Economics essays - south africa investment

South Africa Investment

Analysing the attractiveness of South Africa for automotive industry

Chapter 1: Introduction

Introduction

The Foreign Direct Investment (FDI) has spread through the world economy in the past two decades. More countries and more sectors have become part of the international FDI network. The high level and diverse forms of FDI represent an important force generating greater global economic integration. Every country is trying to attract as much as possible of FDI based on the domestic needs.

The FDI is often used in creating infrastructure of the country where a particular country does not have the necessary financial resources on its own to execute large infrastructure projects (Barrell, R. & Pain, N., 1997). In addition, FDI is also seen as a tool of advancing the national industrialisation plans. The FDI is a tool to integrate the world economies. Some countries intentionally put a cap on the FDI investments so as to protect the domestic needs of the countries economy as generally the FDI is a kind of investment which is in the form of a loan and which can be taken off by the Financial Institutional Investors (FII's) any time (Davidson, W. H., 1980).

Hence there is a risk of FII's pulling out the investment they have put in a countries economy. But there should be a strong reason for such step, which can be social unrest, uncertain economic conditions, or political issues. All these things have to be taken care off while investing in any economy. (Kogutt, B., 1993; Borensztein, E., De Gregorio, J. & Lee, J. W., 1998)

Foreign direct investment (FDI) is the process whereby residents of one country acquire ownership of assets through Financial Institutional Investors (FII) for the purpose of controlling the production, distribution and other activities of a firm in another country.

The International Monetary Fund's Balance of Payments Manual defines FDI as an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise.

The United Nations 1999 World Investment Report defines FDI as an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy in an enterprise resident in an economy other than that of the foreign direct investor. The term 'long-term' is used in the last definition in order to distinguish FDI from portfolio investment, the latter characterized by being short-term in nature and involving a high turnover of securities.

In the proposed research, the author would be investigating South Africa as a investment destination for FDI. The author would be concentrating on the automobile sector of the South African industry for its attractiveness as an investment destination of FII's. In the process, the author would be analysing the various economic parameters as well as the industry perspective of the South African automobile industry for carrying out the analysis.

FDI Investment Parameters

There are various parameters which indicate the attractiveness of a particular economy as a FDI destination. The author would like to discuss some of them which are considered to be the most important parameters while considering FDI destination.

Rate of Return

The differential rate of return hypothesis represents one of the first attempts to explain FDI flows. This hypothesis postulates that capital flows from countries with low rates of return to countries with high rates of return move in a process that leads eventually to the equality real rates of return (Balasubramanyam, V. N., Salisu, M. & Sapsford, D., 1996).

The rationale for this hypothesis is that firms considering FDI behave in such a way as to equate the marginal return on and the marginal cost of capital. The hypothesis obviously assumes risk neutrality, making the rate of return the only variable upon which the investment decision depends. Risk neutrality in this case implies that the investor considers domestic and foreign direct investments to be perfect substitutes, or in general that direct investment in any country, including the home country, is a perfect substitute for direct investment in any other country.

One problem with the differential rates of return hypothesis is that it is not consistent with the observation that countries experience inflows and outflows of FDI simultaneously. This is because a rate of return differential implies capital flows in one direction only, from the low-rate country to the high-rate country, and not vice versa. There is obviously something missing in this hypothesis. However, one must bear in mind that testing this

hypothesis entails serious statistical problems pertaining to measurement errors.

The hypothesis relates FDI to the expected rate of return, which is invariably calculated as the accounting rate of return on invested capital. The problem is that testing is based on the rate of return calculated from reported profit, which is different from expected profit and actual profit. This is because profit is affected by such factors as transfer pricing. In practice, it is rather difficult to obtain evidence on the divergence of reported profit from actual profit, but in general the available evidence indicates that reported profit fails to reflect accurately actual profit.

Furthermore, accounting profit cannot produce a reliable and objective measure of the rate of return, since it can be influenced by many subjective and procedural factors, such as the method used for writing off fixed assets, inventory accounting (FIFO versus LIFO), and inflation accounting. There is also a difference between the profit earned during the whole period under investigation and the profit realised over the reporting period.

Market Size

According to the market size hypothesis, the volume of FDI in a host country depends on its market size, which is measured by the sales of an MNC in that country, or by the country's GDP which indicates the size of the economy. This is particularly so for the case of import-substituting FDI.

As soon as the size of the market of a particular country has grown to a level warranting the exploitation of economies of scale, the country becomes a potential target for FDI inflows. Researchers have pointed out that a

sufficiently large market allows for the specialisation of the factors of production, and consequently the achievement of cost minimisation.

Industrial Organisation

According to this hypothesis, when a firm establishes a subsidiary in another country it faces several disadvantages in competing with local firms. These disadvantages emanate from differences in language, culture, the legal system and other inter-country differences. For example, MNC's may have to pay higher wages in the host country than do local firms, because employment with them is regarded by local workers as being more risky.

If, in spite of these disadvantages, the firm engages in FDI, it must have some advantages arising from intangible assets such as a well-known brand name, patent-protected technology, managerial skills, and other firm-specific factors. The comparative advantage has to be firm specific, it must be transferable to foreign subsidiaries, and it should be large enough to overcome these disadvantages.

Investment Destination Analysis: South Africa

All these factors play an important role in deciding as to whether an economy is a favourable destination for FDI or not. In the coming sections, the author would like to discuss South Africa as an investment destination. (Morisset, J., 1999; Marais, H., 2001; Edwards, L., 2004)

Economic Growth

In the last decade of apartheid, the economy grew at 1. 1 percent per year. The growth rate averaged 2. 9 percent per year from 1994 to 2003 and 2. 7 percent per year between 1998 and 2006. In 2007 growth was 3. 7 percent.

Although the growth rate has fluctuated, no decrease has occurred in any calendar year since 1993. On the other hand, growth has not exceeded 4. 5 percent in any year. South Africa appears locked into a path of sustained but moderate growth.

The growth rate statistics makes the South African economy to be have sluggish growth rate as compared to the other fast developing economies such as China (10% GDP growth rate) and India (about 9% growth rate), but when the growth rate of South Africa is considered from the perspective of the developed countries such as USA and UK which have a minimal growth rate in the range of 2%, then South Africa becomes an attractive investment destination.

Investment and Savings

The investment climate shapes firms incentives to invest and individual's incentives to save. Investment and savings in South Africa are examined below in both a cross-country and historical context. In the 1970s and 1980s, capital investment and employment creation accounted for most growth. In the 1990s, a decline in employment and low investment meant labour augmentation contributed negatively and capital investment contributed only weakly to growth.

The strongest contributor to growth in the 1990s was productivity growth due to technological change. The International Monetary Fund (IMF), which estimated South Africa's potential GDP growth at 3 percent per year, has similarly argued that increased productivity, rather than growth in labour and capital inputs, is the main contributor to growth.

The IMF contends that productivity growth arises from the lowering of trade barriers, increased exposure to international trade, and the private sector's increased share in fixed investment that raises the productivity of capital. It identifies two major constraints on potential growth: the HIV/ AIDS epidemic and the availability of skilled labour. (Golub, S., 2000)

This parameter also makes it difficult to consider South Africa as a potential FDI destination in the first instance. However, when the perspective of the African countries in taken into account, then the South African economy is does pretty well.

Interest Rates and Inflation

Real interest rates were clearly on the rise by 1994, but after 1998 they trended downward, apart from a brief spike in 2001. Given that the rate at which firms borrow is generally declining, the concern of firms about macroeconomic variables relates principally to the exchange rate. Although inflation spiked in 2002-03, before falling in 2004-05, it was between 5 and 10 percent between 1993 and 2003.

Thus, although not especially high by international standards, inflation in South Africa remains higher than inflation in the best-performing economies. The recent improvement suggests that inflation might have less of an impact in the short term than it has had over past decades. (Aliber, M., 2003)

Exchange Rate

The exchange rate is rated the second most serious constraint to enterprise operations and growth. Between 2000 and 2002, the trade weighted real exchange rate depreciated by about 25 percent. The rand depreciated

against most major currencies over this period, falling by about 27 percent against the US dollar, 26 percent against the British pound, and 28 percent against the euro in real terms.

Over the next two years, the rand appreciated against all major currencies, especially the US dollar. Between 2002 and 2004, in the two years prior to the survey, it appreciated 29 percent against the euro, 35 percent against the British pound, and 67 percent against the US dollar in real terms. Since mid-2001, the Rand has possibly been the most volatile currency openly traded in global markets. Because the precipitous decline and subsequent appreciation of the currency were contrary to nearly all established economists forecasts, businesses made investment and operational decisions on anticipated exchange rates that were often wide of the mark. (Froot, K. A. & Stein, J. C., 1991)

Research Questions

For accessing South African automobile industry, the author would first consider the South African economic perspective and then the focus would be shifted towards the automobile industry. The following research questions would be considered for analysis:

- What are the parameters for judging any country as a favourable FDI destination?
- How South Africa would be fared as a FDI destination.
- What are the advantage and disadvantages of the FDI investment in the automobile industry of South Africa?

- What are the returns that the FII's can expect on their investments in the automobile industry of South Africa?

Research Methodology

From the category of the present research, the secondary research methodology would be appropriate for accessing the South African automobile industry as the primary research data collection would not give a clear understanding of the case.

The secondary data would provide the details of the South African case by giving the necessary statistics of the economic parameters which are to be considered for the FDI investment. (Saunders, M., Lewis, P. & Thornhill, A., 2007)

Secondary data is the existing data that the researcher can use for re-evaluation and other research purposes. In addition, this can be categorised into three: documentary data, survey-based data, and multiple sources data. On the other hand, one of the key methods in order to gather these secondary data is the desk research.

Basically, desk research is another qualitative approach and a valuable source of supportive information for the primary data. Data gathered through this method are from the published works, making the researcher as the secondary user.

Moreover, by employing this method, the researcher has gained access to wide-ranging academic materials such as journals, books, academic magazines, and even website documents. To be more specific, most of the

secondary data had been obtained in academic journals. (Churchill, G. A., 1979; Stewart, D. W. & Kamins, M. A., 1993)

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