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# The Dark Side of Foreign Direct Investment: A South African Perspective

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**South African Institute of International Affairs**

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## ABSTRACT

The current account in the balance of payments is always of interest to the international finance community and South Africa is no exception in this regard. The current account signals a country's ability to meet its external financial obligations, an important signal to investors. However, the effect of all the components of the current account is not always well understood. One of these components is net investment income, which is often a source of vulnerability for the current account during an economic downturn, particularly for a middle-income country such as South Africa. Net investment income for a country is the balance between income payments to foreign investors on their inward investments and income receipts to domestic investors on their outward investments abroad. This component is dependent on the decision of firms to declare dividends on their profits or reinvest their earnings in Brownfield investments. These types of decisions have significant repercussions for emerging liberalised economies. This study thus explores how these decisions aligned with maximising shareholder value have important implications for the current account.

The role of government is to channel the most productive investments into labour-absorbing and, if possible, export-orientated industries to reinforce the current momentum of export orientation. As companies seek to reinvest their earnings in their companies, value chains or subsidiaries based in South Africa, investment income payments will decrease and the pressure of the net investment income balance on the current account balance will be eased, thus placing South Africa in a better position to ride out an economic downturn.

## ABOUT THE AUTHOR

Cézanne Samuel is an economist specialising in international trade and investment. She works for the South African Department of Trade and Industry and is a former Konrad-Adenauer-Stiftung intern at the South African Institute of International Affairs. Her fields of interest include regional trade agreements, specifically the Southern African Development Community Economic Partnership Agreement (EPA), and tripartite negotiations, foreign direct investment (FDI) and intellectual property rights, specifically geographical indications.

## ABBREVIATIONS AND ACRONYMS

BRIC	Brazil, Russia, India and China
EPA	Economic Partnership Agreement
FDI	foreign direct investment
GDP	gross domestic product
IPAP	Industrial Policy Action Plan
R&D	research and development
SARB	South African Reserve Bank
TNC	transnational company
UNCTAD	UN Conference on Trade and Development
WTO	World Trade Organization

## INTRODUCTION

The South African current account deficit has received a great deal of attention in the past decade. This is not unwarranted as a prolonged current account deficit is commonly acknowledged as signalling an unsustainable balance of payments and this state of affairs usually precedes a currency crisis. A currency crisis is a sudden decline in the value of a currency. This decline causes havoc as exchange rates adjust and make what was previously affordable no longer affordable. A further result is a mismatch with investors' expectations, which causes them to lose confidence in the economy. Once that occurs, investors will begin to sell their asset holdings, which could be government bonds, stocks and shares in companies. The proceeds from the sale of domestic assets are converted into foreign currency. This worsens the exchange rate, resulting in a run on the currency as investors dispose of their holdings of that currency. A precipitous decline in the value of the currency renders the country incapable of servicing its capital spending requirements. Indeed, the causes of a current account deficit are choice topics in macroeconomic literature. A highly valued currency, uncertainty about government policy and an overburdened fiscus make investors nervous, and a heavily indebted country reflected in large and prolonged current account deficits is a commonly cited cause.

This paper addresses one aspect of the current account that is often neglected, namely the 'net investment income' component of the current account and the role it plays along with foreign direct investment (FDI) in creating potential vulnerabilities for a middle-income emerging country such as South Africa during an economic downturn. It also explores the global trend of non-financial corporations to structure their investment decisions around maximising shareholder value rather than focusing on long-term growth perspectives. These types of decisions have significant repercussions for emerging economies that liberalised their financial markets without fully anticipating the volatility that came with free-flowing (in both directions) income and capital. The role of net investment income is further reinforced by commitments made at a bilateral and multilateral level in trade and investment agreements where countries have committed themselves to open, transparent and liberal trade and financial flows. The existence of these environments has simultaneously introduced current account vulnerabilities.

This in no way suggests that FDI is not important for an economy. Quite the opposite is true: FDI when channelled into productive sectors can have exponential benefits for an economy and there are numerous examples to testify to this, such as the recent investments in the renewable energy sectors in South Africa, which have brought new technologies and skills to the economy. This paper recommends means of attracting the type of FDI that interacts and engages more consistently and positively with the domestic economy, rather than FDI that extracts as much profit as possible before it is repatriated to the home countries.

## UNPACKING THE CURRENT ACCOUNT DEFICIT

A company's equity profile is a mixture of shares and debentures (bonds). The returns that investors earn on their contribution to a company's equity are dividends paid on shares and interest coupon payments made on bonds. There are many benefits to companies

raising debt as it offers them the opportunity to embark on new projects when there is no equity available, or to benefit from tax-deductible interest. The cancellation of investment plans can lead to a disruption to economic activity and possibly unemployment. However, the use of bond markets as vehicles for speculative trading and as a means to avoid reinvesting earnings should not be encouraged if the host nation's goal is productive reinvestment. This is because it creates volatility in the current account balance through large investment income outflows.

Often companies will seek to attract foreign investment as their capital requirements for investments cannot be served by the domestic markets. FDI is widely acknowledged as beneficial to developing countries' economic growth. These capital inflows can help countries meet developmental goals if the flows enable a transfer of technical and managerial skills, increases in productive capacity, and advances in technology. As developing countries tend to have higher rates of economic growth, higher rates of interest and higher rates of return, foreign investors are financially motivated to buy bonds and stocks in these countries. Positive, strong inflows of FDI can serve to boost the exchange rate and can further assist in enhancing the trade balance if these capital injections support export-orientated industries. Such FDI has long-term benefits for local productivity and competitiveness as companies are compelled to produce at a global standard. FDI also provides large transnational companies (TNCs) with the opportunity to earn profit from economic activities outside their home countries.

Nevertheless, investment income receipts and payments can have significant consequences for the current account in the balance of payments, and this raises questions about the characteristics of FDI and the impact of certain policies, including those relating to taxation and incentives. Income derived from FDI is known as 'investment income'. It is measured in the current account as net investment income. Net investment income for a country is the balance between income payments to foreign investors on their inward investments and income receipts to domestic investors on their outward investments abroad. The income earned on investments made is the primary motivation for business to invest in another country. Investment income payments can comprise coupon payments on debentures, interest on bank debt, dividends on publicly traded shares and dividends declared by foreign-owned private companies. Net investment income is one of the four components of the current account balance, together with the trade balance, net services receipts and current transfers.

Investment income payments to foreigners increase the current account deficit as they are outflows and therefore reduce the capital resources available to the host economy. These investment income flows are affected by the business cycle and display considerable volatility. It is this feature that largely prevents FDI from being anti-cyclical and stabilising, due to its effect on the balance of payments through the current account. This aspect of FDI makes many developing countries cautious about full financial liberalisation. Some notable examples of economic crises caused by balance of payments instability in the wake of financial liberalisation are the 1994 economic crisis in Mexico (known as the 'Tequila crisis') and the 1997 Asian financial crisis. These economic events are also marked by large current account deficits and fixed exchange rate systems.

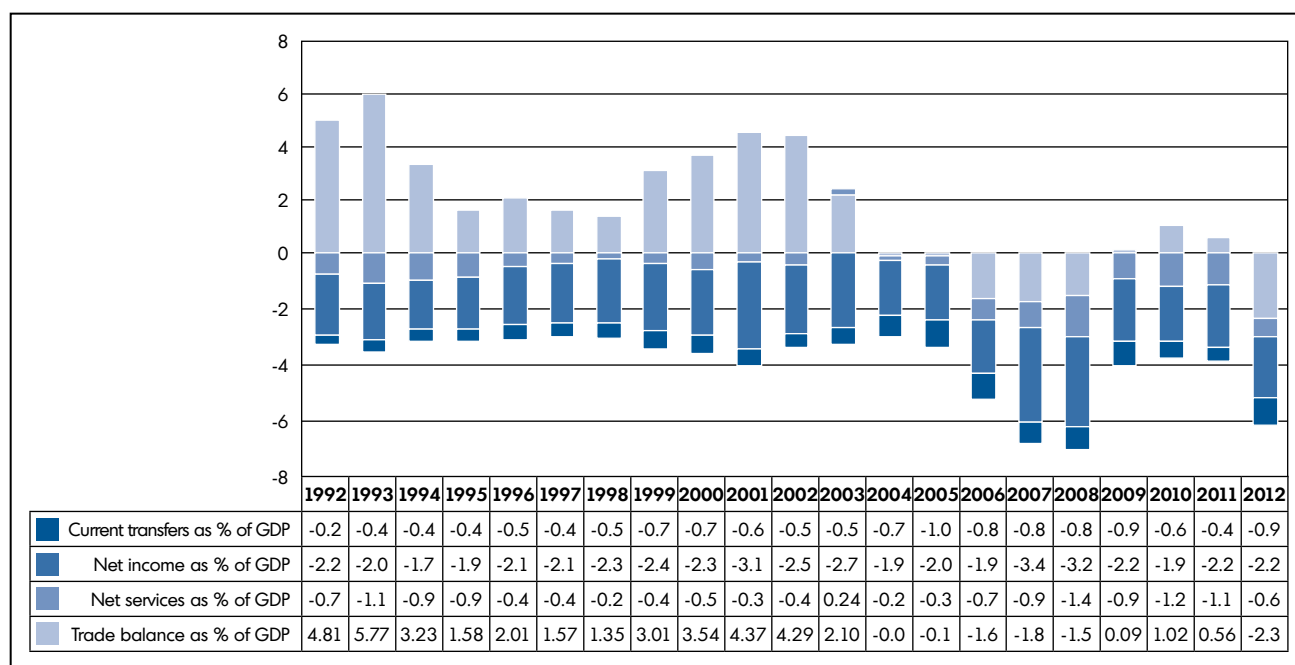
## EMERGING TRENDS IN NET INVESTMENT INCOME

### South Africa

Most emerging economies have negative net investment income positions. This makes sense as these economies are most likely credit-constrained and will need FDI to finance their business endeavours. This situation is presented in the figures that follow. Net investment income often represents the largest deficit in the current account balance. The threat of capital flight, combined with destabilising current account outflows, places many developing countries such as South Africa in a highly vulnerable position during periods of decreased economic activity.

Indeed, statistics published by the South African Reserve Bank (SARB) indicate that net investment income has been a large contributor to the South African current account deficit in recent years. This is often overlooked in analyses of the current account deficit and raises concerns about the potential negative long-term effects of FDI on the balance of payments. The choice that a company makes in reinvesting earnings is similarly an important one. Brownfield investments (ie, the purchase of a previously constructed factory or other facility in order to use it for a new activity) are a significant source of FDI inflows and globally account for 30% of inward FDI according to the 2013 UN Conference on Trade and Development (UNCTAD) World Investment Report.<sup>1</sup> In recent years the current account deficit was almost the same size as the trade balance (Figure 1).

**Figure 1: Composition of the South African current account**



Source: SARB (South African Reserve Bank) statistics, <http://www.resbank.co.za/Research/Statistics/Pages/OnlineDownloadFacility.aspx>: online statistical queries and own calculations.

Figure 1 also presents the vulnerable external position in which South Africa finds itself. As previously noted, large investment income deficits are usual for emerging middle-income countries such as South Africa. This is because the FDI rate of return is higher in developing countries in comparison to that of developed countries. In Africa, in particular, extractive and processing industries have consistently higher rates of return. The issue of large investment income deficits is, however, offset in many other emerging economies: their trade balance inflows often outweigh the ratio of investment income outflows. Except for India, these countries are supported by the balance of net services and current transfers. This follows as the Indian economy is very strongly service-orientated and India has a large number of foreign nationals working abroad who send home remittances. South Africa, by contrast, has a large trade deficit, which further increases the current account deficit rather than acting as a buoy for the other components. This is a worrying sign as the currency crises mentioned previously were preceded by prolonged current account deficits.

**Table 1: The effect of income payments on the current account balance**

Date	Current account as a % of GDP	Net direct dividend balance on FDI as a % of GDP	Proportion of net dividend balance on FDI to current account (%)
1993	2.13	-0.08	-4%
1994	0.01	0.00	25%
1995	-1.65	0.19	-12%
1996	-1.15	0.12	-10%
1997	-1.49	0.05	-3%
1998	-1.76	-0.12	7%
1999	-0.51	-0.26	50%
2000	-0.13	-0.99	768%
2001	0.28	-1.72	-612%
2002	0.83	-1.33	-161%
2003	-0.99	-1.57	158%
2004	-3.03	-1.14	38%
2005	-3.47	-1.32	38%
2006	-5.31	-1.47	28%
2007	-6.97	-2.57	37%
2008	-7.17	-2.54	35%
2009	-4.03	-1.60	40%
2010	-2.82	-1.47	52%
2011	-3.39	-1.85	55%
2012	-6.26	-1.81	29%

Source: author's own calculations and South African Reserve Bank (SARB), Historic Macroeconomic Information, online download facility. Pretoria: SARB, <http://www.resbank.co.za/Research/Statistics/Pages/OnlineDownloadFacility.aspx><http://www.resbank.co.za/Research/Statistics/Pages/OnlineDownloadFacility.aspx>.



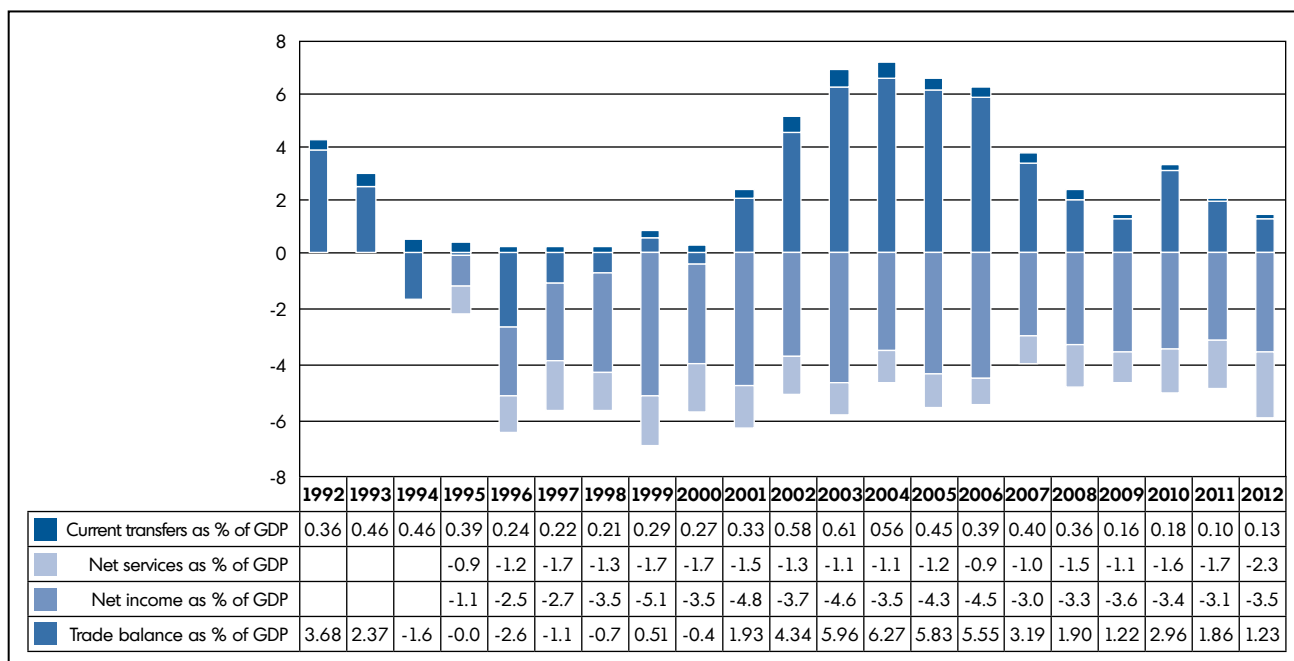
The impact of dividends from FDI holdings on the net investment income position and, ultimately, the current account deficit, is significant. Table 1 shows this by analysing the effect of FDI dividend outflows in column 3. Column 1 shows that the current account balance as a percentage of gross domestic product (GDP) was -6.26% in 2012 as a result of the deficit. Column 2 shows that the balance on FDI dividends was -1.81% in 2012, and the proportion it made up of the current account balance was 28.95% (rounded up) in 2012, as indicated in column 3. Here one sees the large contribution that dividend payments on FDI holdings make to the current account deficit. Overall, the balance on net dividend from FDI holdings is presented in column 2 and since the balance is in deficit, it shows that payments on dividends from FDI are high. Column 3 indicates that this balance often contributes to the deficit on the current account balance.

Furthermore, if one had to analyse this situation in the long term, the impact of income outflows from dividend payments on FDI holdings by foreigners has been a constant plague on the current account deficit since the early 1990s, as shown in Table 1.

**Other emerging economies**

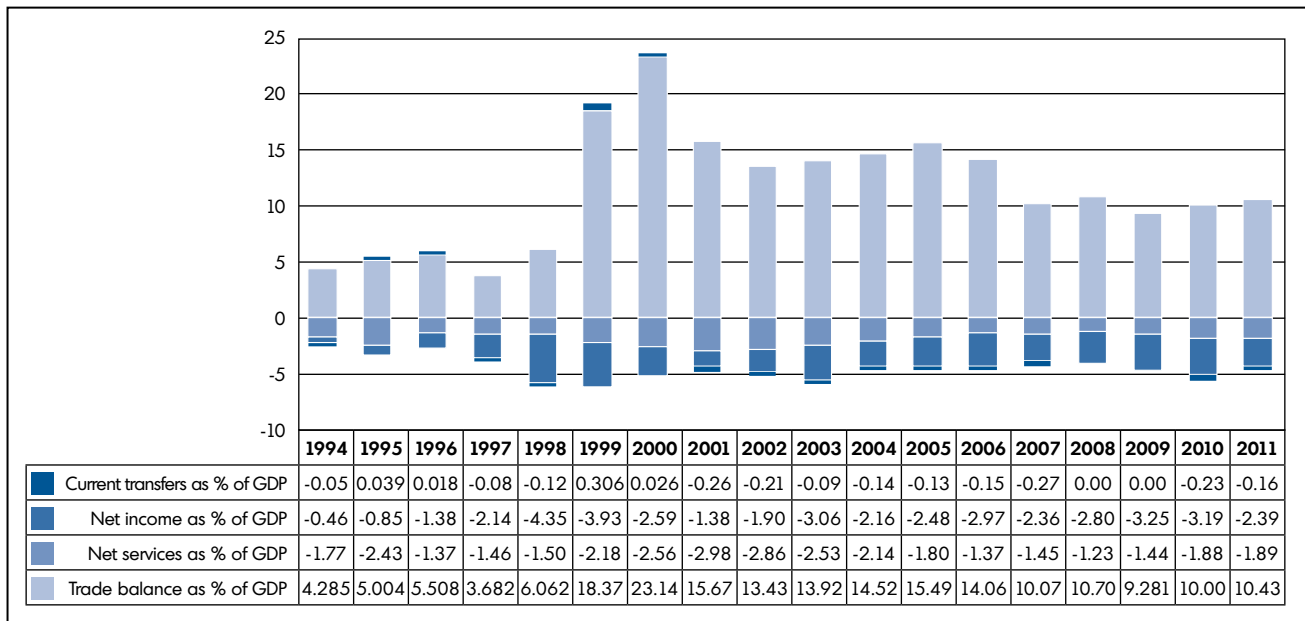
Since 2007, net investment income has been the largest contributor to the current account deficit in Brazil (Figure 2). This indicates that despite the trade balance shifting towards a surplus based on continued strong export performance, there is still a current account deficit due to the payments of investment income on FDI.

**Figure 2: Composition of the Brazilian current account**



Source: Central Bank of Brazil, <http://www.bcb.gov.br/?TIMESERIESEN>.

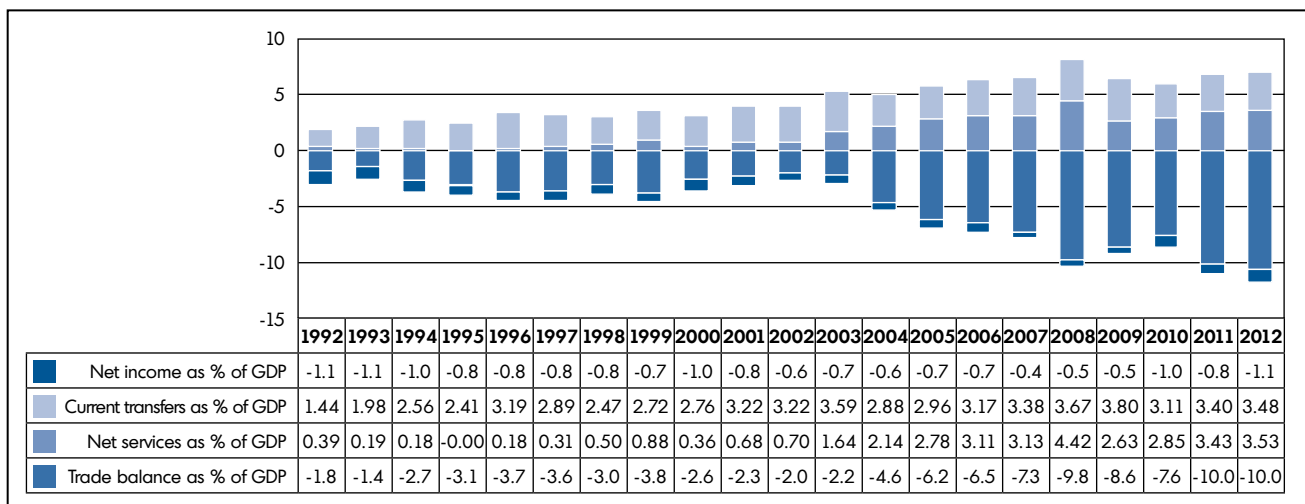
**Figure 3: Composition of the Russian current account**



Source: Central Bank of Russia, <http://www.cbr.ru/eng/statistics/?Prtid=svs>.

Figure 3 shows that the net income balance on the Russian current account is not a very large component thereof. It is overshadowed by the large trade surplus generated, most likely by oil and gas exports. However, given these statistics, one could attribute the relatively small net investment income balance to reinvestments by foreign companies operating in Russia, or Russian investments abroad that generate sufficient investment income receipts to offset the payments made to foreign entities. A further analysis of FDI trends in Russia is necessary to establish this conclusively.

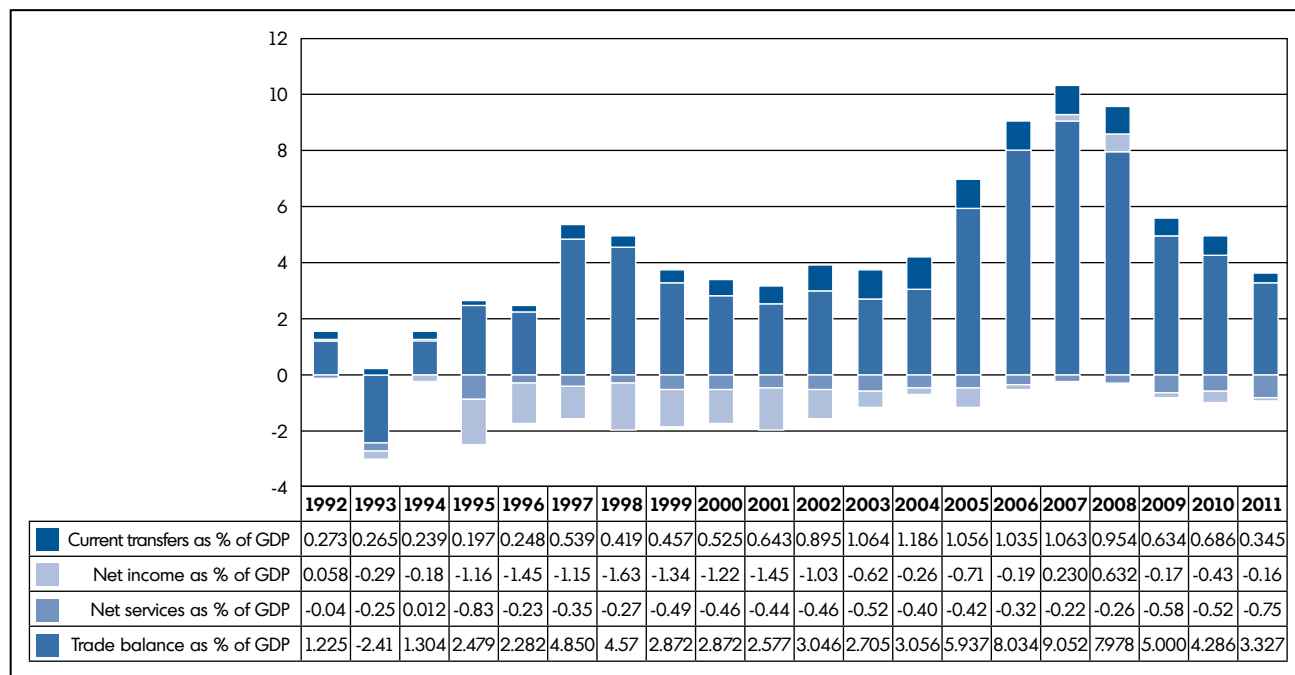
**Figure 4: Composition of the Indian current account**



Source: Reserve Bank of India, <http://dbie.rbi.org.in/DBIE/dbie.rbi?site=home>.

Figure 4 shows that the Indian net investment income position is relatively small in the current account balance. This is because it is dwarfed by the growing trade deficit. However, it does show that investment income payments are greater than investment income receipts.

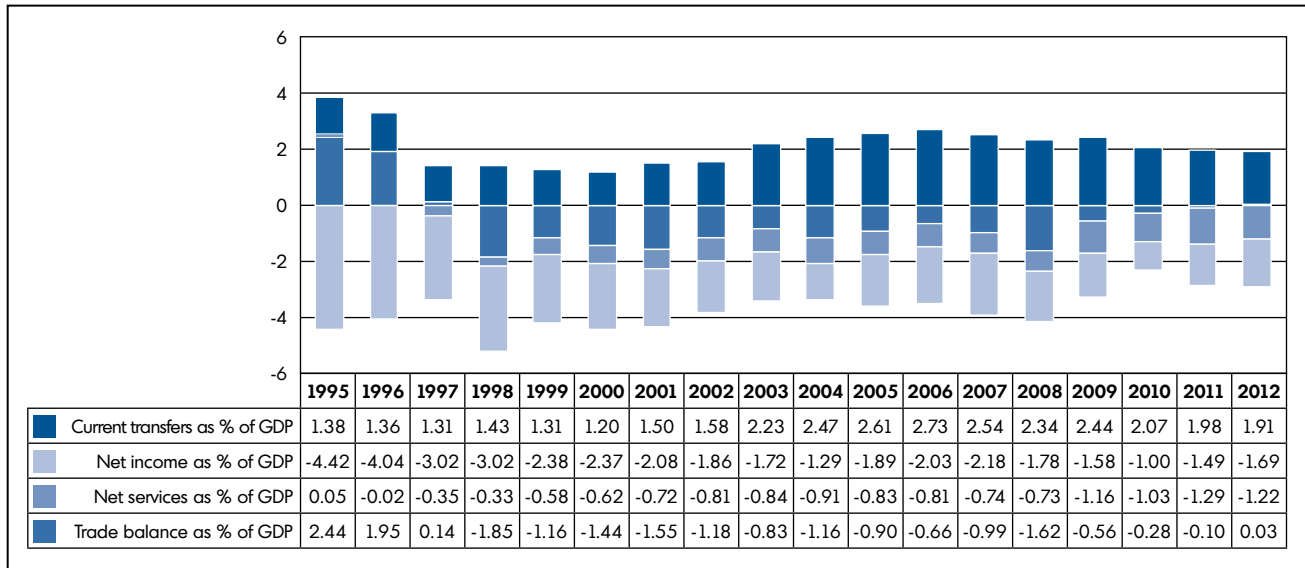
**Figure 5: Composition of the Chinese current account**



Source: Ministry of Commerce, People’s Republic of China, <http://english.mofcom.gov.cn/article/statistic/>.

Figure 5 shows that the net investment income position of China is very small in comparison to other components of the current account balance. This is most likely because China has become a serious investor and has made an obvious FDI footprint in other developing countries, particularly resource-rich African countries. The net investment income balance is small because, in as much as China pays its foreign investors for their capital endowments in China, Chinese investors receive a substantial amount of investment income receipts. This results in a relatively small balance of net investment income.

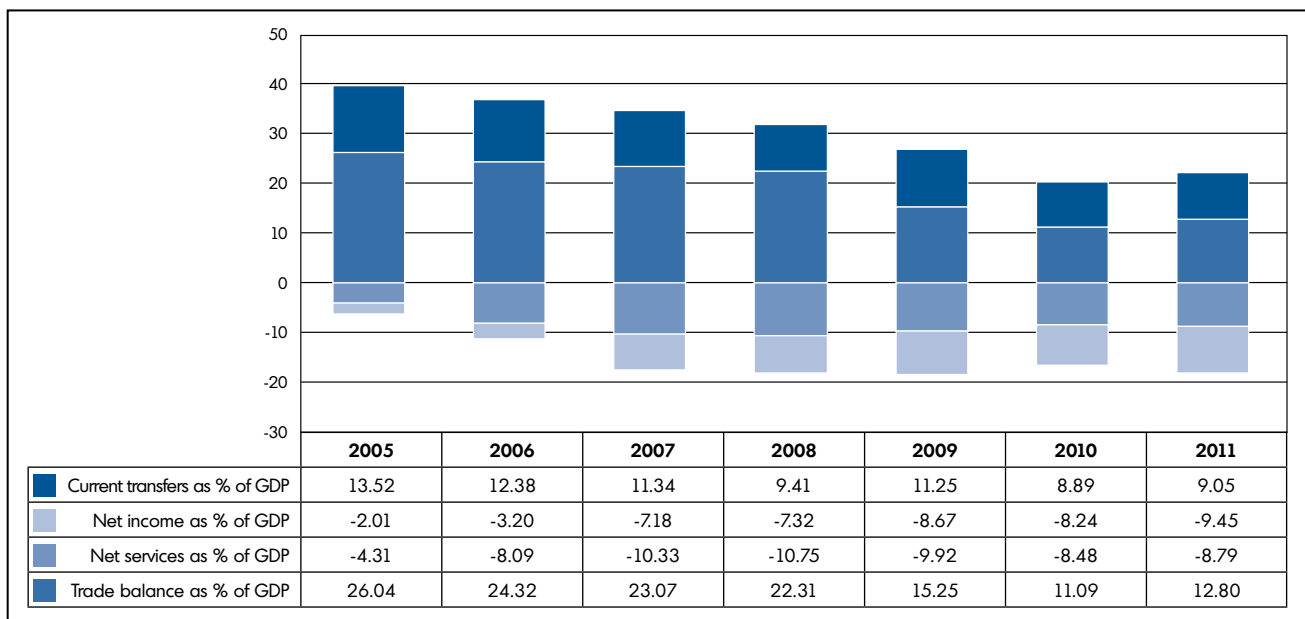
**Figure 6: Composition of the Mexican current account**



Source: Bank of Mexico, <http://www.banxico.org.mx/SieInternet/consultarDirectorioInternetAction.do?accion=consultarDirectorioCuadros&sector=1&sectorDescripcion=Balance%20of%20payments&locale=en>.

Figure 6 shows that a significant component of the Mexican current account balance comprises the investment income balance. While the deficit in investment income has been tapering off since the 1994 Tequila crisis, it is still a large feature of the current account balance. Investment income payments are greater than investment income receipts.

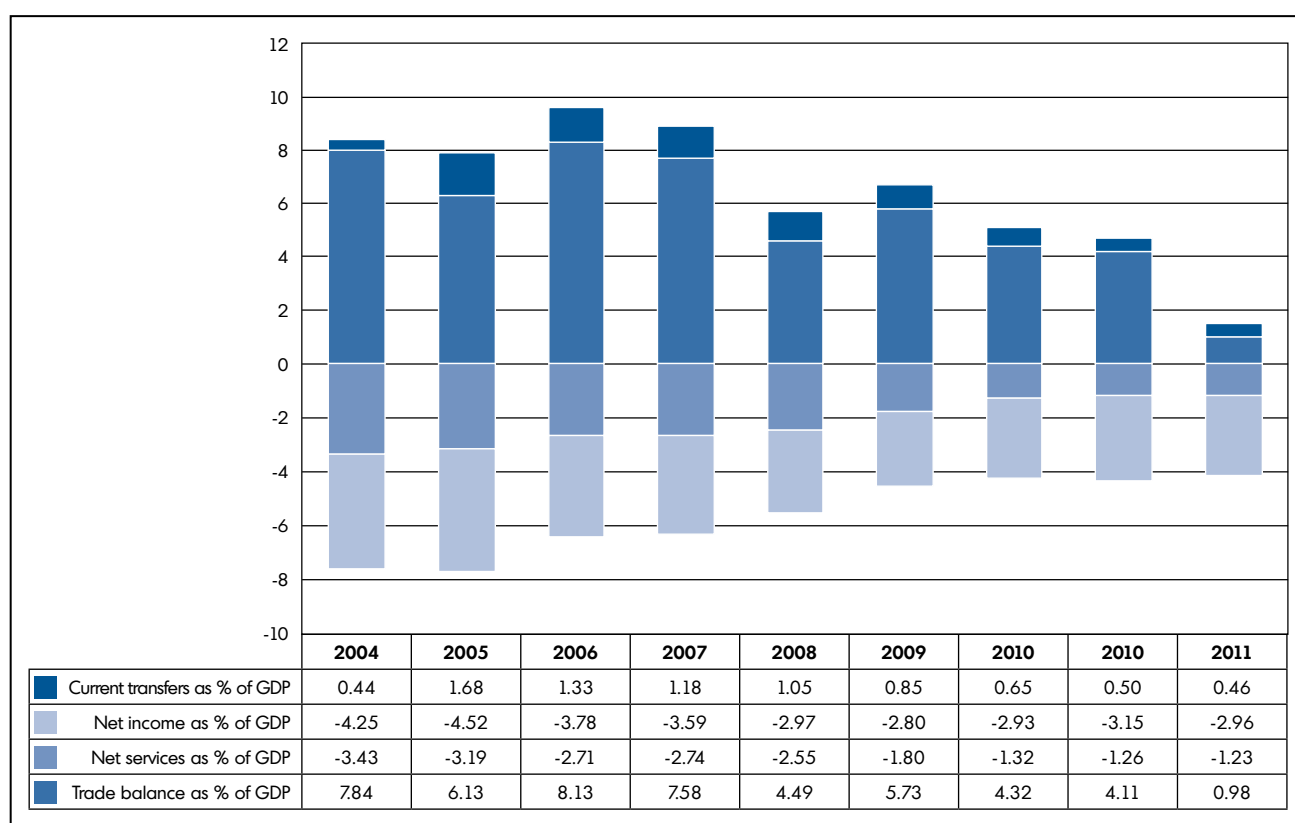
**Figure 7: Composition of the Nigerian current account**



Source: Central Bank of Nigeria, [http://statistics.cbn.gov.ng/cbn-onlinestats/External\\_Sector\\_Stat.aspx](http://statistics.cbn.gov.ng/cbn-onlinestats/External_Sector_Stat.aspx).

Figure 7<sup>2</sup> shows that a large component of the Nigerian current account deficit is net investment income. However, this is overshadowed by a consistently positive trade balance. This indicates that the investment income deficit has increased in recent years, which could signal that business is maturing and choosing to repatriate rather than reinvest. FDI into Nigeria could be flowing to other industries but it is not, which hints at the fact that the structure of the Nigerian economy needs to be diversified. However, a detailed analysis of FDI patterns in the Nigerian economy would be necessary to confirm this.

**Figure 8: Composition of the Indonesian current account**



Source: Bank Indonesia, <http://www.bi.go.id/web/en/Statistik/Statistik+Utang+Luar+Negeri+Indonesia/>.

Figure 8<sup>3</sup> shows that the Indonesian net investment position, which is in a deficit, was the largest component of the current account balance in 2012. This could pose a significant threat to the Indonesian balance of payments if the trade balance continues to shrink.

Reasons for the large investment income deficit vary, but it is often a question of foreign-owned companies deciding to repatriate rather than reinvest their earnings. This decision tends to rest on investor sentiment of the business environment and the prospects for growth in the host country. There are many factors that drive investor sentiment, both internally and externally. Internally, decisions are driven by conditions facing the parent company, the maturity of a foreign company's investment, other FDI holdings made

abroad and the demands made by existing shareholders. The external factors relate to market conditions, policy frameworks and the incentives offered to companies in the domestic economy to reinvest their earnings.

## THE THEORY OF SHAREHOLDER VALUE MAXIMISATION

In South Africa FDI is largely structured around foreign companies exploiting the abundant natural resources and the industries linked to this activity. Recently, FDI in manufacturing and financial services has increased, but not at the same level as mining. According to recent statistics published by the SARB on direct foreign liabilities, total direct investment in manufacturing stands at ZAR<sup>4</sup> 240 billion and total direct investment in mining at ZAR 443 billion as of 31 December 2011.<sup>5</sup> Furthermore, the deep integration of South African capital with capital in industrialised countries means that moving wealth, income and assets has been comparatively easy for wealthy South Africans. Large TNCs are the biggest payers of dividends and the majority of these companies have foreign parent companies. If a parent company experiences a liquidity shortage, it will not hesitate to call in liquidity from its subsidiaries rather than allowing those firms based in the host country (mainly developing countries) to reinvest.<sup>6</sup> In addition, a proportion of South African companies, particularly the large dominant market leaders, has re-domiciled. While their operations are based in South Africa or in the region, the bulk of their shareholders and head offices is in developed countries. This means that dividend payments that would previously have remained in South Africa are now repatriated abroad.

From an international perspective, the concept of financialisation of non-financial corporations in recent decades becomes relevant. While there has been limited change to the structure of the industrial base in South Africa, there has been a change in how business is now conducted and in the priorities of business. There has been a clear shift towards the maximisation of shareholder value as industrial firms become multinational and align themselves with the financial sector. The nature of decision-making in these companies is often a much shorter-term perspective on investments. Furthermore, intense competition in global equity markets forces large corporations not only to raise profits, but also to declare dividends to increase the share price of their firm. This strategy contrasts with strategies to reinvest earnings in the company in the form of Brownfield investments with a long-term planning horizon. Companies' involvement in financial markets and the growing influence of shareholders have resulted in firms seeking to raise debt in equity markets for planned expenditure, as opposed to funding any expansion out of their earnings.

At an international level, there is also strong competition among developing countries for FDI. This has resulted in the shift of power towards TNCs in their dealings with developing countries as these countries have an increasing need for external finance, given their situation of low domestic savings and investment. Previously, developing countries had little choice but to accept the heightened level of vulnerability brought about by large foreign TNCs and their links to financial markets. These developments go a long way in explaining the current vulnerabilities that South Africa is experiencing with its current account. Some commentators on the South African economy argue that rapid liberalisation in the early 1990s has resulted in massive exposed positions in terms of trade and capital flows. However, with the growing presence of large BRIC (Brazilian,

Russian, Indian and Chinese) investors, developing countries are now better positioned to negotiate the terms of investments. In cases such as this, South Africa need not be vulnerable, as it is becoming more attractive, with FDI present and growing in every sector of the economy. The question remains not what can be done to prevent investors from leaving, but rather what can be done to encourage investors to remain and reinvest. Policy needs to be devised that encourages and attracts FDI, and that meets specific objectives. In addition, incentives must be structured within a regulatory framework.

To prevent further vulnerabilities through the South African current account deficit, each of its components must be addressed adequately. The trade deficit must be turned around as exports become more competitive and the country is able to export more value-added products through the implementation of the Industrial Policy Action Plan (IPAP) and other policies. In addition, policies that aim to attract FDI that is focused on ploughing profits back into the company or the value chain it has invested in, rather than repatriating them, are worth considering. It should be remembered that these company decisions are made by headquarters rather than the entity operating in South Africa. It is a question of shareholders' tax interests and the nature of the firm. Smaller, young firms will tend to focus on reinvesting their earnings to grow their business. However, older and more established firms that have limited growth prospects will prefer to declare dividends to appease their shareholders. As such, a useful synergy exists to attract foreign investment into newly developed and/or identified segments of the economy. A good example of this is the recently developed ABSA Capital Platinum Fund. It provides investors with a vehicle to invest in the platinum sector, which has increasingly positive outward projections despite the faltering platinum mines. Attracting more FDI into relatively underdeveloped, yet potentially lucrative, sectors is also a possible solution. In these sectors the company will be able to invest in research and development (R&D), and buy a larger plant or facilities.

An understanding of how firms' decisions to reinvest or declare dividends are related to the taxation policies that face these companies must be established and developed. Such decisions are also based on the expected returns from certain projects that companies undertake. These topics of analysis, although elucidating and interesting, are beyond the scope of this paper.

### **Policy tools to attract the right kind of foreign direct investment**

Policies should aim to ensure that FDI does not create vulnerability for the current account, but that it is labour-absorbing and export-orientated. Policy on FDI should allow for a transfer of technical and managerial expertise from skilled foreign expatriates working in the company or through skills development in the parent company, to equip workers with global best practices. Policy should allow for the increase in capacity in the form of new machines, larger factory space or upgraded information and communications technology facilities. It should also allow for new technologies to be developed. Ultimately, FDI should allow for a business opportunity to be realised in the face of domestic financing shortcomings. The profits realised from this business opportunity should ideally be used to further expand or move the business into a new project.

Currently, companies that invest in South Africa are offered tax allowance incentives. Companies can apply for support for their investments in capital equipment and training.

However, these incentives target only the manufacturing industry and entail the strict allocation of points based on criteria, resulting in preferential status being assigned to a project. The points are allocated based on the contribution that the project makes to employment, small, medium and micro enterprises, and energy efficiency, among other things. Furthermore, in the case of Greenfield investments (ie, in factories that are erected on a previously undeveloped site), the project must be located in an industrial development zone.

Of the 31 project applications received, 28 have been approved since the inception of the scheme in 2010. Some 3 600 direct jobs have been created. However, the budget for this scheme of more than R24 billion has nearly been depleted. Given these facts, it is worthwhile reconsidering the criteria for successful application and administration of the scheme. One policy objective should be to maximise the number of reinvestments in order to retain as much of the rent as possible on FDI in the domestic economy and generate even more productive capacity. The task of an emerging economy such as South Africa is to develop policies that attract FDI that enhances growth, productivity and skills. However, along with attracting this sort of FDI, South Africa needs to ensure that it is well positioned to achieve its socio-economic goals, which will allow for more freedom to attract the kind of FDI that suits the economic goals of the country. It could offer incentives by streamlining the regulatory environment; for example, businesses who invest near infrastructure developments could be required to have fewer licences. Regulatory incentives will vary by firm type and sector involved, and will therefore need to be assessed, designed and implemented accurately.

Firms whose asset value is based on technology will clearly value patent protection more highly than those who produce standard products using cheap labour. Firms with a long investment horizon are more concerned about property protection, while exporters are less concerned by domestic market access than services firms that are highly dependent on local consumer protection rules.<sup>6</sup>

Most World Trade Organization (WTO) and other trade agreements limit or prohibit investment incentives as subsidies. However, there has been increased interest in the provision of positive incentives to FDI through policies aimed at making production more efficient, and contributing to skills and technology transfer. These new investment policies relate to information provision, 'matchmaking', technology upgrading and training for local firms. The WTO regulates investment subsidies in the Agreement on Subsidies and Countervailing Measures, particularly those investments that target export-orientated industries.

A further option is to consider prescribed assets. Prescribed assets are specified asset classes, assets with similar characteristics, that are subject to the same laws and regulations into which government requires fund managers to invest a certain percentage of money. This is usually in the form of investments in government-linked instruments such as a treasury bond. This idea needs to be carefully targeted, designed and implemented. It should not serve as a negative signal to investors that their money will be trapped in the domestic economy. Rather, they should have access to incentives to reinvest, either in their company as Brownfield investments or in Greenfield investments in other segments of the value chain.

Incentives can also be offered to invest in R&D and human capital. South African labour is not as competitive when compared to other middle-income countries, and even



some low-income countries. Although tax incentives are offered to companies to train their staff, more could be done to attract TNCs to spread their technical expertise. The speed with which these projects are implemented must be accelerated as South Africa cannot afford to lose further momentum in this area.

Tax incentives and credits are often couched in an ongoing debate on anti-cyclical expenditure and consumption. This is beyond the scope of this paper. However, targeted tax incentives that are not overly cumbersome are useful tools. In designing tax incentives, it is necessary to consider what type of economic activity is desired and what its overall economic effect will be. To limit the impact of outflows-related FDI on the current account balance, corporate-level incentives, rather than shareholder-level incentives are necessary. This would mean that incentives are targeted at the good performance of firm characteristics rather than financial characteristics; in other words, a company that trained its employees would have better incentives than a company that only reported healthy profits. Sound management of the incentives is also necessary as an assessment of behavioural responses and managing public awareness of these policy objectives.

## POLICY RECOMMENDATIONS

### **1 Develop or understand how the current account balance is related to investment**

A better understanding of how the current account relates to investment on broad issues must be achieved. Exploring how investment income specifically relates to the current account balance in this regard is important. The current account balance is an important economic indicator as it relates to how a country's external expenditure is financed. The implications of investment income payments specifically require better understanding. Incentives need to be better designed to attract reinvestment of companies that are already engaging with the domestic economy. These incentives must be couched in a strong regulatory environment, and be informed by policies aimed at attracting investment that builds on and expands skills, capacity and the transfer of technology.

### **2 What kind of foreign direct investment should South Africa attract?**

An investigation into the corporate characteristics of the FDI present in South Africa is needed. This will provide a more comprehensive understanding of what drives investment into South Africa. Furthermore, a clear understanding is necessary of which investment types contribute best to the achievement of South Africa's policies and economic goals. This analysis should be done in the context of the IPAP as these sectors have already been identified as promoting economic development. Once these sectors have been assessed, incentives need to be designed that make Brownfield and Greenfield investments attractive in these specific sectors, taking into account the characteristics of firms that operate within them.

### 3 Unlocking domestic private investment

The question of how to unlock the vast reserves of South African corporate entities and guide them into more productive uses needs to be addressed. When domestic investors signal their unwillingness to engage further in the economy, it sends a negative signal to foreign investors that either opportunities are not as forthcoming or the business environment does not lend itself to greater investment. Enhanced engagement with the private sector to understand the challenges they face regarding reinvestment and what incentives can be offered to assist is essential. As discussed previously, there are existing incentive schemes, yet more can be done to tailor them to target specific categories of firms. The focus should be more on corporate structured incentives rather than incentives that use financial aspects of a firm as indicators.

### 4 Additional areas for research and analysis

This research indicates that more work is required to understand and unpack the issue of ‘quality of investments’ entering the domestic economy. Such work would have to explore in detail what the impact of FDI on the overall balance of payments would be; it would also need to quantify and qualify the contribution of FDI in establishing linkages to domestic firms, black economic empowerment policies, skills and enterprise development, and to technology transfer. An interesting dimension to explore is the effect that FDI has in creating value chains in the country and in the broader southern African region.

If one has to focus on taxation and companies, transfer pricing should be explored. Transfer pricing occurs where profits are reallocated to avoid taxation. Companies that operate in multiple segments of the supply chain can over-invoice among themselves to avoid paying taxes on higher profits.<sup>8</sup> This occurs in global value chains through the import and export of the components of a product.

## CONCLUSION

FDI in productive sectors can have excellent benefits for an economy and the same principle applies to South Africa. However, FDI on its own is not a panacea for achieving the country’s broad socio-economic goals. It is also important to recognise that FDI is only a means to an end; it is not a goal in itself. The end goal is rather the productive expansion of the economy and employment growth. FDI should target employment creation; build backward and forward linkages with domestic enterprises; support entrepreneurial or equity development through joint ventures; promote the spillover of technological and business expertise; and upgrade skills. FDI needs to be complemented by incentives to facilitate investment in targeted sectors, while not being too cumbersome. It also needs to be monitored to encourage more reinvestment in Brownfield ventures in the company. Co-ordination at policy level can assist and guide investment. For a developing country such as South Africa, the government’s investment promotion efforts should therefore focus on attracting FDI that contributes to the expansion of productive manufacturing sectors such as agri-processing, light manufacturing, transport and logistics services, and professional services industries that are at the higher end of the value chain. If FDI could

be guided into these areas, it would shift the concentration of capital inflows from the minerals, energy and financial sectors that have traditionally attracted the bulk of FDI.

In South Africa investment could be promoted where companies operate in demarcated industrial or special economic zones, or where there are existing plans to develop infrastructure networks. The operations of these projects must be streamlined as the often short timelines that foreign investments work on need to be accommodated. This will go a long way towards improving the business environment. Clearly, companies are interested in operating in South Africa as is evident from the large component of the country's investment coming from FDI. The role of government must be to channel the most productive investments into labour-absorbing and, if possible, export-orientated industries to reinforce the current momentum of export orientation. If the FDI can be encouraged to locate where the state is currently investing in infrastructure, it would make even more sense. Understanding what influences a company's decision to reinvest or declare dividends is important as this can impact hugely on the current account balance.

As companies seek to reinvest their earnings in their companies, value chains or subsidiaries based in South Africa, investment income payments will decrease and the pressure of the net investment income balance on the current account balance will be eased. This will place South Africa in a better position in terms of its balance of payments and help reduce the vulnerabilities that the economy faces during an economic downturn.

## ENDNOTES

- 1 UNCTAD (UN Conference on Trade and Development), *World Investment Report 2013: Global Value Chains; Investment and Trade for Development*. Geneva: United Nations, [http://unctad.org/en/PublicationsLibrary/wir2013\\_en.pdf](http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf), accessed 25 October 2013.
- 2 Figures on the current account balance were unavailable before 2005.
- 3 Figures on the current account balance were unavailable before 2004.
- 4 ZAR is the three letter currency code for South African rands.
- 5 SARB, Historic Macroeconomic Information, online download facility. Pretoria: SARB, <http://www.resbank.co.za/Research/Statistics/Pages/OnlineDownloadFacility.aspx>.
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