries is not taxed again in its home country). An inclusion rate of 50% applies to all capital gains. Companies registered anywhere in the world are subject to income tax on all income from South African sources. Companies are taxed at the rate of 29% and in most respects, a company is defined for tax purposes to include a close corporation. Dividends received from foreign sources (non-residents as defined) are subject to tax at normal tax rates, while dividends received from a resident company or a company in which a resident holds more than 20% is exempt from tax. Companies in a group may not share their tax losses with profitable companies in the same group. Tax losses may not be carried back but may be carried forward indefinitely, provided that there is a trade in every tax year. Tax assessment is based on taxable income determined in accordance with the Income Tax Act (Roelofse, 2007; Jenkins, 1986).

South Africa has vast distances and a lack of navigable rivers with the result that a sophisticated transport infrastructure has been developed. The state-owned rail network (Spoornet) provides a multiple-mode transportation service that represents 50% of the transport business in South Africa. The railway is the most common mode of transport for conveying bulk freight. Transportation by road is handled by a sister company, Autonet, with a number of smaller private enterprises providing road haulage. The national airline, South African Airways, is state owned and handles the major air services. South African harbours are highly efficient – the ports of Durban, Cape Town and Port Elizabeth are equipped to handle containerised traffic to Europe and the Far East, with feeder services from East London and Walvis Bay, and an inland depot near Johannesburg (Van der Walt, 1997).

The South African economy has reinforced high levels of business confidence, more rapid job creation as well as strong demand. GDP is currently averaging about 5%. The national budget surpluses in 2006/07 and 2007/08 also signify the success in economic performance after the transition of the economy, as well as the healthy state of public finance. It remains the objective of the South African government to accelerate growth, promote social development and meet basic needs. The economic policy of the country seeks to widen participation and employment, support increased export levels, foster small business growth and lower the cost of doing business (Roelofse, 2007).

8.3 FDI AND ITS IMPACT ON THE SOUTH AFRICAN ECONOMY

World Investment Report (2001) estimates that in 2000 South Africa attracted FDI of US$152 million compared to US$877 million in 1999 and US$3817 in 1997. The poor FDI figures for 2000 are partly a reflection of the decrease in government activity, such as privatisation, which attracts foreign inflows. Approximately 60% of FDI into South Africa takes the form of mergers and acquisitions, largely as a result of state-leveraged deals and the privatisation of state assets such as the Airports Company SA, South African Airways, Telkom and others. The most prominent foreign investors in South Africa have been the US, UK, Australia, Germany, Japan, Malaysia, Switzerland, China and Canada.

FDI has been concentrated in a few sectors: energy and oil, motor and components, food and beverages, hotels, leisure and gaming, and, in recent times, banking. FDI in South Africa has been in the form of acquisitions of bonds. In 2005, Barclays paid about R30 billion for a 56.6% stake in Absa, while Vodafone paid R16 billion to increase its stake in Vodacom. In 2006, Associated British Foods paid R3.8 billion for a controlling stake in the sugar group, Illovo, while private equity group CCMP and management funded the R5.4 billion acquisition of building company Waco International (*Business Day*, 2006).

It can be deduced from the above that FDI has been in the form of acquisitions in the service sectors in South Africa. Foreign-owned service companies are an important source of spillovers to the domestic business sectors, particularly compared with the often-limited linkages between extractive industries and the host economies. For example, the entry of foreign banks has helped improve the efficiency of South Africa's financial sector by enforcing healthy competition among the big four banks (First National Bank, Nedbank, Standard Bank and Absa), which is a critical input to economic growth and, in the long term, economic development (World Bank Report, 2003; *Business Day*, 2006).

A notable contradiction by the United Nations with regard to FDI and its effect on growth, is that efforts to enhance the standard of living in developing countries are guided by the United Nations' Millennium Development Goals (MDGs), which stipulates that to finance its development goals, a country like South Africa will rely first and foremost on mobilising domestic resources, supplemented by external financing such as FDI and official development assistance (ODA). However, UNCTAD (1999) also states that evidence is mixed when it comes to the economic growth effects of FDI. The United Nations' studies fail to identify the direct effects of FDI on economic growth. FDI as such has no significant growth effects when viewed as an independent variable. However, it is pointed out that FDI (specifically greenfield type) contributes to economic growth when combined with other variables, i.e. the product of FDI and a measure of human capital (secondary level of education) or a certain level of technological advancement. This suggests that FDI contributes to economic growth only when a sufficient absorptive capability of advanced technologies is available in the host country or there is a higher level of education in the labour force. This contradictory view is supported by Barro

(1997), who explains that FDI is seen as an effective channelling tool to transferring technology and fostering growth in countries. The effects of FDI on the growth rate of output is constrained by the existence of diminishing returns on physical capital, therefore FDI could only exert a once-off (short-term) effect on output per capita. However, in the context of the New Theory of Economic Growth, FDI may not only affect the level of output in the short term, but also the rate of growth of the output. It is argued that FDI facilitates the use and exploitation of local raw materials.

In 2005, dividends paid to non-residents grew 20.2% in the first half, after 31.7% growth in the previous year. Of the R36.5 billion paid in dividends to foreign investors in 2005, R30.4 billion was to foreign direct investors in South Africa. Increased FDI in South African companies is leading to a surge in dividends flowing out of the country as companies report record results. This has resulted in pressure on the balance of payments and South Africa's current account deficit (the current account is made up of trade accounts as well as income and service flows). It is well noted that FDI helps to finance the current account deficit, but dividend payments create deficits, which may result in a negative effect on the economy. Increased outflows in the form of dividends may lead to rand depreciation due to the fact that the demand for other currencies increases with a corresponding increase in the supply of the rand. A weakness in the rand may encourage an increase in interest rates or in the cost of borrowing, which slows demand and supply activities in the economy, which may lower growth in the South African economy (*Business Day*, 2006).

Diagrammatically represented in Figure 8.1 is the level of net FDI in the South African economy from 2002 to the first quarter in 2006.

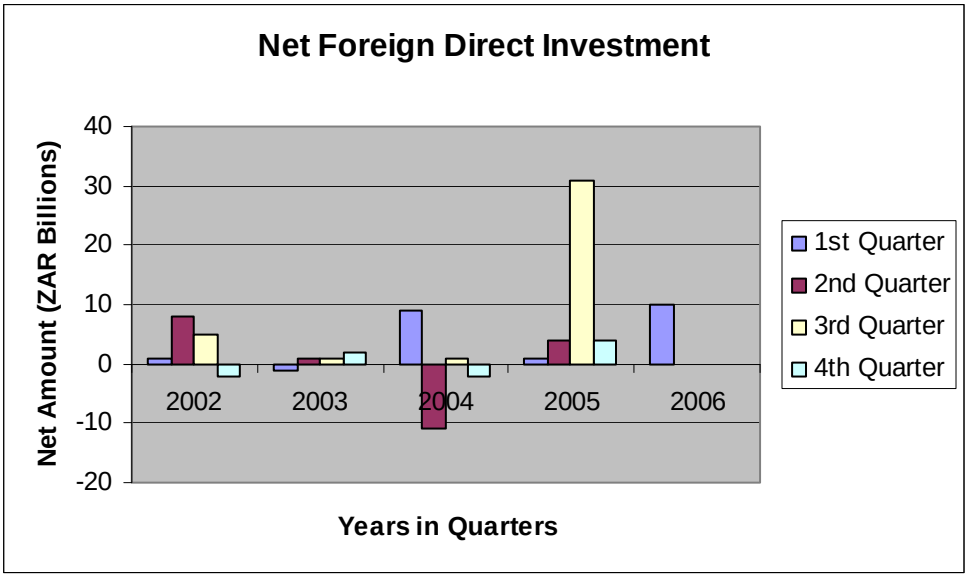

Figure 8.1: The level of net FDI in the South African economy from 2002 to the first quarter in 2006

(From the South African Reserve Bank, Quarterly Bulletin, December 2006:1–4)

From Figure 8.1 it can be seen that on isolating the third quarter in 2005 where significant FDI inflow transactions took place (mainly the Barclays purchase of a majority stake in Absa), net FDI inflow has on average been at the same level in South Africa. (It should be noted that only the first quarter of 2006 was available.)

A further threat to growth is the level of disinvestments in South Africa by foreign investors. In the year 2006, disinvestments in the South African economy grew sevenfold to R34 billion, exceeding the levels of FDI received in the economy. According to the Reserve Bank, FDI flows into South Africa was R18 billion in 2006, while UNCTAD estimated FDI to be R27 billion. In either case, FDI inflows were less than outflows, creating an FDI deficit. The high level of disinvestments was said to have emanated from the mining sector where foreign investors like Barrick and the Russian group Polyus sold their investments in South Deep and Goldfields for R10 billion and R20 billion respectively. Investors are divided as to whether this is once-off disinvestment as a result of the specific needs of Barrick and Polyus, or the result of government's interference in the mining sector.

Disinvestments have similar consequential effects as dividend pay-outs (as explained above). Disinvestment directly affects the operational activities of companies in South Africa in that, once capital investment is disinvested, funding for operational activities shrinks, which leads to a decrease in the cash flow, trading activities/performance as well as the financial position of the companies, which ultimately impacts on the growth of the South African economy (*Business Day*,2006).

FDI has played an increasingly important role in the economy since 1994. FDI turned positive and increased rapidly between 1994 and 1996, and 1997 continued to witness this favourable turnaround. Owing partly to the completion of the first privatisation transaction involving foreign participation (the sale of a 3% equity interest in Telkom to a consortium of non-resident US and Malaysian companies), the second quarter of 1997 witnessed a particularly large inflow of FDI. Investment Southern Africa (ISA) estimates that 955 MNEs now own stakes in 2 050 entities in South Africa, which manage 380 000 employees and control about $44.8 billion assets (Craig, 1998:2–21).

Cooper (1992:117) explains that in view of the above, the turnaround in FDI is not surprising as South Africa as an advantaged location for FDI was hardly exploited during the 1980s and early 1990s so that the post-apartheid economy has a latent potential to attract FDI. The increase that has occurred thus probably says little about the impact of economic policy and more about the return of investors that disinvested due to sanctions and returned in response to Telkom's privatisation.

It is no wonder that South Africa accounted for a tiny proportion of world FDI flows in 2000. Although the country has managed an impressive increase in FDI inflows since the early 1990s, there have not been strong and sustained year-on-year increases throughout the decade. However, South Africa receives a very large proportion of Africa's FDI flows. The country was hit to some extent by the contagion of the financial crisis witnessed in Southeast Asia in 1997/98 as investors shunned developing markets. The trend was also exacerbated by the uncertainty brought on by the September 11 terrorist attacks in the US and the overall downturn in the world economy (Jensen, 2002).

Cooper (1992:98), who has a similar view to Jensen (2002), attempts to clarify this in that with outward orientation taken into account, it is apparent that South Africa still performs comparatively bad, as the country only generated 0.7% of its GDP from FDI in 2000. Two key ratios, i.e. South Africa's share of world FDI to its share of world GDP and to its share of the world's exports, demonstrate that the country receives much less FDI than its importance in the world economy would justify. In most developing countries, one of the key perceived benefits of FDI is a stable foreign capital inflow creating a surplus on the financial account of the balance of payments to make up for deficits in the current account. The net balance of FDI inflows against outflows is therefore expected to be strongly positive, but Jensen (2002) argues that it has definitely not been the case for South Africa, where domestic businesses have been expanding rapidly, particularly into the Southern African region.

Despite sound macroeconomic fundamentals, South Africa is performing rather poorly in attracting FDI, especially when compared to other emerging markets, writes Vickers (2002:161). Its geographical anchor, Africa, also appears to be a lost cause, since the continent attracted less than 1% of global FDI flows in 2000.

The bulk of FDI into South Africa has been natural-resource-seeking and market-seeking FDI, as evidenced by the high value concentration in the banking, telecommunications, and food and beverage sectors. The (presumed) benefits of FDI have not been forthcoming in South Africa; in particular, FDI has had a crowding-out effect on some of the local producers. This is particularly so in the dairy, pharmaceuticals, steel, electric and electronics sectors. Most FDI into South Africa is capital intensive and goes to already established service sectors and new manufacturing sectors. Foreign investment in South Africa's export-oriented manufacturing sector has been very low. This is where MNEs locate part of their value-added chain abroad to improve the profitability of their overall economic operations. This is the type of investment that the GEAR programme hoped to attract as part of its industrialisation strategy. An exception is South Africa's automobile and components industry (World Investment Report, 2001).

In the World Investment Report (2001), it is explained that the government's motor industry development programme (MIDP) has been at the heart of this industry's gains.

The MIDP provides for a system of export incentives for local car and component makers while gradually reducing tariffs on exports. Between 2000 and 2001, BMW was exporting 36 000 units a year, DaimlerChrysler 30 000 units, and Volkswagen 29 000 units. The industry is also a significant and stable employer, with an estimated 33 000 jobs in vehicle manufacturing and 7 000 in component and tyre production. This highlights the potential of export-oriented investment to contribute towards South Africa's development objectives (such as job creation); although there is the danger of export-oriented stagnation, namely an increase in manufacturing exports but a stagnation/decrease in productivity.

Investor surveys have shown that current investors are satisfied with the investment environment in South Africa and express their intentions to make further investments. The chairman of DaimlerChrysler (which has invested heavily in new plant in South Africa), for example, has given South Africa resounding commendations as an investment destination. However, it should be noted that the decisions of MNEs concerning where and how to invest are strongly affected by cognitive perceptions of economic and other risk factors (Gelb & Black, 2004).

Potential investors cite a number of reasons for their reluctance to invest in the country, which include the following:

South Africa's population of about 44 million people is considered too small and its market is considered underdeveloped to attract FDI, particularly market-oriented FDI. The market size is also too small due to the high incidence of poverty, especially among the black majority, and also the unequal distribution of income. The link between economic growth and FDI in South Africa is ambiguous. It is argued that FDI, once attracted, will stimulate economic growth as opposed to the reverse where South Africa actually needs a significant amount of economic growth to attract FDI in the first place. Economic growth in South Africa and the attraction of FDI therefore require greater levels of long-term domestic fixed investment, by both the private and the public sectors (Tsai, 1994).

Tsai (1994) further explains that uncertainty and lack of confidence reflected in low rates of domestic savings and investment, and the listing of major South African companies on foreign stock exchanges (e.g. Old Mutual, Anglo American Corporation, South African Breweries and Dimension Data) are all contributing factors to low FDI to South Africa. The question asked by multinationals is: if South Africans do not invest in the South African economy, why should we as non-nationals do so? The risk factor generally associated with investment in emerging markets also applies to South Africa. Politically volatile events in the region (culminating with recent events in Zimbabwe) have spawned concerns over property rights, the rule of law and governance in southern Africa. The high crime rate in the country has a negative psychological effect and raises the cost of doing business as well.

Lack of political will is another factor that is discouraging FDI in South Africa. While the current ANC-led government is committed to economic growth, driven by the private sector, the South Africa Communist Party and COSATU (Confederation of South Africa Trade Union), which form part of the ruling coalition, oppose the privatisation programme and openly reject the role of the private sector in some areas of the economy. Until now, the promises of growth and employment have kept these parts of the coalition behind the government, but the apparent failure of policies to fulfil expectations is fuelling dissent. This may make it difficult for the government to continue with its policy programme.

Investors have expressed some concern about the skill levels in large parts of the workforce, but the more immediate problem is the HIV/Aids pandemic that affects a large proportion of the economically active sections of the population. South Africa's bureaucratic and complex immigration policy for skilled persons aggravates this dearth of skilled human capital. The scale of the problem is coupled with government's perceived failure to take the necessary radical policy steps to deal with it (UNCTAD, 2001:6–12).

Wei (2000:36) adds that South Africa's labour regime is perceived to be inflexible and over-regulated. The difficulty in laying-off workers and complying with employment equity legislation is perceived by global multinationals as a disincentive to investment. Also, the country has strong and active unions that have high status in the country

because of their role in the overthrow of the apartheid regime. Opposition of organised labour is likely to create a major roadblock to future privatisation while strikes continue to create disruption in the economy.

Investment incentives in the country do not always attract the right kind of investment. Examples of some incentives available in South Africa are exemption from import duties, equipment and inputs, accelerated depreciation allowances, specific tax deductions, training grants, employment subsidies, infrastructural development, etc. Although such incentives have attracted investment initially, they seem to have lost their effectiveness (World Bank Report, 2004).

Cargill and Segal (2003) argue that South Africa has undergone a thorough liberalisation of FDI in recent years. Now, foreign control is allowed across certain sectors. There is also an automatic approval process for investments, and a large number of bilateral investment treaties with both developed and developing countries have been signed that provide for investor protection, dispute settlement, national treatment and most-favoured nation treatment for foreign investors. South Africa's active investment promotion agency, TISA, supports investment missions and actively promotes the country as a destination for investment through a network of officials located in South African embassies in 48 countries.

Until recently, the South African government rejected the use of incentives to attract foreign investors. Industrial development zones (IDZs), South Africa's equivalent of export processing zones, are known to allow duty-free imports and provide good infrastructure and world-class management, but do not provide tax breaks. IDZs have been created in relatively underdeveloped regions to try to spread the positive effects of investment geographically. However, investors have not shown the expected level of interest in these zones, and the lack of incentives in contrast to those offered in other countries is cited as one of the possible reasons. South Africa has now introduced a wide range of schemes and incentives that are available to both foreign and domestic investors. These include preferential access to credit and tax breaks related to job creation or technology transfer, etc. (Donaldson, 2005).

In many ways, South Africa has a state-of-the-art investment policy. Public–private partnerships and clustering represent worldwide exemplary practice in investment policymaking. South Africa also has a well-resourced and developed strategy for targeting investors. For example, investors from Belgium, France and Switzerland are targeted for chemicals and pharmaceuticals industries.

8.4 THE PROSPECTS OF FDI IN SOUTH AFRICA

A lot could be written about the future prospects for existing and potential FDI in South Africa, but the imponderables are so many and so great that it is impossible to be specific. South Africa experienced a decline in the share of average annual FDI inflows on gross capital formation from 0.8% in the period 1980–1982, to 0.4% in the period 1985–1987. This was one of the worse performances in the world and can be explained at least partially in terms of sanction pressures. It must be noted that the 0.8% in the early period was already much lower than most other developed and developing economies. There are several contemporary characteristics of FDI that indicate positively for FDI prospects.

Macroeconomic policy exerts a stronger influence on FDI than trade and industrial policy. In this regard, FDI outflows on the financial account can only be reversed if investor confidence is restored. In the peculiar circumstances present in South Africa this requires not only sound monetary and fiscal policies but also a political solution that defuses the threat to personal security and property posed by continued violence. It also requires clarity on the issue of nationalisation and expropriation. A possible solution to the need for clarity could be found in the formulation of an investment code which sets out attitudes towards FDI in particular and foreign investment in general, and establishes guidelines for monitoring FDI as well as guarantees on the repatriation of profits and royalties (IMF, 2002).

Krugman (1998) indicates that certain labour organisations have called for investment codes with the view of imposing more stringent controls over FDI than exist at present. The National Union of Mine Workers of South Africa (NUMSA) resolved at its 2003 annual congress that its umbrella body, the Congress of South African Trade Unions (COSATU), should urgently draw up a draft code of investment which would improve the level of FDI in the country and which would also direct investment in favour of the

working masses. The views of labour organisations may not be representative, but the call for a code of investment makes good sense, and the same principle applies to the issue of nationalisation and expropriation, the protection of intellectual property rights and the free transfer of profits, licence fees, etc. All in all, foreign investors need clarity on the course of future economic policy before they will consider investing in South Africa (Cooper, 1992:113).

A return to political stability has not done much to induce large-scale private foreign investment, given the subcontinent's dubious history. The question is whether this actually matters. As long as technology is accessible in the form of joint ventures, licensing agreements, etc., there is little need for FDI capital inflow as such. In any event, the major source of foreign capital from the investor country perspective is bank lending. As the events of the disinvestments era have clearly demonstrated, access to foreign bank lending and to international agencies like the IMF is more crucial to development than investment by MNEs. For countries like South Africa with a history of political instability and fluctuating economic performance, the unbundling of FDI is an efficient and rational response on the part of both MNEs (who are looking to minimise risk) and host countries (who are looking to maximise the potential contribution of FDI to development) (Cooper, 1992).

The second principal factor already implicit, if inoperative in many licensing agreements is that the new South Africa, is seen as a gateway to Africa and is generally perceived as a reliable supplier with a strong competitive advantage in African markets. Although the African market is small in global terms, fierce competition for foreign investors is likely to stimulate FDI and joint ventures in particular. This view of South Africa as an export platform is compatible with government's commitment to an export promotion trade policy, but it also calls for the close monitoring of licensing agreements that may preclude exports (Bell, 2004; Cooper, 1992).

8.5 RECOMMENDATIONS FOR INCREASE IN FDI IN SOUTH AFRICA

Generating investment is central to the development, expansion and profitability of an economy. In particular, FDI is a major driver of private-sector growth. Jauch (2002:4) maintains that South Africa is keen on attracting FDI in order to overcome scarcities of

resources such as capital, entrepreneurship, access to foreign markets, efficient managerial techniques, technology transfers, innovation, employment creation and ultimately economic growth. However, as a result of the level of demand for it in Africa, higher prices in the form of innovative strategies have to be paid in order to attract such investment in South Africa. Some strategies to attract FDI include the following:

1. Policies for the promotion of FDI are unlikely to succeed if they are not included as part of the broader economic development and policy reform framework. As FDI can only thrive in a market economic context, market economic reforms need to be accelerated and sustained in the country, and these principles should, as much as possible, be aligned with the world's best practice. Their success depends on strong political will and commitment. The country has as much as possible maintained macroeconomic stability, in particular in interest rates, inflation (within a target range of 3–6% in recent years) and consequentially exchange rates, while generally accepted market economic principles of accounting and auditing has been established and to a larger extent been made legally binding for all profit-oriented enterprises.

2. South Africa has undertaken wide-ranging reforms over the past few years. After 1994, there has been a significant yet steady reformation of the economic and political systems. There is no question that Africa suffers from a lack of visibility in industrialised countries. The international media, and to a greater degree the local media, are focused largely on humanitarian crises and conflict. To be at the forefront of FDI attraction, these are issues that need the swift attention of the government of the Republic of South Africa without compromising the independence of the media. Much has been sacrificed to achieve macroeconomic stability and a positive growth rate, and these sacrifices must not go unnoticed. Although efforts have been embarked on through the government's establishment of agencies such as TISA as well as president Thabo Mbeki's prestigious International Investment Advisory Council, more effort is needed by the government, bilateral aid agencies, multilateral agencies, development banks and, more importantly, the media to identify investment opportunities in the country and use it as a platform to create a positive image for South Africa and Africa at large as a good investment destination.

3. In order to ensure consistent retention and attraction of FDI in the country, a formalisation of the relationship between provincial investment agencies and TISA must be established through signing of a memorandum of understanding or service level agreements. Currently, Trade and Investment KwaZulu-Natal is the only provincial investment agency that enjoys a working relationship with TISA. A formalised relationship between national and provincial levels on investment facilitation and promotion could have many benefits, inter alia developing and packaging investment opportunities, sharing resources, simplifying bureaucratic procedures and participating in investment road shows.

4. South Africa will benefit by participating in the negotiation of regional investment codes and other regional efforts to attract FDI, which supports its development objectives. A regional investment code/framework could lead to greater FDI inflows to South Africa and its neighbours. The content of such a code should extend to include region-wide incentives for large companies to invest in labour training, health and education, given that it is in their interest to have a stable workforce in the region. This will require responsibility on the part of the South African government to create an incentive framework that would reconcile the investment ventures of South African firms with regional development priorities. It could include incentives that would encourage South African firms to source from local suppliers, favour labour-intensive productive enterprises, and encourage infrastructure investment linked to the comparative strengths of a country and regional development needs.

5. The objective of investment attraction must be seen as a national objective and not only the objective of the South African government on its own. Civil society actors in South Africa need to become more involved in decision making on investment-related issues. Agencies like the National Economic Development and Labour Council (NEDLAC), where government comes together with organised business, labour and community groupings on a national level to discuss and aim to reach consensus on issues of social and economic policy, and Business Unity South Africa (BUSA) need to have the attraction of foreign investment as part of their key objectives and also develop a working social accord between business, labour and government outside the institutional framework, i.e. one that establishes both a socially acceptable and investor-friendly

labour market regime, supports skills development and raises productivity. (BUSA was created in October 2003 through the merger of the Black Business Council and Business South Africa and began operating in January 2004. The merger created the first truly unified organisation for business in South Africa. BUSA represents South African business on macroeconomic and high-level issues that affect it at national and international levels. The function of BUSA is to ensure that business plays a constructive role in the country's economic growth, development and transformation and to create an environment in which businesses of all sizes and in all sectors can thrive, expand and be competitive. BUSA is a confederation of chambers of commerce and industry, professional associations, corporate associations and unisectoral employers' organisations.). Agreements negotiated between business, labour and government in the sector job summits would provide a more enabling framework for investment.

6. Both the World Bank and the International Finance Committee (IFC) have repeatedly documented the cumbersome procedures that new investors must go through to set up a business in sub-Saharan Africa. Some countries have over 100 different procedures to open a business; others have bureaucratic systems that result in delays and frustrations. No matter how much macroeconomic reform is undertaken, private investors will continue to be deterred by the massive amount of red tape that confronts them in Africa. As countries in other parts of the world simplify their investment procedures and prepare to do business in an increasingly free-trade environment, South Africa runs a real risk of being left behind if its investment policies are not simplified to allow for the opening of businesses and investments.

Currently there have been many economic reforms to simplify investment procedures for foreign investors in South Africa. These include, among others, the drive by the South African government to revamp the Companies Act, 1973 as well as the Close Corporations Act to be in line with current economic objectives and to ultimately simplify ways of doing business in the country. In addition, exchange controls to reduce restrictions on foreign firms wishing to invest in share capital in the country have been relaxed. and controls over the repatriation by non-residents of investment income or capital gains. However, dividends may not be paid to non-residents without the approval of the South African Reserve Bank. Also, a new system of immigration control has been

put in place to ensure that temporary and permanent residence permits are issued as expeditiously as possible. Under the Immigration Amendment Act (No.19 of 2004), and the new Immigration Regulations, both of which came into effect by proclamation on 1 July 2005, immigration procedures have been simplified, making requirements for entry and residence objective, predictable and reasonable.

7. For South Africa to be successful in the attraction of FDI, the country needs to strengthen its unique national competitive advantages, which would be of particular interest to foreign investors. Policies and strategies for the promotion and attraction of FDI should clearly delineate areas in which FDI is desired. The Industrial Development Corporation of South Africa has defined the investment opportunities that each of the nine provinces of South Africa represents (e.g. Gauteng is known for aluminium products, automotive components, beer and malt, carbonated drinks, food processing, integrated solutions, pharmaceuticals and telecommunications equipment, while the Eastern Cape is known for aquaculture, automotive components, pharmaceuticals (generic and high volume), mohair apparel and sanitary ware). However, these definitions should be used by all agencies that promote investments into South Africa only as a marketing tool.

8. To achieve success in FDI attraction, the South African government can maintain an attractive environment for investors by signing multilateral treaties. Other important steps toward increasing investment include making an extra effort to address the level of crime in the country, making property rights more transparent, and enforcing marketplace transactions and contractual arrangements in a fair manner. It is acknowledged that some level of success has been achieved in these areas; however, a more rigorous effort is needed. Donors and other external parties can play a role in helping governments to build credibility and strengthen markets.

9. If continuously maintained in South Africa, a well-disciplined, relatively cheap, but reasonably well-educated labour force; access to adequate infrastructural and institutional facilities; a stable legal and financial framework and environment; a stable political environment with a government committed to economic development and reform, as well as the absence of corruption in FDI approval, could result in success in the country's FDI

attraction objective. South Africa should abandon its "anyhow" open-door policy to FDI, determine the national policy and set a context for FDI, and resist all additional conditions that come with FDI and, instead, set up its own conditions.

10. Other mediums through which South Africa can attract more FDI through learning from the experiences of other economies on FDI promotion and implementation as well as consistent success of investment projects. This does not mean that South Africa should strive for full replication of the policies of successful countries, but only for selected aspects that would fit its particular needs and requirements. For instance, the costs and benefits of the selected aspects should be carefully evaluated. Successful attraction of FDI should be followed by successful implementation of investment projects. For this purpose, local government entities and officials need to ensure that post-approval implementation of both foreign and domestic investment projects in provinces proceeds smoothly and that local investment regulations and procedures are consistent with central government policies, i.e. proper consultation and coordination mechanisms between central and provincial government need to be strengthened to facilitate and ensure effective investment realisation.

11. The inclusion of corporate social responsibility reporting (non-financial activities) in the reporting structure, (which could relate to HIV/Aids awareness and support, black economic empowerment, skills development, business against crime and ethical investment (sound labour and environmental practices)) of publicly listed companies operating in South Africa, as required by the King II report on corporate governance, has also created a positive image for the country. The limitation is that this requirement is not applicable to private or proprietary limited companies. Extending corporate social responsibility reporting to private companies in South Africa will take governance in corporates and South Africa to another level, which may result in South Africa being an attractive investment destination for foreign entities as a result of more transparency in financial reporting.

12. Ensuring that both local as well as foreign companies have equal access to investment opportunities through competitive bidding will lead to success in FDI attraction. The South African government currently has the Preferential Procurement Act

in place, 2001, which allows for foreign companies to compete for local businesses. However, there does not appear to be a similar Act for the private sector, allowing somewhat little room for transparency. South Africa will broaden its possibility of becoming an attractive investment destination if it can swiftly intervene in military and social conflicts on the African continent and, more specifically, in other southern African countries (e.g. the Democratic Republic of Congo and Zimbabwe), on the basis of compliance with the standard of international law and the Charter of the United Nations with a view to creating a more favourable environment for FDI. (Cull, 1992:21–30; Vickers, 2002; Ramachandran, 1999; Hirsch, 1997; Pillay, 1997; Manuel, 2006; Department of Trade and Industry, 2006; Rob & Vettas, 2003).

8.6 SUMMARY

Decades of inappropriate trade and domestic policies have contributed to the relatively poor economic performance of Africa and, for that matter, to South Africa's inability to attract and effectively utilise FDI in the growth process. South Africa, which is relatively developed and rich compared to its neighbours, has attracted considerably less FDI than anticipated, as discussed in the chapter. South Africa is an excellent example of a country with enormous economic potential that does not achieve the rates of investment that it needs to realise. As far as governmental policies are concerned, the most important point to be recognised and emphasised is that most of what can be done to enhance private investment flows and the gains resulting from them lies in the hands of South Africa itself, and not within the powers of foreign investors. As emphasised in the preceding discussion, the ability of the country to attract FDI and the benefits gained from this type of investment depend to a large degree on the effectiveness of the general economic policies followed by South Africa.

Determined policy reform by the government could make a huge difference but, as the discussion above demonstrates, it is not investment policy on its own that matters. Rather it is the investment environment taken as a whole. In general, the same policies that would help to raise domestic investment are the same ones that would attract more FDI.

It can also be deduced from the discussions above that most FDI in South Africa has been in the form of mergers and acquisitions, which suggests that South Africa should be

working on other forms of FDI, such as greenfield investments, which come with a number of advantages. Also, in South Africa there are significant groups in the public sector and civil society that oppose further economic reforms. If policies are to be effectively carried through from paper to practice, the government will have to spend time on winning over these groups and creating a strong domestic opinion in favour of FDI reform. The public has much to gain from increased foreign investment governed by an adequate regulatory regime, but their views are often coloured by the negative publicity that surrounds particular cases. There is hope for FDI growth in the country if the set of recommendations discussed above can be put in place in a timely manner.

CHAPTER 9: CONCLUSION

The purpose of this dissertation is to look at FDI and its importance to the South African economy. FDI is regarded as an impetus for economic growth in South Africa in that it is by its nature a stable form of capital in comparison to portfolio flows or foreign aid. However, the effectiveness of FDI in ensuring development in South Africa is also very much dependent on the level of repatriation of returns on the investment made by the investors. A discussion of the importance of FDI in the economy of South Africa requires an understanding of the following: what FDI is, FDI trends, determinants of FDI, the types of FDI and the effects of FDI. Further to understanding the importance of FDI to the South African economy is the study of the policies by which such investment can be attracted, as well as the advantages and disadvantages that flow from it.

Through consideration of the definitions of FDI by various disciplines and a careful evaluation of the elements of the various definitions, the following definition was arrived at: FDI is an investment involving a long-term relationship and control or significant influence by a resident enterprise of one economy (direct investor) in another enterprise resident in an economy (direct investee) other than that of the investor. The long-term relationship implies the existence of a lasting interest by the direct investor in the direct investee. This definition is more encompassing in that it considers the five types of FDI discussed in Chapter 3, namely export-oriented, market-development, government-initiated, merger and acquisition, and greenfield types of FDI.

Owing to the susceptibility of FDI and portfolio investment being construed as the same type of investment because they are all investments made by foreign investors, a clear distinction was drawn, which is that, with FDI, the purchaser/investor acquires a 10% (or more) stake in a company, demonstrating a significant influence or control, while portfolio investment flow constitutes a purchase of ownership of less than 10% or without significant influence.

After examining trends of world FDI, a conclusion was drawn that world FDI flows do appear to be biased since various studies (as discussed in Chapter 2) point to the fact that flows to less-developed economies are fewer than those to developed economies. A study by UNCTAD revealed that less-developed nations have only attracted a total of 27.07%

compared to the 72.93% that went to developed nations between 1982 and 1994. The bias in the flow of FDI to different economies leads to the question of how FDI is determined, which is discussed in Chapter 3.

The determinants were studied in the form of economic models. The theoretical model describes interest rate as the key determinant to FDI and expresses it as a function of FDI, i.e. FDI = *f*(I). The basic assumption of this model is that a relatively higher interest rate environment will attract more FDI, and vice versa. Also, the theoretical model looks at the effect of the exchange rate as a determinant of FDI from both a level and a volatility perspective. In terms of levels, relative depreciation of a country's currency increases the relative wealth of foreign firms hence their capacity to invest, and vice versa. With regard to volatility, where a potential host nation is facing large exchange rate volatilities, a foreign firm running the risk of reducing its net worth over time may only invest in the local country if it intends to sell on the local market, but will refrain from doing so if it intends to re-export.

The eclectic model, which is an advantage- and question-based model, addresses the questions of why, where and how a potential investor will invest in a potential host country. It further assumes that it is only when positive answers are given to the questions of why (locational advantages), where (ownership advantages) and how (internalisation advantages) that an investor will invest in a potential host country, as this ensures a competitive edge. A fundamental flaw with this model is that it does not consider other important feasibility factors such as locational factors, labour costs, marketing factors, trade barriers and government policy.

The gravity model explains the fact that investors will invest only after considering (a) how big an economy is, and (b) the cost of the distance between the investor and investee countries. However, this presumption is limited as it only deals with the export-oriented type of FDI and not the other types, and assumes the size of a market is limited to the host country's boundaries by only looking at that country's population, while in actual fact, markets may extend to neighbouring countries. In addition, other factors including transactional cost-related variables, such as common language, common border, general

openness of destination, country of foreign competition, etc. are not considered in this model.

In an attempt to understand the different forms of FDI that emanate from the determinants discussed in Chapter 3, the next chapter was dedicated to understanding some of the forms that FDI takes. Five different types of FDI are discussed, namely export oriented, market development, government initiated, greenfield, and mergers and acquisitions. It can be deduced that government-initiated investment cannot be clearly distinguished from the other types of FDI, since there is a level of government involvement in all the other types of FDI.

A wide range of interests and a variety of complex objectives lead potential host nations to pursue a particular type of FDI, and the decision to invest is made within considerable uncertainty and risk as each type comes with its own benefits and drawbacks, although the net result appears to be that FDI does have a positive effect on an economy's growth and development. However, each country needs to make its own judgement in the light of its conditions and needs, and in the framework of its broader development objectives. It also needs to be aware of and assess the trade-offs involved, whether related to efficiency, output growth, the distribution of income, access to markets or various other non-economic objectives.

To understand the impact that all these types of FDI, and for that matter FDI at large, have on an economy, the next chapter focused on its effects. The effects of FDI were discussed its effects on the balance of payment (BOP), exchange and interest rates as well as employment. The effect of FDI on BOP has a consequential effect on both exchange and interest rates. Initial receipt of FDI creates a BOP surplus. Subsequent repatriation of returns creates BOP account deficit. The influx of FDI has an impact on the exchange rate and, through the multiplier effects, the interest rate of a host country. The extent of the effect, as explained in Chapter 5, depends on the exchange rate policy under which the host country operate. On the other hand, it can be said that the effects of FDI on the balance on payments of an economy can be either positive or negative. If negative, the resolution of the problem lies in attracting more FDI inflows and relaxing exchange

controls. However, the case for FDI must rest on broader considerations than its impact on the level of foreign reserves.

The effect on employment is mixed in that, in as much as business set-ups undertaken as a result of FDI create employment, a counter-argument is that foreign investors, in order to implement their innovative strategies, tend to employ skilled workers from their country of origin, which in effect leads to unemployment and also leaves the host country's skilled workers redundant.

With the positive aspect of the impact of FDI in mind, the need for this type of investment was then studied in the next chapter. In a world of increased competition and rapid technological changes, FDI's complementary and catalytic role can be very valuable. FDI's developmental benefits are potentially strong but whether this potential is realised or not very much depends on the host country having a clear vision of how FDI fits into its overall development strategy. It can be summed-up that FDI has a beneficial impact on developing host countries; however, recent work also points to some potential risks/disadvantages, as discussed in Chapter 6. On balance, even though FDI can be a mixed blessing, the consensus view in the literature discussed is that the benefits of FDI tend to significantly outweigh its costs to host countries. It must also be stressed that most FDI drawbacks are generally of a short duration and can be corrected through appropriate host country policy measures.

The recommendation for host countries is to focus on improving the investment climate for all kinds of capital, domestic as well as foreign. The challenge for host countries seeking FDI is to identify the specific combination of factors that will attract FDI locally. Policy measures can be implemented to correct some of the drawbacks posed by FDI and be implemented to attract more of this investment.

The next chapter was used to discuss policies that can be implemented by host countries in their pursuit of this investment. Various countries are attempting to attract foreign investors through a variety of policies. Some of these rely on targeted financial incentives, tax concessions and specific subsidies. Others focus on improving domestic infrastructure and local skills bases to meet the demands and expectations of foreign

investors, or seek to improve their general business climate by decreasing administrative barriers and red tape, liberalising the investment environment, instituting fiscal reforms, offering packages as incentives, and so on.

However, key to attracting FDI is the realignment of a country's policy directives. To attain maximum benefit, such policies should comprise of the following: firstly, overall economic policies that increase locational advantages; secondly, national FDI policies that reduce the transaction cost of investors; and thirdly, international FDI policies that deal with agreements (whether bilateral, regional or multilateral) on foreign investments.

After a detailed review of the key concepts of FDI as discussed in the preceding chapters, the next chapter was dedicated to discussion of FDI in the context of its importance to the South African economy. It can be construed from the description of the South African economy in Chapter 8 that the country is still an emerging economy, but nevertheless considered as having the biggest economy on the African continent. To move from an emerging economy to a developed nation, FDI is seen as a bigger and important part of the transition, given the enormous advantages that can be generated from this type of investment.

It is noted that approximately 60% of FDI into South Africa takes the form of mergers and acquisitions, largely as a result of state-leveraged deals and the acquisition of conglomerates in South Africa. The overall deduction is that FDI has been in the form of acquisitions in the service sectors in South Africa. Foreign-owned service companies are an important source of spill-over to the domestic business sectors. Another case in point is that South Africa has been experiencing a counteracting effect of FDI, i.e. remittance of returns on investment. This has a weakening effect on the South African rand and consequently strengthens the case for increases in interest rates, especially within the current inflationary environment, creating an unstable economic climate, which is detrimental to FDI. In 2006, disinvestments by foreign investors in South Africa exceeded direct investment. Disinvestments directly affect the operational activities of companies in South Africa in that, once capital investment is disinvested, funding for operational activities shrinks, which leads to a decrease in the cash flow and trading

activities/performance as well as the financial position of the companies, which ultimately impacts on the growth of the South African economy.

The challenges of remittances and disinvestments, and the low level of FDI attraction in the African and for that matter, the South African region, calls for the strengthening and upholding of economic policies that attract FDI into South Africa. South Africa is an excellent example of a country with enormous economic potential that does not achieve the rates of investment that it needs to realise. As far as governmental policies are concerned, the most important point to be recognised and emphasised is that most of what can be done to enhance private investment flows, and the gains resulting there from, lies in the hands of South Africa as a country and not within the powers of foreign investors. To position itself for more FDI, it is imperative that South Africa pays the higher price in the form of innovative strategies, as discussed in Chapter 8, in order to attract more of this investment into the country.

FIFA's awarding of the 2010 Soccer World Cup to South Africa has gone a long way to show the trust that the world attaches to South African economy. The world of investors is lying in wait for the manifestation of the public investment that will go into the preparation of the soccer showpiece. Aside from public investment is the issue of security (which is also a major determinant of FDI in South Africa), which has become both a political and a social concern of the government of South Africa. The world is watching to see whether the South African government will rise to occasion and be able to provide the necessary security to foreigners who will be visiting South Africa for the World Cup. It is the writer's opinion that South Africa should use this opportunity, along with FDI attraction policies, to show the world at large that the South African economy has a solid foundation for investments (domestic and foreign) and that it has really become a gateway to Africa.

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