

Working Paper No. 20/01

**South Africa: A developing country
and net outward investor**

by

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SNF Project No. 4425

Foreign Direct Investment and Development:
Lessons for Southern Africa from the Southeast Asian Experience

The project is financed by the Research Council of Norway

FOUNDATION FOR RESEARCH IN ECONOMICS AND BUSINESS ADMINISTRATION
BERGEN, JUNE 2001
ISSN 0803-4028

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South Africa: A developing country and net outward investor

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Abstract

This paper describes and analyses the role of foreign direct investment (FDI) in South Africa's industrial development. Inward FDI played an important role for early developments in the financial and manufacturing sectors, but during the past two decades outward investment has outpaced inward investment. Both inward and outward investments (except outward investment in the SADC region) have largely been in the form of mergers and acquisitions. This may lead to integration of South African companies in international supply networks, but it does not create jobs in the short run. The major factors limiting FDI inflows are probably shortage of skills, inflexible labor markets, a relatively small and slowly growing domestic and regional market and a highly concentrated ownership structure in the South African economy. The gap between domestic savings and the investment level necessary to generate economic growth around 5-6 percent is much wider than what can be filled by FDI.

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1 Introduction

South Africa was a net outward investor during the period 1986-98 in spite of being a developing country. This position is a result of a unique economic and political history. South Africa has one of the world's richest mineral resources under its soil, and has been a significant mineral exporter throughout its economic history. Exports of minerals often results in a current account surplus that in turn is reflected in a positive stock of net foreign assets. The oil-exporting countries in the Middle East and Botswana are examples of this. However, most developing mineral-exporting countries lack industrial capacity, and their net foreign assets therefore consist of financial assets and property, while they are net recipients of foreign direct investment (FDI). The composition of the South African net stock of foreign assets is just the opposite of this. The total net stock is negative, the country being a net borrower and a net recipient of portfolio investment, while the country until recently was a net outward direct investor. The reversal of this position occurred in 1999, but was not due to net inflows of FDI. What happened was that four of the largest South African companies moved their major listings and therefore their headquarters to London. Their considerable assets in South Africa all of a sudden became part of the inward FDI stock.¹

South Africa's industrial development started in the late 19th century following the discovery of diamonds in 1869 and gold a few years later. When the South African Union was formed in 1910,² the mining sector was already firmly established in the economy and contributed to 27 percent of GDP (Jones and Muller 1992). The capital investments in the mining sector came almost entirely from abroad before 1910 and foreign capital continued to dominate up to World War II. Even human capital largely came from permanent and temporary migration.

The mining industry became the engine of growth in the South African economy. Income earned in the mining sector created a market for consumer goods and the proliferation of small-scale manufacturing and repair shops. The mining sector also constituted a market for an emerging, large-scale chemical industry, the mining industry generated substantial government revenue, which was invested in infrastructure, but also spent on subsidies to agriculture and manufacturing. Finally, minerals formed the basis for a number of down-stream industries.

South Africa experienced reoccurring balance of payments problems and even balance of payments crises during the second half of the 20th century. Several factors contributed to this. First, the gold price, and thereby export revenue, became more volatile after major industrial countries left the gold standard. Second, the political change following the victory of the National Party in 1948 led to capital flight, particularly on the part of foreign companies. Following a balance of payments crisis in 1961, capital controls were introduced and the economy gradually became more inward-looking. The open, relatively rapidly growing economy was gradually replaced by a stagnating, protected economy and the country eventually became an international pariah, before the development again was reversed in the late 1980s,

¹ Later two other companies followed suit.

² Four self-governing British colonies formed the Union of South Africa in 1910. Two of these were until the Boer war of 1899-1902 self-proclaimed independent Boer republics.

leading to the first free elections in 1994 and a gradual opening of the economy by the new democratic government.

This paper provides an overview of the political economy of South Africa, focusing on the role of international capital flows in the development of the South African economy. It starts by a brief overview of the economic development of the South African economy since the South African Union was formed in 1910 in section 2. Section 3 discusses international trade patterns and trade policy in South Africa. Section 4 presents and analyzes data on FDI while section 5 concludes.

1 Economic development 1910-2000, an overview

The development of the South African economy has been one of mineral-led growth. Southern Africa is one of the richest areas in the world in terms of mineral deposits, and South Africa is at present the world's largest producer of gold, platinum group metals, vanadium, chrome, manganese ore and sillimanite minerals. The country also has vast deposits of coal, which probably has given the country a comparative advantage in energy-intensive industries such as steel and aluminium.³ Finally, the country has vast deposits of other minerals and is among the world's top 5 producers of a number of them. This resource base has attracted foreign capital; it has been the income basis for the major South African multinational companies and the country's major source of export revenue. Finally, backward and forward linkages from the mining industry have been the driving force for manufacturing and service sector developments. Table 2.1 below presents data on the development of industrial structure during the period 1912-2000.

Table 2.1. Industrial structure, shares of GDP

	Agriculture	Mining	Manufacturing	Finance	Other
1912	17.4	27.1	6.7	Na	48.8
1921	22.0	16.9	12.2	Na	48.9
1930	13.9	18.0	13.1	Na	55.0
1939	12.8	20.6	17.7	Na	48.9
1950	8.0	15.6	13.2	14.6	48.7
1960	7.1	18.1	15.6	14.5	44.7
1970	4.8	15.2	20.3	14.6	45.1
1980	5.1	9.4	23.9	14.8	46.8
1990	5.1	7.6	22.7	16.1	48.5
2000	4.4	6.2	20.6	19.7	49.0

Source: Jones and Muller (1992) and Reserve Bank (www.resbank.co.za)

It is worth noticing that the country had an industrial economy in the sense that mining and manufacturing accounted for about a third of GDP while agriculture accounted for only about a sixth of GDP already in 1912. The prominent role of the financial sector is also worth noticing. The sector accounted for close to 15 percent of GDP already in 1950, and was larger than the manufacturing sector. In the year 2000 the financial sector was again almost on par with the manufacturing sector, and among the fastest-growing sectors in the economy. Such a prominent role of the financial sector is rarely found outside international financial centers. In Britain, which indeed hosts a world financial center, the sector accounted for about 13 percent

³ Energy prices have, however, been heavily subsidized.

of GDP in 1970 increasing to 21 percent in 1999 (OECD 2000). According to research reviewed in Levine (1997) financial sector development is an important determinant of economic growth and even a good predictor of future growth. South Africa has so far not lived up to these predictions, and we will discuss the structural difficulties that have held back development in sections 2 and 3.

In order to put South Africa's economic development into perspective, it is useful to compare the country's long-term growth performance to a sample of countries. Table 2.2 presents data on GDP per capita in 1913, 1960 and 1994. The first year for which comparable data are available is 1913. Next, 1960 represents the end of an era in South Africa's history. In 1961 the country withdrew from the Commonwealth and introduced its own currency, the Rand, which replaced the Pound Sterling. It was also the year of the Sharpeville massacre resulting in a flight of capital and the introduction of capital controls on non-residents in 1961. Finally, 1994 represents another turning point in South African history. This time development went towards a more open economy and the lifting of remaining sanctions against the country. The figures in brackets in table 2.2 present average annual growth in per capita income during the period 1913-60 and 1960-94 respectively.

Table 2.2. GDP per capita at constant 1990 USD⁴

	1913	1960	1994
South Africa	1451	2624 (1.3)	3451 (0.8)
Japan	1334	3879 (2.3)	19505 (4.8)
South Korea	948	1302 (0.7)	10010 (6.0)
Philippines	1418	1488 (0.1)	2213 (1.2)
Mexico	1467	2781 (1.4)	5098 (1.8)
Chile	2653	4304 (1.0)	7764 (1.7)
Portugal	1354	3095 (1.8)	11083 (3.8)
Norway	2275	6549 (2.2)	18372 (3.0)
New Zealand	5178	9491 (1.3)	15085 (1.4)

Source: Maddison (1995)

We see that South Africa had an income per capita about the same level as Japan, Portugal, the Philippines and Mexico in 1913. This was less than 30 percent of GDP per capita in the leading industrial nations at the time, but still relatively high compared to world average income.⁵ During the period 1913-1960, a period of rapid industrialization, GDP per capita grew faster than in South Korea, the Philippines and Chile, while Japan and Portugal had overtaken South Africa in terms of GDP per capita by 1960. South Africa had the slowest growth in the sample during the period

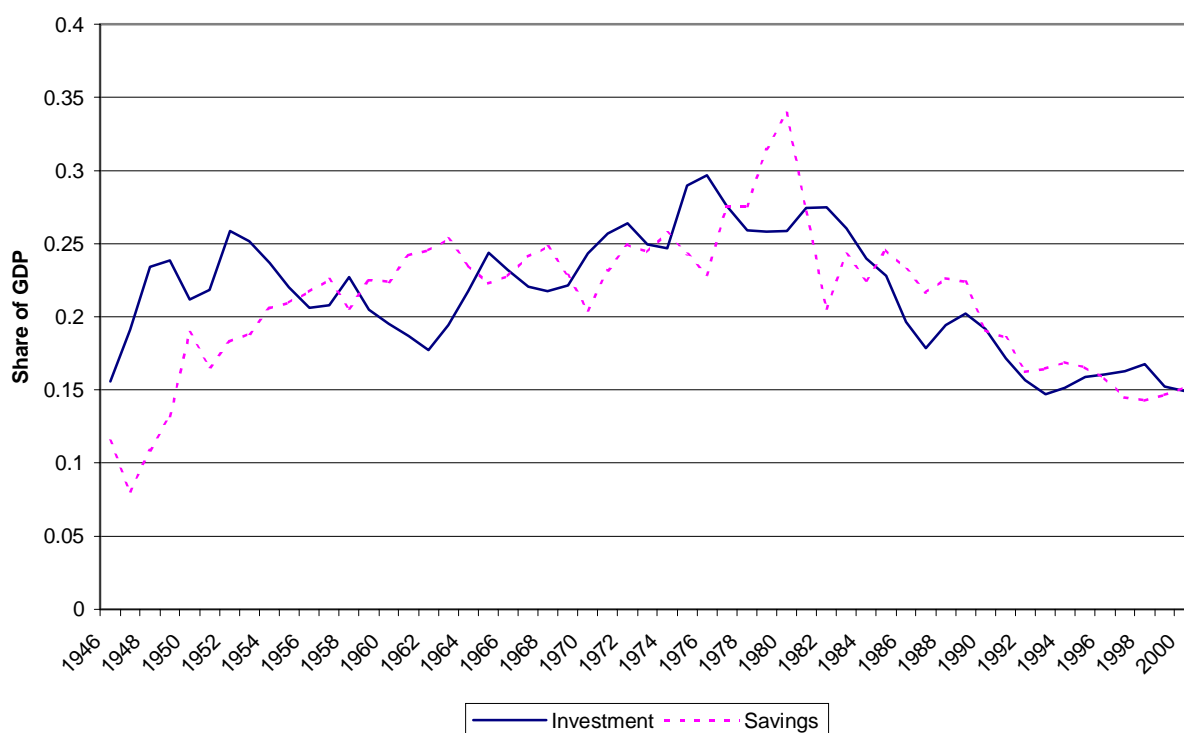
⁴ GDP per capita figures are given at 1990 Geary-Khamis dollar.

⁵ The world's four richest countries in 1913 were Australia USD 5505, the USA USD 5307, New Zealand USD 5178 and the UK USD 5032 (Maddison, 1995)

1960-94, a period of import-substituting industrial policy, increasing barriers to trade and a rising level of conflict both internally and towards the rest of the world.

The national savings rate fluctuated around 25 percent of GDP during the period 1960-1980. This was about the same rate as the OECD countries. Since 1980 the national savings rate has declined steadily from about 34 percent in 1980 to less than 15 percent in 1999. Savings in South Africa thus fall way behind the Asian newly industrial countries, which had savings and investment rates between 30 and 40 percent on average during the 1990s. An investment rate about half of this is nowhere near the required level for obtaining sustained annual growth of 5-6 percent, which is the aim of the South African government's macroeconomic policy program for growth, employment and redistribution (GEAR). Furthermore, the gap between actual and required investments for obtaining the GEAR objectives is far beyond what can be filled by foreign investments.

Figure 2.1. Savings and investment, share of GDP.



Source: South African Reserve Bank

The domestic savings-investment gap is reflected by a current account deficit when investment exceeds savings and a surplus when savings exceed investment. The figure suggests that except for the early days when investment exceeded savings significantly, foreign capital has not played a significant role in financing South African investments. Furthermore, as will be discussed in section 4, foreign financing has increasingly come in the form of loans and portfolio investment, not direct investment.

The 1980s were largely a lost decade in terms of economic growth and development, seeing an exodus of foreign investors, social unrest and economic stagnation. Since 1994 growth has picked up somewhat, but the average annual growth rate during the

period 1994-2000 was only 2.5 percent. Starting out with a relatively high level of income per capita and vast mineral resources, but falling behind over time, South Africa appears to be yet another “paradox of plenty” a phrase coined by Karl (1997) in a recent book on the economic history of mineral-rich countries.

1.1 The mining sector

The mining sector has been the major driving force in the South African economy from before the formation of the Union in 1910 until recently. A closer look at the historical development of the mining sector and the structure of the sector is therefore necessary in order to understand the political economy of South Africa and the role of international capital flows in the country’s development.

The first significant mining enterprise in South Africa was diamond mining. Diamonds were discovered in 1869 and triggered a “diamond rush” from near and far afield. Diggers and traders came from all over the world, and workers came from the entire sub-Saharan Africa. In the early days claims were awarded to individuals subject to a fee. Trading and brokerage were also regulated through the introduction of licenses. Yet, early diamond mining was competitive and at times fairly chaotic. The quantities recovered increased steeply during the first two decades and the diamond prices plummeted accordingly. Furthermore, as the open pits became deeper, the claimholders increasingly got in each other’s way. These developments raised the need for a more organized industry. Amalgamation of claims was a step in this direction and mining companies replaced individual miners. Most of the companies were registered in London, which is where they raised capital.

A motley crew of financiers, entrepreneurs and fortune-seekers, many of them commuting between London and Kimberly (the location of the diamond mines) managed to secure large numbers of valuable claims and accumulated huge fortunes. The British press called the most successful of them “the Randlords”. Among them was the legendary Cecil Rhodes, who founded De Beers Company.⁶ After years of competition and shifting alliances among the Randlords, Cecil Rhodes managed to amalgamate most of the Kimberley mines under his De Beers Company. It was, however only after another South African legend, Ernest Oppenheimer, had forced his way to the board of De Beers two decades later that the company started to exploit its monopoly power in terms of controlling the price of diamonds (Wheatcroft 1985). De Beers has sustained its monopoly for almost a century.

Diamonds were replaced by gold as the most important mineral before the Union was formed in 1910. Gold mining soon ventured into underground operations which required large-scale investment both in mining and processing equipment, and infrastructure for transporting the equipment, inputs and output. The Randlords were the people best positioned in terms of financial muscle and local experience to venture into gold mining. Their experience did, however, hardly comprise exploration and mining technology of the kind needed for the gold mines. That is probably a reason

⁶ In addition he was a student at Oxford University (!) and he played an important role in politics, expanding the British empire northwards and having a colony (Rhodesia, the present Zimbabwe) named after him. His vision was even greater; he wanted to extend the British Empire from Cape to Cairo.

why the industry was organized into holding companies controlling a large number of individually incorporated mines. The holding companies, or mining houses as they were called, provided a package of managerial, technical and financial services to each individual mine. They also managed labor relations and recruitment, although this was increasingly left to the Chamber of Mines.⁷ In this way resources were pooled and relevant experience from the diamond-mining sector could be transferred to the new industry.

During the period 1893-1933, 7 mining houses were established.⁸ In order to raise funds for large-scale investment they quite often sold more than 50 percent of the shares in an individual mine to the public - local and foreign. Yet, the mining houses kept control over the individual mines through a system of crossholding and “pyramiding” (see section 2.5). The first mining houses were floated at the London Stock Exchange and controlled from London. However, after the Union was formed in 1910, a new generation of mining magnates took over, among them the before mentioned Ernest Oppenheimer. His aim was to establish a South African mining industry incorporated in and managed from South Africa. He established Anglo American Corporation and raised the necessary funds in Britain and America, hence the name of the company. The American finance house J.P. Morgan was one of the large shareholders. The other mining houses subsequently followed and established their headquarters in South Africa. Perhaps ironically, two of them were also the first to establish their headquarters in London after sanctions were lifted in 1994.

The mining houses came to be South Africa’s largest companies and a few of them are even among the world’s leading mineral companies today (Anglo American Corporation, De Beers and Billiton). In addition, they have integrated backwards into chemical industries and other inputs, including finance, forwards into downstream processing industries, and horizontally into different minerals. Since the mineral deposits were located in remote areas with very little economic activities, the mining houses have always been engaged in unrelated businesses in order to secure the necessities of the community that arose around the mine. The motivation for agglomeration has, however changed over time, as will be discussed further in other sections of the paper.

South Africa has large deposits of coal close to the major gold fields. This helped the development of sufficient and relatively low-cost electricity supply both for the mines, subsequent industrialization and relatively low-cost railway transport. During the 1960s coal became South Africa’s second largest export earner (after gold) after Anglo American had developed a technology for cleaning the coal for ash⁹ and the mining houses built a railway line to the coast at Richards Bay and a bulk terminal for shipping the coal. This led to a dramatic increase in producer prices for coal as the world market price was about three times higher than the local price. The extent of local energy subsidies became apparent as a result, and local price controls were eventually abolished, but this happened only in 1987.

⁷ See Pogue (1999) for a discussion.

⁸ The 7 mining houses were Rand Mines, Consolidated Gold Fields, Consolidated Investment Company (JCI) which was later bought by Anglo American Corporation, General Mining and Finance Corporation, Union Corporation, Anglo American Corporation and Anglo Transvaal Consolidated Investment (Anglovaal).

⁹ South African coal has a higher ash content than the major markets could accept.

During the 1980s platinum group metals replaced coal as the second largest export earner, and in the year 2000 platinum group metals exports even exceeded gold exports in value terms. At present about 80 different minerals are extracted in South Africa. The mining sector accounts for about 6 percent of GDP and 40 percent of merchandise exports.

1.2 The manufacturing sector

While foreign capital mainly came in the form of portfolio investments in the mining sector, FDI dominated the manufacturing sector. In addition the sector was driven by forward and backward integration as well as agglomeration within the mining houses, and of course consumer demand in a growing economy.

Early industrialization was largely market-driven with little state intervention. One exception was the establishment of a local monopoly in the explosives industry (see section 2.2.1) shortly before the turn of the 19th century. Explosives are a crucial input to the mining industry and the monopoly was a source of controversy and it was strongly opposed by the mining houses. Industrial policy that had the side-effect of increasing the cost of mining operations continued to be a thorn in the side of the mining houses who, with the exception of De Beers, had no influence over their output prices.

The first major policy driven industrial development was the establishment of a parastatal steel producer, Iscor, in 1928. In this respect South Africa followed the major industrial countries in Europe who saw the steel industry as a strategic industry that became subject to a number of state interventions. Another strategic industry was the defense industry. It was first established with British aid in the 1930s. After the National Party government that took office in 1948 introduced the apartheid policy, the country became increasingly isolated. The policy could only be sustained by means of force and self-sufficiency in vital products such as arms (and energy, which is discussed in section 2.2.1). The development of a local defense industry received increased priority following the first UN resolution introducing a voluntary arms embargo on South Africa in 1963, and subsequent tightening of the embargo. Military interventions in the region (Angola and Mozambique) boosted the industry further. Armscor, a parastatal with the objective of development, production and procurement of arms was established in 1968. The defense industry grew rapidly and accounted for 10 percent of total manufacturing sector employment at its heyday. The arms industry further accounted for about 10 percent of total R&D expenditure in the country (Cock and Mckenzie 1998).

Although technologically sophisticated – the defense industry has developed nuclear bombs, sophisticated radar systems and an attack helicopter, to mention but a few well-known products - the industry has turned out to be largely uncompetitive when exposed to international competition. In spite of restructuring, the sector's output declined by about 40 percent during the period 1989-95. When a new arms acquisitions program for the South African Defense Force was approved in 1999, most of the contracts went to foreign firms, albeit with significant local industry participation. Parts of the electronics industry are, however, a more successful offspring of the defense industry.

The National Party government also introduced a policy of import substitution entailing an escalation of import tariffs and direct import control through quotas. At first this policy encouraged foreign direct investment, joint ventures and license production arrangements with foreign firms. Both local and foreign firms produced mainly for the domestic market, which grew rapidly during the 1950s and 1960s. The structure of the manufacturing sector is presented in table 2.1. The table depicts the industries' share of total value added in the manufacturing industry in 1996, the latest census year.

Table 2.1. Composition of the manufacturing sector

Industry	Share of total
Food and beverages	15.3
Textiles, leather and footwear	7.8
Wood and wood products	3.6
Paper, printing and publishing	9.6
Fuel	4.3
Chemicals	10.5
Rubber and plastics	4.4
Non-metallic mineral products	4.5
Basic metals	11.1
Fabricated metals	7.0
Machinery and equipment	9.6
Motor vehicles and other transport	8.9
Other	3.4

Source: Statistics South Africa (2000)

The light consumer goods industries (food and textiles) accounted for close to a quarter of total value added. Heavy, resource-based industries (fuel, chemicals, mineral products and basic metals) accounted for almost a third of total value added, while more technology-based industries (machinery and equipment and motor vehicles) accounted for almost a fifth of value added. South Africa in other words has a diversified manufacturing sector not very different from many of the OECD countries. We now turn to a more detailed discussion of two manufacturing industries that have gained prominence in South Africa; the chemical industry including fuels, and the automotive industry.

1.2.1 The chemicals industry

The first chemical industry plant came as a result of the establishment of a state monopoly for explosives, which was licensed to the Swedish Nobel Dynamite Trust. The Swedish company opened the world's largest commercial explosives factory near Johannesburg in 1896. The major mining houses strongly opposed the monopoly granted by the government, as this led to higher costs than what would otherwise have been the case. Their countermeasure was backward integration, establishing their own explosives factories. The explosives monopoly was eventually lifted, and the mining houses merged their explosive factories in 1924 and formed the chemicals company AECI. It subsequently diversified into a number of chemicals such as fertilizers, paints and industrial chemicals. The British multinational ICI was a joint venture partner in AECI, and still holds a large minority stake in the company.

Another important driving force for developments in the chemical industry was the fear of fuel shortages. The Second World War led to problems of fuel supply and later there was a constant threat of an oil embargo against South Africa. Since South Africa does not have any significant oil deposits, they looked for substitutes. There existed a German invention that could produce oil from coal, the so-called Fischer-Tropsch process. It had not been applied on a commercialized scale, but one of the mining houses (Anglovaal), which sat on huge coal deposits, saw it as interesting and persuaded the government to subsidize its research and development expenditure in order to commercialize the technology. A state-owned chemical company, Sasol, was subsequently established in 1950 for the purpose of producing synthetic fuel for the local market.¹⁰ The long feared oil embargo materialized only in 1986, but by then South Africa already had its synthetic fuel industry.

Compared to using crude oil as a feedstock, the Sasol technology is highly inefficient at oil prices below a certain level. Thus, during periods of low oil prices and access to imported oil, Sasol has been heavily subsidized. The oil price floor that makes Sasol's synthetic fuel competitive has, however, declined as the company's productivity has improved (Hodge 2000).

Sasol also has a chemical industry division, and its relative contribution to company output and profits is increasing. There are significant synergies between the two divisions as by-products of synthetic fuel production are cheap and clean raw materials for the chemical division. Furthermore, the synthetic fuel technology can be used for converting natural gas into liquid fuels, mainly diesel. The Sasol technology may thus solve one of the largest problems facing the international petroleum industry; what to do with the natural gas found in oil fields located where there is no local market for natural gas. Such gas has hitherto been flared, but this cannot continue due to environmental concerns. Sasol's technology can be used onshore to produce diesel directly from natural gas instead of converting it to LNG, saving the cost of specialized terminals and LNG tankers for transport. In addition, smaller scale production of diesel from natural gas has been developed for use on offshore oil rigs. Sasol has entered into a joint venture with Chevron in order to develop, introduce and market this technology.¹¹ Investments are under way in Qatar and Nigeria. Finally, Sasol invests in oil and gas exploration and field development. The most significant is the development of a gas field in Mozambique. The gas will be piped to Sasol's plant in South Africa for processing.

Sasol was partly privatized in 1979 and fully privatized in 1991.¹² Foreign investors hold about a third of the shares in the company at present, but these are purely portfolio investments. Sasol's history is one of technology transfer from abroad through licensing and local adoption, followed by the establishment of sufficiently large-scale plants to exploit economies of scale in a protected home market and from that platform develop into a multinational resource-based company. In addition to the oil and gas investments, Sasol's chemical division has expanded abroad in Europe and the US through mergers, acquisitions and strategic alliances. These investments are first and foremost focused on marketing, but have also comprised production facilities

¹⁰ Two towns were created around the Sasol plants; Sasolburg and Secunda.

¹¹ Chevron is a US based multinational oil company.

¹² The state-owned Industrial Development Corporation, IDC, has retained a 9 percent share in Sasol.

that have been a vehicle for exporting Sasol's basic chemicals and technology. In spite of the company's somewhat unusual history, it has turned out to be one of South Africa's largest and most successful companies. The company's exports and foreign sales accounted for about a quarter of total turnover in 1999.

1.2.2 The automotive industry

Ford Motors established the first assembly plant in South Africa in 1924, and General Motors followed in 1926. Later the major German car producers established assembly plants in South Africa (Volkswagen, BMW and Mercedes), all producing for the local and regional market. The South African government was concerned about the very low local content of these vehicles and introduced a local content program in the 1960s. Six such programs followed one after the other during the period 1961-95 and combined measures such as tariff protection of both cars and parts and import permits subject to relatively complex rules (Barnes 2000). Local producers were given substantial tariff protection, the effective tariff rates went as high as 100 percent and more, and induced a number of foreign firms to set up production in South Africa rather than exporting parts to the country. In addition, the South African state through its Industrial Development Corporation (IDC) set up an engine factory in joint venture with a German firm, which provided the technology.¹³ The program indeed did increase the local content of the car industry, and a local value chain was established, but at a very high cost to consumers.

During the sanctions period the American car producers sold their South African plants to local firms, which continued production, while the German producers stayed in the country.¹⁴ The car parts producers also divested and production continued by local firms producing on a license. Two Japanese latecomers to South Africa, Toyota and Nissan, entered the market through franchising production to local firms. The foreign investors returned during the second half of the 1990s, when General Motors bought a 49 percent stake in Delta motors, and Ford bought a 45 percent stake in Samcor and took over management control. Likewise the Japanese carmakers bought minority stakes in the local franchise firms (Barnes 2000).

The return of the multinationals started the process of reintegration of the South African car industry into the world economy and the global production networks of the multinational car and parts makers. A comprehensive restructuring has followed. The number of makes being assembled in South Africa has declined. The car parts industry, which has remained under local ownership, has become more specialized and international sourcing of parts and exports of car parts have grown rapidly. In other words, lifting of sanctions, a sharp reduction in tariffs on both cars and parts, and the return of the multinationals in the car industry have resulted in extensive intra-industry trade both vertically and horizontally in this sector.

¹³ IDC invested in new ventures on a commercial basis, often in joint ventures with foreign companies. It also made low-interest investment loans to local companies.

¹⁴ Ford was sold to Samcor, a fully owned Anglo American company, and GM was sold to Delta Motors, a local company.

1.3 The financial sector

The financial sector has played an exceptionally important role in the development of the South African economy from the early days. Mineral-led growth requires large-scale investments, and is characterized by large and fluctuating cash flows denominated in foreign currencies. There is thus need for financial services in order to expedite complex financial transactions, smooth expenditure, diversify risk and mobilize resources. The interaction between financial sector development and the structure of the South African economy has thus probably been important for the relatively large and sophisticated financial sector South Africa has hosted for most of its modern history.

Two British banks, Barclays and Standard Bank dominated the banking sector from the 1920s until their British owners divested during the sanctions period in the 1980s. These two banks held most of the country's demand deposits, partly in South Africa and partly in Britain. The two banks did not provide long-term finance for investment, but rather concentrated on short-term working capital and financing foreign trade. In order to fill demand for long-term investment, locally owned building societies and cooperative banks were established. These industries were competitive with a large number of firms. Their relative importance grew before the 1960s, but then started to decline as they had difficulties in competing for funds. The building societies had all been de-mutualized and incorporated into the large financial conglomerates in the 1980s.

The companies that came to be the flagships of the South African financial sector were the life insurance companies. These were locally owned and four large companies dominated (Old Mutual, Sanlam, Southern Life, which in turn was controlled by Anglo American, and Liberty Life).¹⁵ The insurance companies were the most successful in attracting local savings, partly due to tax advantages for savers. They were restricted to making loans to the public sector and invest the remaining assets, which were and still are considerable, in local stocks. The insurance companies therefore not only came to dominate the financial industry, they also became formidable investors and own a large share of the total assets listed on the Johannesburg Stock Exchange (see section 2.5 below). South African insurance companies' assets compared to total GDP is in fact very high in international comparison. At about 80 percent it is similar to the UK and much higher than the USA (Genesis 1999). The sector has been liberalized and opened up to foreign competition and capital controls on local companies have been reduced. The insurance companies are now allowed to invest 15 percent of their total South African assets abroad.

Foreign companies started entering the insurance market during the 1950s, but these were mainly in the short-term insurance and re-insurance business. Since 1994 short-term insurance and security firms have re-entered the South African market and the foreign companies have already gained a market share of about 40 percent in the short-term insurance market (Genesis 1999). Outside these niches, foreign investors have not been important in the insurance business.

¹⁵ Southern and Anglo American Life merged in 1984 and became Southern Life.

Returning to the banks, in addition to the two large British banks, the industry consisted of another foreign bank, the Netherlands Bank (Nedbank), a local Afrikaner-owned bank, Volkskas, was established in order to service the Afrikaner community and finally Trust Bank, a bank targeting the retail banking market, was established in 1955. Volkskas' relative market share grew exceptionally during the 1950s when the newly elected National Party government decided to transfer government accounts, including the parastatals to Volkskas. Thus, in 1960 the country had 5 major banks, 3 foreign and two locally owned, each targeting different market segments, although the two British banks mainly competed in the same markets (i.e., servicing big business, including the mining houses).

The structure of the banking sector has changed tremendously since then. First, all 5 major banks came under national control, starting with Nedbank in 1961. During the sanctions period both the British banks divested and were taken over by the only local firms with sufficient capacity to do so, the life insurance companies. Southern Life took over Barclays and Liberty Life took over Standard Bank. By 1985 the insurance companies controlled four of the five major banks in the country.¹⁶ During the 1990s another wave of mergers, acquisitions and restructuring took place and both Volkskas and Trust Bank ceased to exist as independent banks.¹⁷ The banks in turn developed into financial holding companies for a number of specialized financial services, including credit cards. In 1998 there were 43 registered banks in South Africa, but the 5 largest accounted for 83 percent of total assets.

A large number of foreign banks have again entered the market, but most of them have so far only established representative offices.¹⁸ Their combined market share was only about 5 percent in the late 1990s. Yet, the foreign banks soon became prominent in commercial loans and syndicated loans to the big South African companies, corporate advisory services and foreign exchange dealings. Furthermore, their entry has prompted cost reductions through information technology and more focused distribution channels in local banks (Hawkins 2001). The foreign banks are totally absent from the retail banking market, however (Genesis 1999).¹⁹

South Africa has developed a relatively sophisticated financial sector, and provides modern services in retail banking as well as investment banking, insurance and a broad range of specialized financial services. In the early 1990s South Africa had a similar coverage of automated teller machines (ATM) as the leading EU countries. Customers can pay their electricity bills and other utilities over the till in supermarkets, and the banks have developed, albeit not always successfully, financial services designed for relatively poor customers. The major South African banks have established branches in a number of African countries and South African financial services companies have made acquisitions in both Europe, the US and Hong Kong. We finally note that the IMF (1998) finds that South African banks are well capitalized, well run and organized, and they have sophisticated risk management

¹⁶ Sanlam took over Trust Bank in 1973, Old Mutual took over Nedbank in 1985.

¹⁷ They were both merged into the at present largest South African bank, ABSA.

¹⁸ By the end of 1999, 79 foreign banks had registered in South Africa, of which 12 had established branches able to accept deposits (South African Reserve Bank 2000).

¹⁹ This is probably partly due to regulations; the minimum deposits the foreign banks could take was 1 million Rand. This regulation was lifted in 2000.

schemes and corporate governance systems. These qualities limited the contagion of the Asian financial crisis to a short-lived growth slowdown in South Africa.

1.4 Human capital and labor relations

Human capital accumulation is perhaps the most important engine of economic development. South Africa has consciously and actively prevented the majority of its population from acquiring skills through the apartheid labor market and education policy. Regarding the quality of education, Case and Deaton (1999) find that educational resources have been and still are sharply different by race and that this has negatively affected educational attainment and test scores for disadvantaged groups. South Africa no longer produces data on educational attainment by race, but data from 1991 presented in table 2.2 illustrates the racial differences in educational attainment, which will prevail for a long period to come even if everybody had access to the same quality and quantity of education from now on. The table depicts the share of the population that has reached the stated education level.

Table 2.2. Educational attainment, share of population above 15 years

	No education	St. 8-9	Matric	Diploma with matric	Bachelor
African	34.3	9.3	4.4	0.8	0.1
Colored	23.5	11.7	5.9	1.3	0.3
Indian	18.2	17.5	17.1	2.4	1.9
White	10.9	21.5	2.8	8.5	6.0
Total average	29.5	11.4	8.1	1.9	1.0

Source: *South African Institute of Race Relations*

While three times as high proportion of the African population had no education compared to the white population, sixty times as high proportion of Whites had a bachelor degree compared to the African population. Only 0.08 percent of the total population and 0.7 percent of the white population had a Masters degree.

The South African labor market has been distorted by apartheid laws for most of the country's modern history and there is still a long way to go before the wage and occupational structure of the labor force reflects talent and effort rather than race. The apartheid policy included regulation of industry location, influx control to white areas and reservation of the most skilled positions for white workers. Asian and colored workers also gained some privileges relative to African workers. These regulations, apart from violating human rights, created skills shortages and encouraged the use of more capital-intensive technologies than what would otherwise have been the case. Furthermore, in the face of labor shortages even for unskilled workers, the low wages could only be maintained through a substantial inflow of workers from abroad. In the South African mines 75 percent of the workers came from abroad in 1971, declining to 40 percent in 1977 following a tripling of real wages in the sector (Hofmeyr 1996).

The labor market regulations were increasingly circumvented by businesses in order to overcome skills shortages, and the regulations were gradually lifted as a result. They were, however, totally eliminated only in the late 1980s. A convergence of wages between black and white workers followed the dismantling of discriminatory labor market regulations. There are, however, still significant differences regarding career opportunities. For example, Smith (1999) finds that the industry of employment is the most important determinant of African wages, while this is not the

case for white, colored and Asian workers. Since it is the black workforce that gets the lowest quality education, these results may indicate that the skills that black workers possess are acquired on the job, and is therefore highly specific to the sector and even the company.²⁰ If this interpretation is correct, the reallocation of labor and capital following trade liberalization or changes in technology could easily mean reallocation of workers to lesser paid jobs since the on-the-job acquired skills may not be relevant in a new job, if any can be found.

The South African labor market also creates problems for South African firms' ability to adopt modern management systems and venture into the "new economy." Although the country has outstanding information technology firms - one has even listed on the London Stock Exchange - and a rapidly increasing rate of Internet and mobile telecommunication use, companies have had difficulties in implementing the necessary organizational changes that make investment in information technology profitable and productivity enhancing. The technology-driven global trend towards more differentiated and customized products requires a flexible work organization, organized around circles with multi-skilled workers rather than assembly lines with long runs of identical products. Kaplinsky and Morris (1999) find that the change to more diversified outputs did not lead to the necessary change in work organization in the surveyed South African companies. Instead, producing more diversified products within the same work organization resulted in a substantial increase in cost. Inability to shift to a more flexible work organization stems from lack of skills both on the part of workers and management. Illiteracy is widespread among workers, while management has not been enough exposed to modern management techniques and work organization.

1.5 Ownership structures

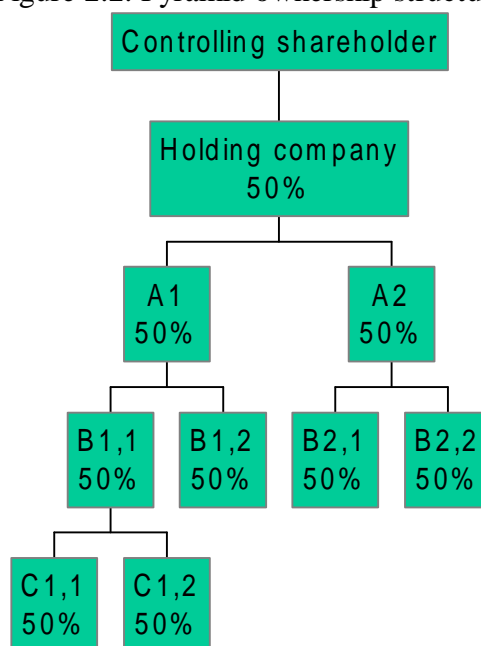
Ownership structures in the South African economy have been highly concentrated and characterized by huge conglomerates. During the period 1983-2000, the top five groups controlled between 55 (1998) and 85 (1987 and 1991) percent of the total Johannesburg Stock Exchange (JSE) capitalization.²¹ The figure stood at 61.4 percent in 2000. Of these Anglo American alone controlled 60 percent at the most (McGregor 2001). This ownership structure is partly a result of the long history of foreign exchange control and South Africa's isolation. The mining houses have earned substantial resource rents, which have been locked into the South African economy and forced the mining houses to invest in local non-mining activities. As discussed in section 2.2, the import substitution policy also induced the mining houses to integrate backwards in order to secure reasonably inexpensive inputs.

The dominant groups *controlled* a much larger share of the companies than they actually *owned* by establishing pyramid structures with a holding company on top. A stylized pyramid structure is shown in figure 2.2.

²⁰ The objective of Smith's study was to investigate whether industries with a high market concentration pay higher wages than industries with low market concentration, which she found to be the case.

²¹ The JSE has changed name to the Johannesburg Securities Exchange.

Figure 2.2. Pyramid ownership structure



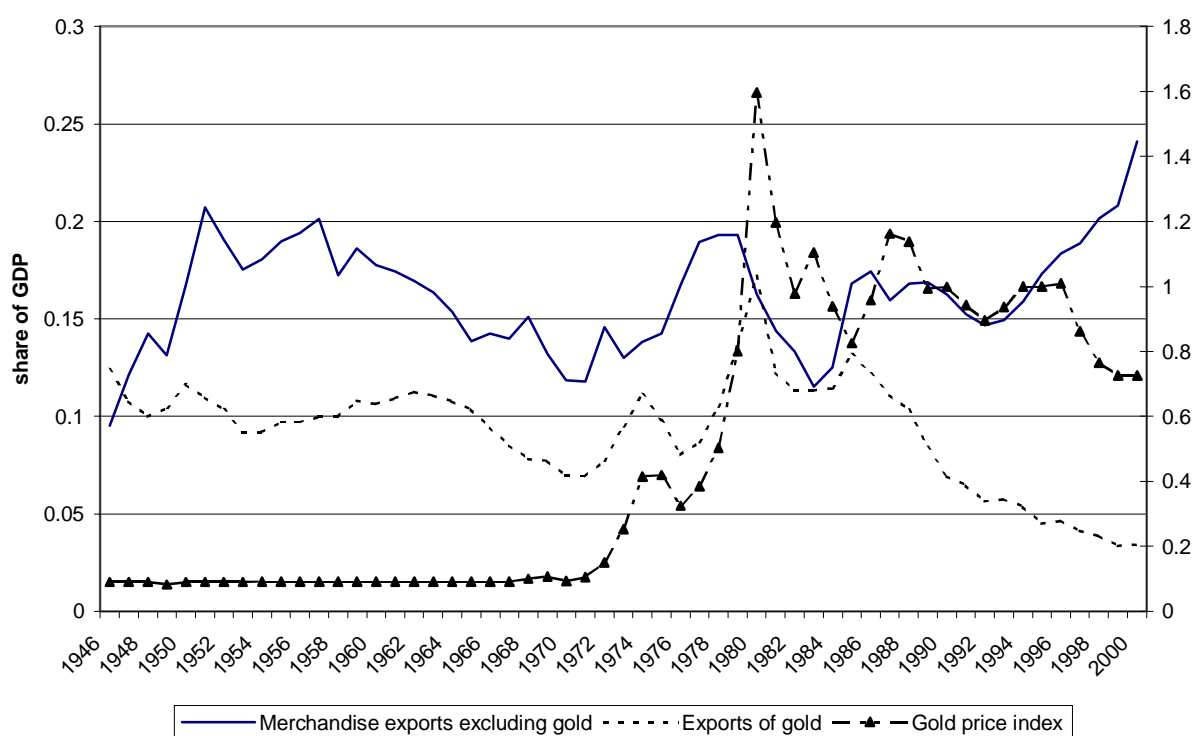
The controlling shareholder owns 50 percent of the shares in the holding company, which owns 50 percent in companies A1 and A2, etc. We see from the figure that the controlling shareholder on top of the pyramid owns only 6.25 percent of the shares in companies C, but still has a majority in terms of voting rights. The largest South African group, Anglo American Corporation's holdings and ownership structure are characterized by a complex labyrinth of crossholdings, involving among others giants such as South African Breweries, De Beers, Sanlam, Old Mutual, Southern Life and AECI. These companies in turn own each other's shares, in addition to a number of other companies. The entire economy has for decades consisted of only 4-6 major corporate groups, each having controlling interests in major mining activities, manufacturing and finance, and the top firms in all industries are controlled by these few groups (Gerson 1993). The structure illustrated by figure 2.2 is closely knit and prevents outsiders such as foreign investors from gaining control over companies even if they buy large shares in the companies. Furthermore, hostile takeovers are impossible within such structures. The ownership structure in the South African economy is thus probably one explanation for the relatively meager inflows and the relatively large outflows of FDI since 1994, compared to what was expected. These capital flows are further discussed in section 4 below.

Since 1994, Anglo American's dominating position has been sharply reduced and stood at 23 percent of JSE market capitalization in 2000. This is a result of unbundling and selling off non-core businesses and outward investment. Unbundling of pyramid and conglomerate structures has been a strategy for the other groups as well in order to disclose value, as shares in such conglomerates typically trade at a discount to net asset value.

2 External trade and balance of payments

South Africa had an open economy where gold accounted for about 60 percent of total exports and about a quarter of total national income in the early days of its history. The major currencies in the world were pegged to a fixed price of gold until the gold standard broke down in 1933 following the great depression. This led to a substantial increase in the price of gold and windfall gains to the South African economy. The introduction of the Bretton Woods exchange rates system in 1944 reintroduced the strong linkage between the major currencies and gold, but the gold standard finally broke down in 1973, following the first oil crisis. Since 1973 the gold price has fluctuated widely, reaching a peak during the second oil crisis in 1980. Figure 3.1 depicts merchandise exports excluding gold and gold exports as shares of GDP during the period 1946-2000. The gold price index is shown on the right-hand vertical axis. It depicts the average annual spot market price at current USD, where the average price in 1995 is set to unity.

Figure 3.1. Exports as share of GDP and the gold price index

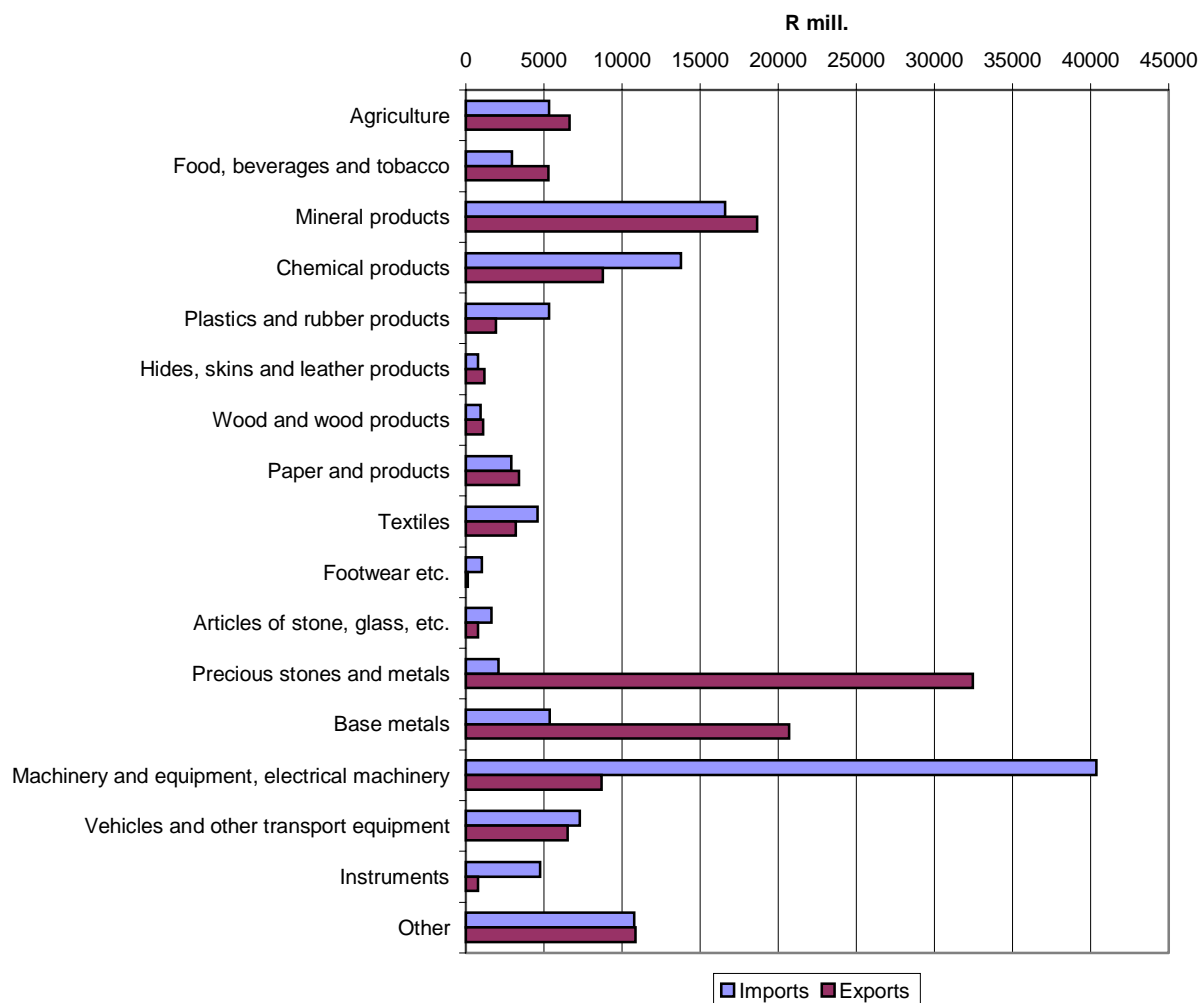


Source: Calculated from the Reserve Bank historical data series www.rebank.co.za

We note that the exports of gold to GDP ratio follows the fluctuations of the gold price index closely. Exports of gold accounted for about 56 percent of total merchandise exports in 1946. The trend has been downward sloping ever since, but the commodity price boom during the period 1973-1980 saw a temporary increase in gold export's share of total exports. In the year 2000, gold exports accounted for only about 12 percent of total exports. The sharp increase in non-gold merchandise exports since the first free elections and the abolition of remaining sanctions in 1994 is encouraging, but a large share of the growth stems from increases both in volume and

prices of platinum group metals. Figure 3.2 shows the composition of merchandise trade in 1997.

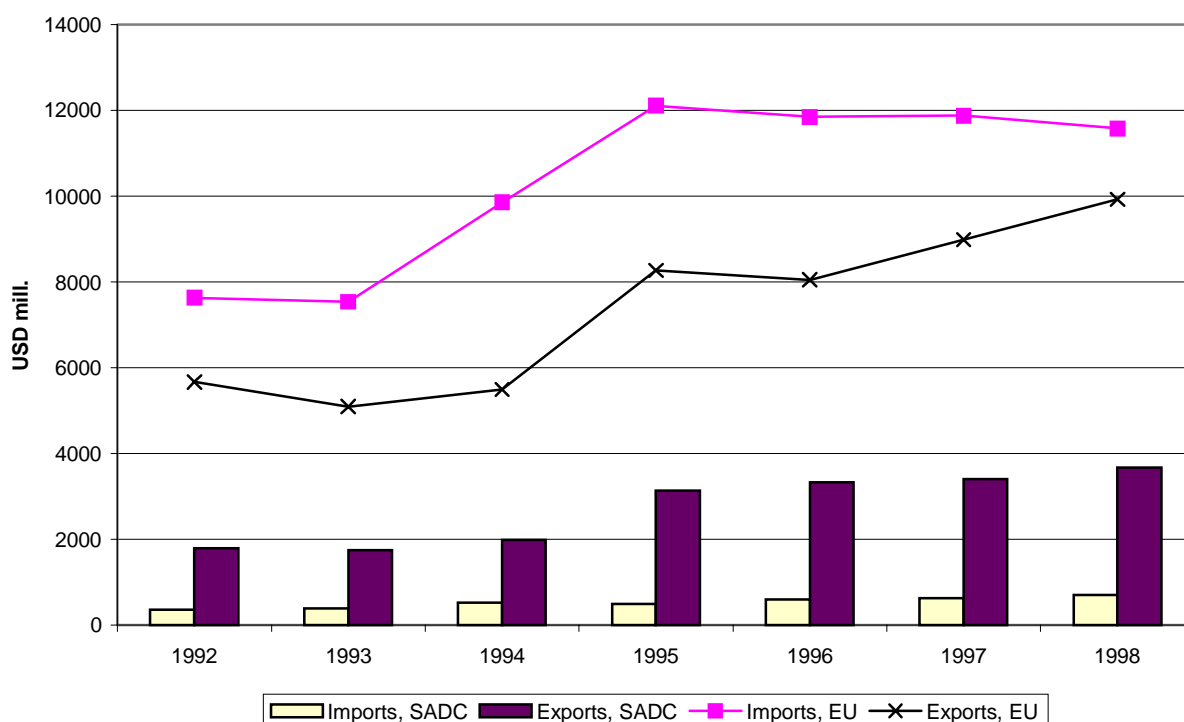
Figure 3.2. The composition of merchandise trade



Source: Customs Department (<http://www.sars.gov.za/>)

South Africa had a surplus on its merchandise trade this year (as in most other years). Exports of mineral products and metals accounted for about 55 percent of total exports, while other resource-intensive industries such as agriculture, food, and paper and products account for another 12 percent. These are also the sectors in which South Africa registered a trade surplus. Turning to direction of trade, figure 3.3 shows total merchandise trade between South Africa and the rest of SADC and between South Africa and the European Union (EU). Clearly, exports to both destinations have increased sharply since 1994, while imports have jumped to a higher level during the period 1993-95 and after that leveled off.

Figure 3.3. Direction of merchandise trade



Source: IMF

When figure 3.2 is broken down by region, it turns out that trade patterns with Africa is very different from trade patterns with Europe. To illustrate the point, we estimated the correlation between the following variables:

- Trade balance by sector, total trade
- Trade balance by sector towards the EU
- Trade balance by sector towards Africa

The correlation was estimated on data from 1997 and on a somewhat more disaggregated level than the data presented in figure 3.2, i.e., for 23 sectors. EU and Africa received 23.3 and 14.7 percent of total South African exports respectively while EU and Africa accounted for 39.6 and 3.4 percent of total imports respectively in 1997. The results are presented in table 3.1.

Table 3.1. Correlation coefficients, sectoral trade balance

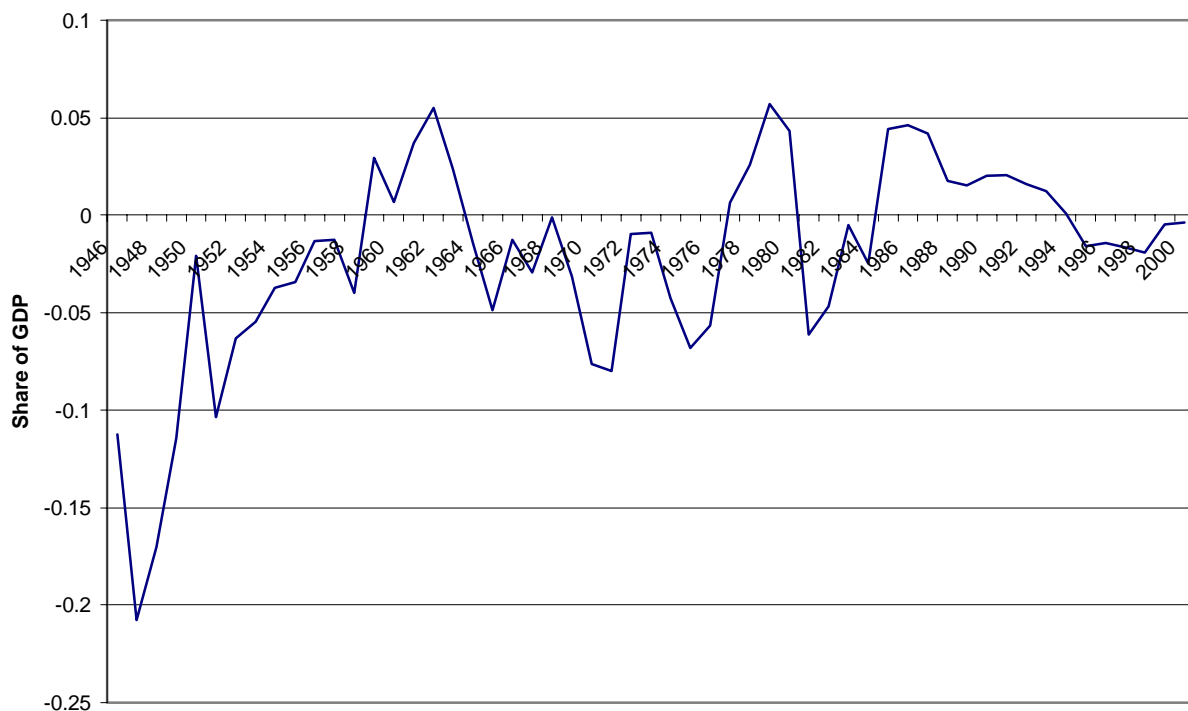
	Total trade	EU
Total trade	1	
EU	0.74	1
Africa	-0.46	-0.61

Notice the negative correlation between trade balances towards Africa and the EU. This means that the sectors that have a trade surplus towards the EU tend to have a trade deficit with Africa and vice versa. South Africa probably enjoys natural protection against overseas competitors in the sub-Saharan markets due to proximity to those markets. Furthermore, most countries trade more with neighboring countries than countries far afield. Nevertheless, the correlations indicate that South Africa's

trade with both EU and the rest of Africa exhibits the typical North-South pattern where South Africa plays the South role towards the EU and the North role towards the other African countries.

Turning to the current account, figure 3.4 shows the current account balance as a share of GDP during the period 1946-2000. The period starts with a balance of payments crisis in 1947-48. For most of the period depicted, South Africa has had a current account deficit and thus has been a net importer of capital. The current account deficit finances the savings investment gap depicted in figure 2.1. During the sanctions period 1985-94, the current account went into surplus, as South Africa did not have access to international financial markets during this period. Since 1995 South Africa has again had a current account deficit and been a net importer of capital. The current account deficit has, however been more moderate during this period and accounted for only 0.4 percent of GDP at factor cost in the year 2000.

Figure 3.4. Current account balance as share of GDP at factor cost



Source: South African Reserve Bank

2.1 Trade policy

South African trade and industrial policy was characterized by wide-ranging state interventions from the end of the Second World War. Tariffs were introduced already in the 1920s and spread to a number of sectors.²² However, protection was quite low initially in order to avoid cost hikes in the mining sector. After the Second World War, protection escalated and import quotas became widespread in addition to relatively high tariffs and periods of currency rationing. The objective of this policy was industrialization through import substitution. However, already in the 1960s

²² The average tariff was about 20 percent in 1925 and affected 371 items (Davis 1994).

import replacement ran up against the ceiling of the domestic market size. Furthermore, the import-substituting industries used imported intermediate goods and capital goods extensively, and the net impact of the import substitution policy on the trade balance was a change in the *composition* of imports rather than a decline in the *level* of imports. The country ran into balance of payment problems during periods of strong growth as a consequence.

In order to ease the balance of payments problems and the anti-export bias, export incentives were introduced during the 1970s and 1980s. The policy change did not involve liberalization, but introduced new forms of market interventions aimed at stimulating exports. The general export incentive scheme introduced in 1990 (GEIS) consolidated existing export promotion measures, and provided subsidies to selected manufacturing exporters. The GEIS subsidy rate was a function of export sales, a manufacturing level factor reflecting the degree of local processing, a local content factor and a factor compensating for fluctuations in the exchange rate. Mining and agriculture was not eligible for the scheme, but about a third of total exports was eligible (Davis 1994), or about 70 percent of total manufactured exports.

The combination of tariff protection and export incentives added up to a very complex system of tariffs, quotas, imports for exports tariff exemption and special policy measures for certain sectors (notably the petroleum, textile and the motor vehicle industries). Such a complex system became subject to rent-seeking and outright fraud, and most likely large deadweight losses. A recent study by the IMF (2000) finds empirical evidence of a positive relationship between trade and total factor productivity both over time and across sectors. It should finally be noted that protection and privileges for one sector implies a burden to other sectors. In South Africa the financial sector has been the hardest hit by this, suffering a grossly negative effective rate of protection (Fedderke and Vaze 2000). In spite of this it has grown faster than overall GDP during the post apartheid period.

Jones and Muller (1992) argue that the South African agricultural policy since the Second World War resembled what later became the common agricultural policy of the European Union. Farms were heavily subsidized as domestic prices were held above world market prices and resulting surpluses were exported at a loss. However, exports have continued when subsidies were scaled back during the 1990s and South Africa has joined the Cairns group pressing for a more liberal international market in agricultural products. Agriculture has, unsurprisingly, been the most difficult area during negotiations on a free trade agreement with the EU. The agreement entered into force 1 of January 2000, and will eliminate tariffs on most trade between the two parties, although 40 percent of South Africa's agricultural exports to the EU will still be subject to tariffs to the end of a ten-year transition period (IMF 2000).

Trade and industrial policy reforms were overdue when the new government took office in 1994. Import quotas have been abolished altogether and since the export incentive system violated GATT regulations, it was gradually phased out ending in 1997. A comprehensive tariff reform was introduced in 1995 with the objective of narrowing tariff dispersion and lowering the effective rate of protection significantly. South Africa has in fact moved faster than what it is obliged to do according to the Uruguay Round agreements in the GATT. Radical trade liberalization measures between 1994 and 1997 notwithstanding, the South African trade regime remains

more complex than in most other market economies (IMF 2000). Furthermore, liberalization appears to have lost momentum since 1997 (van Seventer 2001).

Special treatment of particular sectors has been reduced during the 1990s and the objective is to remove most such privileges. A special development program for the motor vehicle industry remains, however. The motor industry still enjoys a number of incentives, which replace earlier local content measures.²³ The policy has shifted from demand side measures such as tariffs and quotas to supply side measures such as investment incentives, and incentives for R&D and development of skills. While inward-looking demand side strategies tend to raise the costs of production, the supply-side measures aim at reducing the cost of production. A recent trade policy development is extensive use of antidumping measures. In the year 2000, South Africa had the fourth largest number of such measures in force of all the WTO member countries (Zalk 2001).

Recent industrial and trade policy measures have to some extent been based on a comprehensive study of the manufacturing sector, including cluster studies along the lines of Michael Porter's methodology. The lessons and recommendations from these studies have among other things prompted the revitalization of spatial development initiatives (SDIs) in an attempt to obtain a more equal racial and geographical distribution of income in South Africa. The SDIs represent a coordinated development strategy within a limited geographical area where private and government investments are aligned in order to "unlock unrealized economic potential" (Jourdan 1998 p. 718) in the designated area by triggering the forces of industrial agglomeration. It is important to notice that underdevelopment is not by itself a criterion for setting up an SDI. There has to be a significant potential for development as well (Lewis and Bloch 1998). Private-public partnerships in order to provide the necessary infrastructure and utilities such as electricity, water and communications are the cornerstones of the SDIs. There were 11 such SDIs in early 2000, of which 3 had a regional dimension; i.e., involving neighboring countries. The SDIs are first and foremost created in order to generate investment, and are not particularly designed for attracting *foreign* investment.

3 FDI stocks and flows

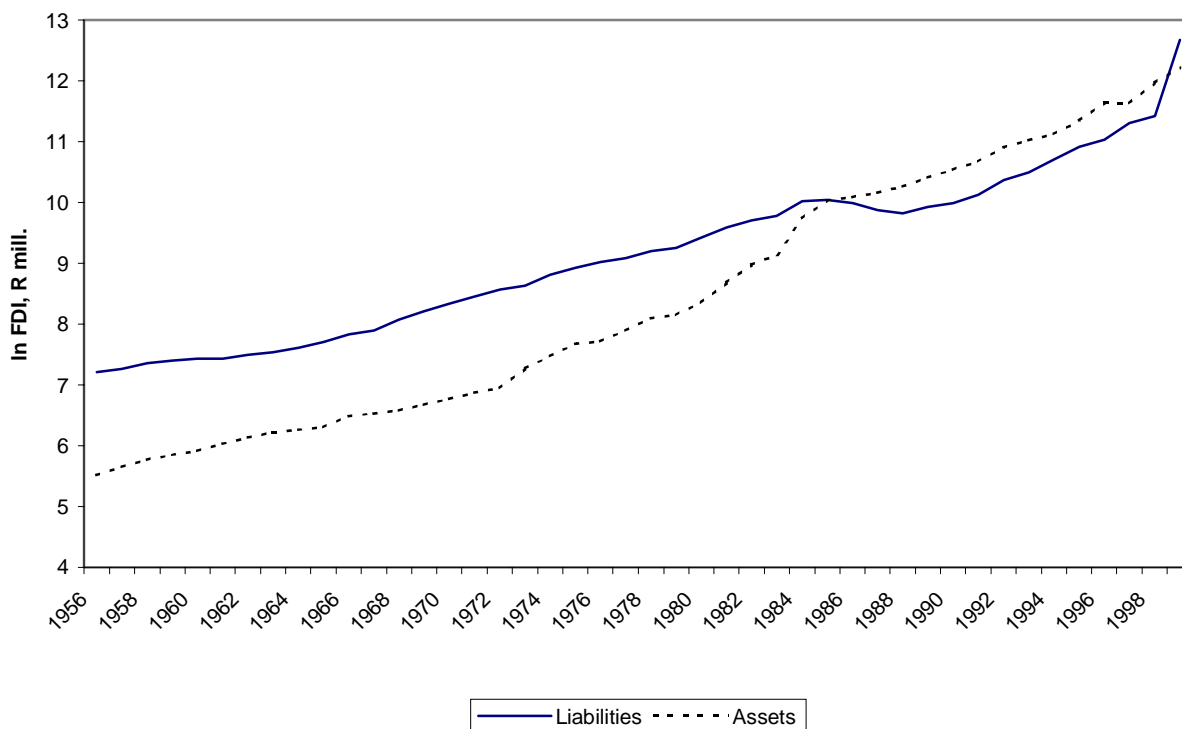
Foreign direct investment accounts for a small share of the total capital stock in South Africa. In 1995, the accumulated inward stock accounted for about 4.5 percent of the local fixed capital stock, while the outward stock amounted to about 7 percent of total fixed capital in South Africa.²⁴ Foreign shareholders held 3.8 percent of total stocks listed on the JSE in 2000 (McGregor 2001). In the year 2000, 25 foreign companies were listed on the JSE, among them 9 had their main listing in London, 5 in other Europe, 10 in other SADC countries and 1 in Canada. In the same period 103 South African companies had secondary listings on foreign stock exchanges, of which 63 were listed in London and 11 on the Nasdaq (McGregor 2001).

²³ Local content regulations violate the WTO agreement.

²⁴ The South African reserve bank publishes data on stocks and flows of FDI at current prices, while the fixed capital stock is published at constant 1995 prices. The only year for which the two data sets are compatible is 1995.

The long-term development in FDI is depicted in figure 4.1. The figures are taken from the South African Reserve Bank's database, which are given at current prices in the local currency. The inward FDI stock increased from R 1.36 billion to R 318.63 billion from 1956 to 1999, while the outward stock increased from R 0.25 billion to R 203.04 billion during the same period. Figure 4.1 depicts the data on a logarithmic scale.

Figure 4.1. Stocks of FDI



Source: South African Reserve Bank

Both outward and inward stocks have increased steadily during the entire period, except for the period 1984-89, when 362 foreign companies divested in South Africa (Jones and Muller 1992). Until then South Africa was a net recipient of FDI in terms of accumulated stocks, but the two graphs cross in 1986. South Africa returned to the status as a net recipient of FDI in 1999, but this time the crossover was not due to FDI inflows, but rather due to the fact that four of South Africa's largest multinational companies moved their major listing from the Johannesburg Stock Exchange to the London stock exchange.²⁵ The London listing requires that the company moves its headquarter to London and registers as a UK company (Heese 2000). The local plants of these firms all of a sudden became part of the inward FDI stock as a result. The change in inward stock from the UK from 1997 to 1999 actually amounts to 2.6 times the total stock of inward investment in 1997! To date (early 2001) about a quarter of market capitalization on the JSE has moved offshore (Ernst & Young 2001).

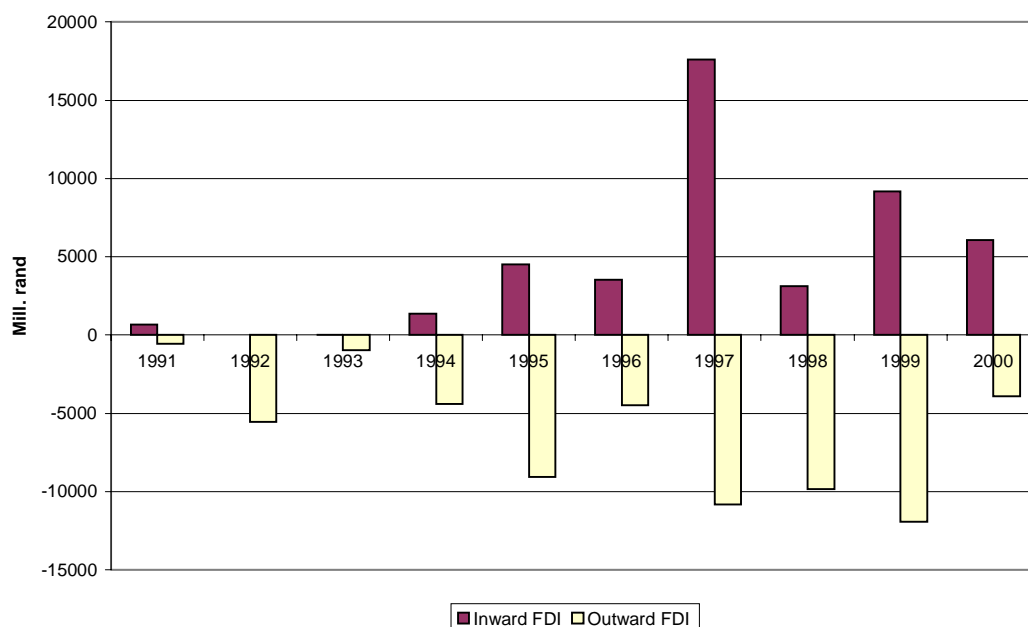
²⁵ Billiton and Anglo American, two mining houses, South African Breweries and Old Mutual, an insurance company listed in London in 1999 while Didata, an information technology firm, followed suit in 2000, and Richemont moved its major listing to Switzerland (Ernst & Young 2001).

The share of direct investment in total inward capital flows has fluctuated over time, but the recent trend is downwards. FDI accounted for almost half of total foreign liabilities in 1956, increasing to 54 percent in 1973. Since then the share has declined to 23 percent in 1998, while the relative shares of portfolio investment and borrowing has increased accordingly. This development suggests that transfer of financial capital has been more prominent than transfer of technology and managerial capacity in recent years.

In spite of stagnation at home and sanctions, South Africa has nurtured some of the developing world's largest and most successful multinational enterprises. Already in 1975 South Africa was the world's 11th largest outward investor (Dunning and Cantwell 1987). South African multinational companies first appeared in the mining industry where the mining houses soon developed international production and marketing networks. Later followed capital-intensive basic processing industries such as pulp and paper, basic chemicals and finance sector companies. Finally, South Africa developed multinational companies in the consumer goods and service industries such as breweries, retail chains, hotels and leisure industry developments. The latter are concentrated in the sub-Saharan African region.

We now turn to an analysis of developments in FDI during the 1990s. Figure 4.2 depicts the inward and outward flows of FDI since 1991. Inward flows were almost insignificant during the run up to the first democratic election in South Africa in 1994. FDI gained some momentum in 1995 and 1996, reached a peak in 1997 and fell back sharply in 1998, partly due to the emerging market financial crisis.²⁶

Figure 4.2. Flows of FDI



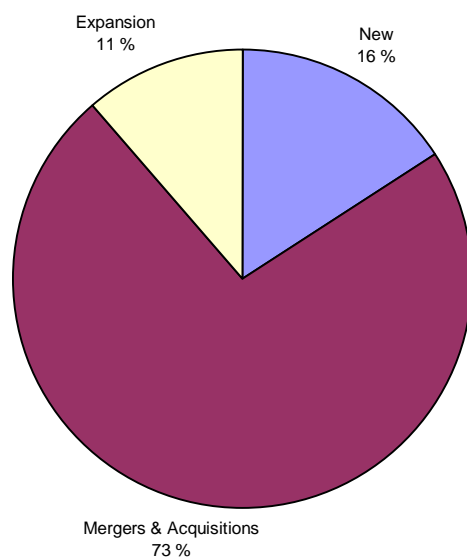
Source: Reserve Bank

²⁶ The Asian crisis did, however, mainly influence short-term capital flows and only to a limited extent FDI.

Outward investments appear to be motivated by the need for the large South African conglomerates to focus on core activities, to exploit South African companies' competitiveness in mining and natural resource-based industries, they are a response to new opportunities in neighboring countries and there appears to be a sense of urgency to reintegrate into the global economy. Thus, lifting of sanctions and easing of capital controls have opened the opportunity for geographical rather than sectoral diversification for the major South African companies, an opportunity they have seized through acquisitions abroad. Another reason for outward FDI has been forward integration through the purchase of existing or potential downstream customers. Sasol's foreign acquisitions appear to have partly been motivated by this.

Figure 4.3 depicts inward investment by type during the 1990s. Mergers and acquisitions (M&A) dominate. This does not contribute much to the total capital stock, productive capacity and employment in South Africa, although both inward and outward M&A might improve managerial capacity and prepare the ground for the integration of South African industries into international supply and marketing networks, as we have seen in the automotive and chemical industries.

Figure 4.3. Inward investment by type



Source: *Business Map*

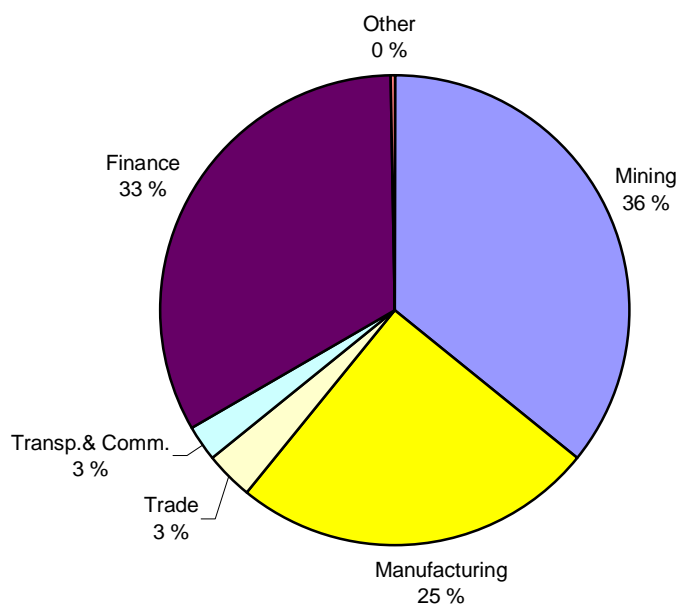
3.1 FDI by sector

The South African Reserve Bank publishes data on inward and outward FDI by institutional sector, i.e., private, non-banking sector, private banking sector and public corporations, while inward investment is also reported by economic activities. The private, non-banking sector has been by far the most important recipient of FDI during the 1990s. However, privatization played an important role in attracting foreign capital in 1997 and 1998. Notably the privatization of Telkom SA was one of

the largest FDI deals during 1997. The private, non-banking sector also totally dominates outward investment during the 1990s, but the banking sector accounted for more than 40 percent of total outward investment in 1998, and the public sector accounted for about 20 percent of the total in 1999. Both these observations reflect economic liberalization in sub-Saharan Africa, allowing FDI in the financial sector, telecommunications and utilities, an opportunity seized by South African companies.

Turning to FDI by economic activity, figure 4.4 presents the accumulated stock by sector 31.12.1999. The large share of the mining sector reflects the London listing of Anglo American and Billiton. A year before only 8 percent of the inward FDI stock was in the mining sector.

Figure 4.4. FDI stocks by sector

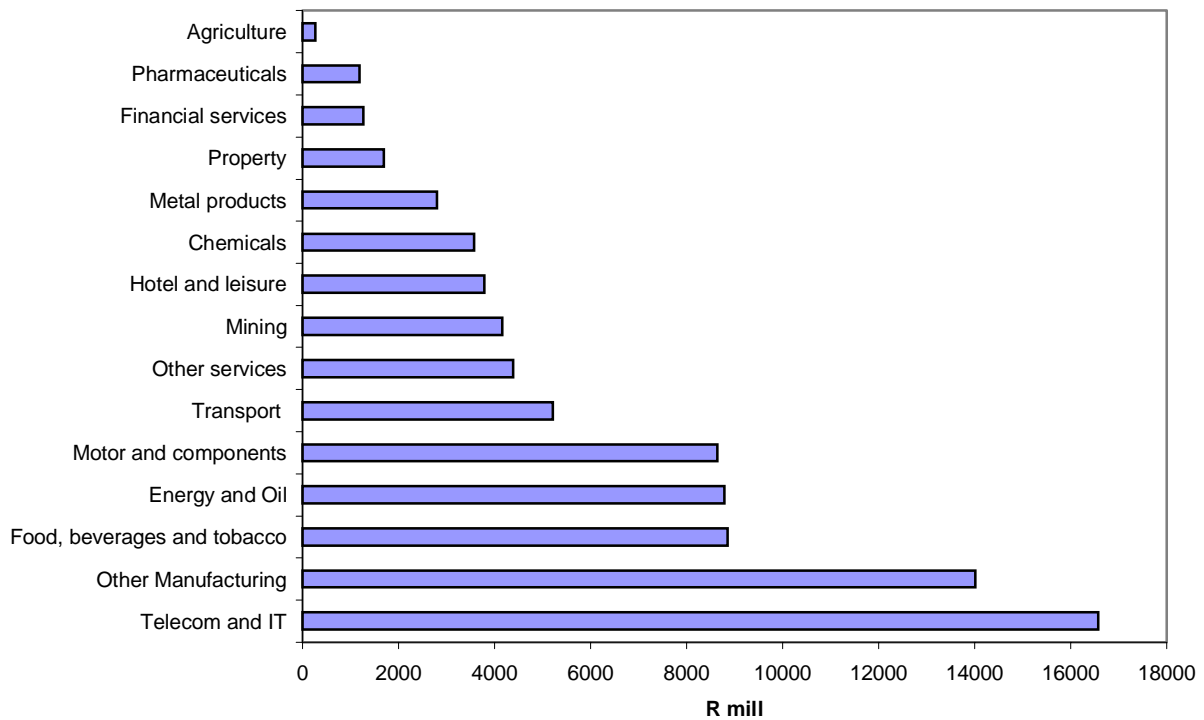


Source: South African Reserve Bank

In order to get an impression on FDI flows at a more detailed industrial sector level, we turn to the data provided by BusinessMap.²⁷

²⁷ These data report the entire amount of planned investment flows at the point in time when a deal is stricken, and in many cases before the deal is approved by the company boards or by authorities where such approval is necessary. Since a number of deals imply an investment flow over time, and some deals do not materialize to the planned extent, or alt all, the data does not give the full picture of FDI inflows to South Africa during the 1990s.

Figure 4.5: Inward FDI by sector



Source: Business Map

The figure covers investment during the period 1994-2000.²⁸ The largest recipient sector is telecommunication and IT. Partial privatization of the fixed line local company and liberalization of the mobile telecommunication subsector have been the driving force behind this development. These are first steps towards full privatization where foreign strategic equity partners contribute to the restructuring process. Malaysian investors dominate in both telecommunication and IT and in energy and oil. Telecom Malaysia and SBC Communications (USA) bought a 30 percent stake in Telkom in 1997, while a joint venture between the local company Cell-C and the Saudi-Arabian Oger won the third mobile licence after a long delay and much controversy, which had yet to be finally settled at the time of writing. Within the manufacturing sector, food, beverages and tobacco and motor vehicles and components are the most prominent. In both these manufacturing sectors investment inflows reflect major multinational companies (re)establishing a presence in South Africa, most of them servicing both the South African and the southern African market. A prestigious and much publicized project is Daimler Chrysler's decision to locate the production of all right-hand drive C-class Mercedeses to South Africa. In the oil and energy sector, Petronas, the Malaysian state-owned oil company bought Engen, a South African oil company.²⁹ The other investments in this sector are expansions to existing activities made by the major multinational oil companies.

²⁸ Projects presented as "intention" or "failed" in the BusinessMap database are not included in the figure.

²⁹ Esso sold its affiliate in South Africa to local investors during the sanctions period and that is what became Engen.

3.2 FDI by country of origin/destination

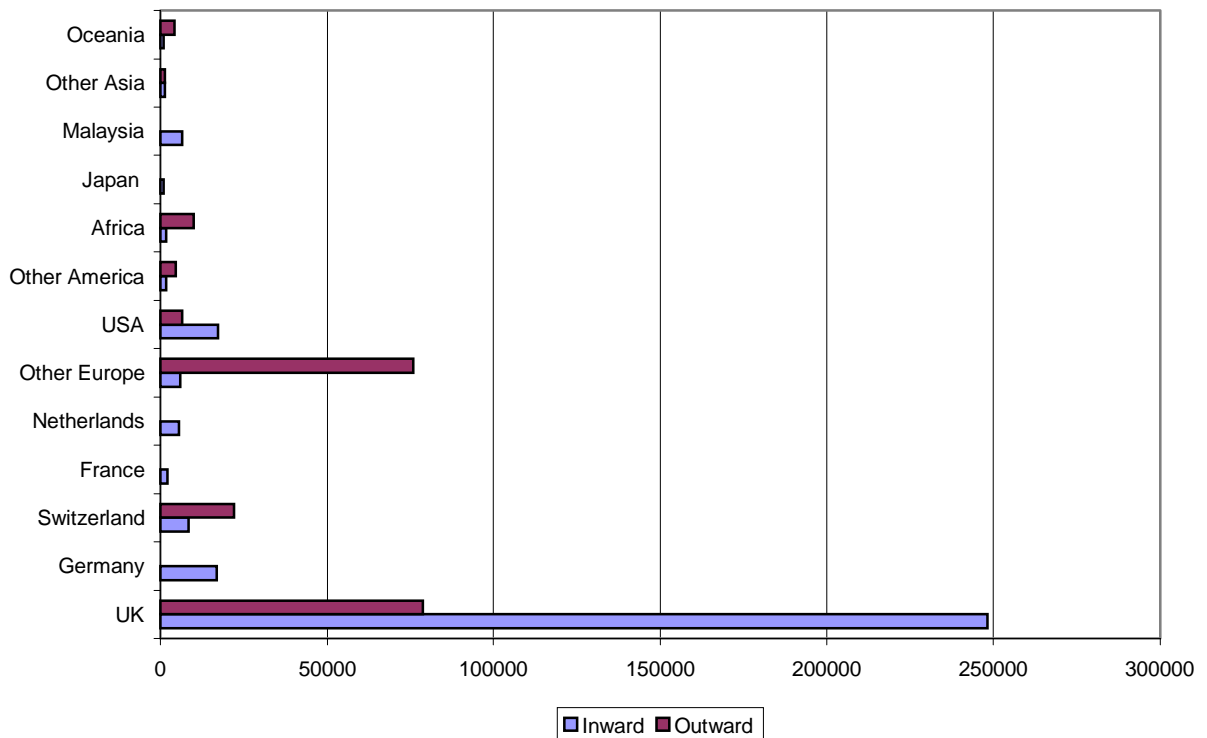
The stock of inward and outward FDI by country in December 1999 is shown in figure 4.6. There are clearly strong links between the UK and South Africa. UK is both the largest source of inward investment and the most important destination of outward investment. Again the large inward stock of FDI from the UK partly reflects the listing of 4 major South African companies on the London Stock Exchange. As should be expected, outward FDI is concentrated on fewer countries than the sources of inward investment.

The large stock of outward investment found in “Other Europe” is due to the fact that the international arms of two of South Africa’s largest mining houses are located in Luxembourg and Switzerland respectively. The fourth most important destination of South African FDI is Africa. According to the Business Map database, South African investments in the SADC countries accounted for 43 percent of the total recorded in these countries. More than 80 percent of these investments are concentrated in the natural resource based industries (mining, basic metals, food, beverages and tobacco and agriculture). There are also several investments in wholesale and retail trade and financial services in the neighboring SADC countries, providing distribution channels for, among other things, South African exports to the region. The composition of FDI and trade with Africa indicate that a significant proportion of trade is intra-company trade, although more research is necessary to establish the extent of such trade. There are, however, few signs of South African investments in labor-intensive industries in the SADC countries motivated by access to lower-cost labor.

The most important sources of inward FDI in addition to UK are the US, Germany, Netherlands, Switzerland and Malaysia. The US and the European sources of FDI have been accumulated during a long history of trade and investment relations with South Africa. The relative importance of Malaysia is, however, of more recent origin. We finally note the absence of one of the largest outward investors in the world, Japan, in South Africa. There is no research establishing the reason for this, so we can only speculate, but the Kaplinsky and Morris study referred to in section 2.4 indicates that Japanese management systems can only with difficulties be applied to the South African environment, which may have deterred Japanese investments.³⁰

³⁰ A study by Ismail (2001) finds that Japanese companies in Malaysia adopt Japanese management systems and are slow to employ local staff in senior management positions.

Figure 4.6. Stock of FDI by country



Source: South African Reserve Bank

3.3 Foreign direct investment policy

South Africa has always welcomed foreign investors, but without awarding them special privileges. Foreign investors were largely subject to the same regulations and restrictions as local companies during the period of heavy state intervention in the economy. The only significant exception was that capital control was less strict on foreign than local residents.

Capital control on foreign residents has been in place most of the time since 1961, but has been gradually abolished during the 1990s. The Financial Rand, the exchange rate applied to transactions on the capital account on the balance of payments, was abolished in 1995, and the only remaining restrictions on foreign residents regarding capital flows are limits on borrowing in the local market. The present policy stance is that inward FDI is welcomed, and foreign investors face the same regulations and investment incentives as local investors. An investment promotion agency was established in 1997 and provides investment information, market research, partner search and assists foreign investors with finding plant locations and with work permit applications, among other things.³¹

The regulations are stricter on FDI in the financial sector in South Africa as it is in most other countries. Foreign banks have to establish a separately capitalized branch or subsidiary with a banking license to be allowed to take deposits, become authorized foreign exchange dealers or primary dealers in government securities. Furthermore, the required capital must be located in South Africa. In the insurance sector only

³¹ www.isa.org.za

separately capitalized South African registered companies are permitted. Outside the financial sector there are few restrictions on FDI.

The policy towards outward foreign direct investment is less clear. Exchange controls ensure that companies have to apply for permission to invest abroad when such investment involves the outflow of capital from South Africa. According to the budget speech by the finance minister for the 2001/02 budget,³² the limit on the use of South African funds for outward investments is R 500 million for overseas investment and R 750 million for investments in Africa. The government did not block or postpone the movement of the South African companies that have this far listed on the London Stock Exchange, but later one insurance company was prevented from making this move and a planned merger between one of South Africa's large mining companies (Gold Fields) and a Canadian mining company was denied by the Ministry of Finance in the year 2000.

3.4 Determinants of FDI flows in South Africa

3.4.1 Inward FDI

South Africa has vast natural resources, and has experienced strong growth based on its mineral resources in the past. During the period of rapid growth, FDI played an important role, particularly in the manufacturing sector. It appears that access to a rapidly growing market and tariff jumping was the main factors attracting foreign investors before the 1960s.

As output in the mineral sector leveled off, new engines of growth have failed to pick up steam. Instead it appears that South Africa has experienced one of the paradoxes of plenty as described in Karl (1997) and formally explored in Rodrigues and Sachs (1999) who argue that the capital stock overshoots the steady state path during mineral-led growth. Adjustment towards steady state therefore takes place through adjustments from above, i.e., a decline in the capital stock per worker. During such a transition, a declining investment rate and meager FDI flows should be expected, even in the absence of sanctions. Another factor deterring FDI is the ownership structure of South African companies. The pyramiding illustrated in figure 2.2 implies that foreign investors have little influence on the company's operations and strategies unless they acquire a large majority stake in the company.

The investment climate has changed substantially after 1994. As tariffs have come down, trade barriers are probably less relevant as a determinant of FDI. Due to slow growth, market seeking investment is largely limited to the few sectors that exhibit strong growth, namely transport and communications, including telecommunications, and finance. Transport and communication grew by 6.7 percent on average during the period 1995-2000, and the financial sector by 5.4 percent, as compared to 2.4 percent for the economy as a whole during the same period. Investments in these sectors also reflect the global trend of an increasing share of FDI in the services sectors following trade and investment liberalization.

³² <http://www.polity.org.za/govdocs/speeches/2001/sp0221.html>

We estimated the correlation between international trade flows and inward FDI. This should provide some indication to the driving forces for FDI. A positive correlation between FDI and exports suggests that foreign investors exploit South Africa's comparative advantage and use South African plants as an export platform. A negative correlation between FDI and imports suggests that foreign firms prefer to service the South African market through a local presence rather than through trade. We found a positive correlation between FDI and exports but no correlation between FDI and imports.³³

A survey by the international consultancy AT Kearney asked the executives of the world's largest multinational firms about their perception of South Africa as a destination for FDI in January 2000. A large majority saw South Africa as a high-risk investment destination and only 2 percent stated that the likelihood of investing in South Africa the next 1-3 years is high. On the positive note, the respondents appreciated the regulatory framework and the business environment as the most important driver for investment in South Africa. Under these headings are western business tradition, developed financial markets, political stability and rule of law. These factors were particularly important for investors in the telecommunications, utilities and primary sectors. The second most important driver for investing in South Africa was the price and quality of inputs.

The most important problems facing investors in South Africa according to the survey are crime and inflexible labor markets and an unskilled labor force. While crime is seen as a problem, it is not cited as a decisive factor for investment. Inflexible labor markets and lack of skills are, however, decisive, particularly in the financial sector and a number of service and manufacturing sectors. This appears to be inconsistent with the view that the cost and quality of inputs is the second most important driver for investment. The cost of inputs such as raw materials and services from infrastructure is however relatively low and of good quality, and South African labor is actually seen as highly qualified in the primary sectors. It is worth noticing that investors did not see market potential as the most important driving force in South Africa, while this is the most important driving force for FDI globally. Moreover, market access to the SADC region was not seen as important at all. The survey finally reports that the respondents saw South Africa as a unique investment destination, difficult to compare to any other country.

3.4.2 Outward FDI

South African outward direct investment broadly falls into two categories. The first is greenfield investments in developing countries in sub-Saharan Africa. These in turn fall into two categories; mining and basic processing of minerals, and service industries such as wholesale and retail trade, finance and hotels and leisure. Mining and basic processing of minerals are attracted by the vast natural resources and cheap energy in neighboring countries, while investments in the services sectors extend the supply networks of South African firms to the neighboring countries, who have recently liberalized investment policy in these sectors and who also have a very

³³ The correlation coefficient was 0.57 between exports by sector in 1997 and FDI by sector during the period 1994-2000. Exports data only covers merchandise trade, so FDI in the service sectors, among them telecommunications, is not included in the estimate.

limited supply of such services. Proximity to these markets and the need to focus on fewer activities but diversify geographically are probably important driving forces for these investments.

The second broad category of outward investment is mergers and acquisitions in developed countries. These are largely motivated by three factors; i) the need to focus on core activities when the home market is small and export markets far away; ii) access to new technology and the opportunity to bring technology up to international standards; iii) forward integration in order to acquire customers and distribution channels in the major export markets.

Six of the largest South African multinational companies have not only invested abroad, they have also moved their headquarters and major listing overseas. The reason cited for this move is access to international financial markets, where capital is less costly than in South Africa, and being closer to major markets. There has been a net outward FDI flow during the period 1991-2000 to the tune of more than 15 billion Rand.

3.5 The impact of FDI in South Africa

In the early days of South African economic development, foreign investors brought technology and managerial capacity to South Africa, particularly in the financial and manufacturing sectors. In addition there was a large number of joint ventures with foreign companies in industries that were newly established in South Africa. The fact that foreign companies that were sold to local firms continued to operate under local ownership, suggests that FDI has been successful in transferring technology to local firms.

In recent years FDI has been largely in the form of mergers and acquisitions. These have to some extent contributed to the breaking up of the conglomerates and the pyramid ownership structure of the South African industry groups. Some of the conglomerates have also seen it in their best interest to “unbundle” the structures, selling off non-core businesses to black empowerment groups or foreign investors, or joint ventures between black empowerment groups and foreign investors. The proceeds from the sales have to a large extent been used for outward FDI. This will most likely integrate the South African branches of the company into international networks, as the automotive industry and Sasol examples show.

FDI in the financial sector has led to increased competition and reduced costs in addition to introducing a broader variety of services and innovations in the local financial sector firms (Genesis 1999). Since the South African branches of foreign banks have the same credit rating as their parents, their cost of capital is less than the South African banks and they can thus provide cheaper capital to large South African firms. Nevertheless, access to lower-cost capital is precisely the reason cited by South African companies for listing abroad. Foreign banks still have a very small market share in South Africa and mainly operate in niche markets.

FDI in the automotive industry during the 1990s combined with the abolishing of local content legislation in the industry has had a tremendous impact both on the automotive industry itself and the upstream suppliers of car parts. Both have increasingly become integrated in the international supply chains in the industry,

leading to increased specialization, more demanding customers facing the car parts industry, leading to efficiency gains and the entry into export markets. However, so far it is only the German car producers, which remained in South Africa during the sanctions period, who have fully integrated the South African subsidiaries and local parts suppliers into their international supply chains.

To conclude, FDI in South Africa during the 1990s has been small and has not created much new productive capacity so far. Both inward and outward flows may, however, contribute to a more competitive local market as it will contribute to the breaking up of conglomerates and pyramids and integrate South African firms into international production and marketing networks.

4 Summary and conclusions

The mining sector and the forward and backward linkages surrounding the sector have been the major driving force for industrialization in South Africa. Foreign capital, both financial and human, played a pivotal role in the development of the sector. Nevertheless, the mining sector soon became a South Africa-based industry and subsequently the home of leading multinational companies in the sector, placing South Africa among the leading outward investors in the world by the mid 1970s. The same pattern can be found in the financial sector, although with a long time lag, and direct investment played a more important role than in the mining sector. Manufacturing has largely been based on foreign technology transferred to South Africa through FDI, joint ventures, license production or franchises. Nevertheless, multinational firms based in South Africa have also emerged in the manufacturing sector. Examples are pulp and paper, chemicals and not least, South African Breweries.

We have seen that South Africa is not an emerging market in the sense that modern industries are established in the country for the first time. Rather, South Africa is in transition from a mature, mineral-led and inward-looking economy to an outward-looking economy. A major problem in the transition process is that the country is relatively abundant in unskilled labor, but has difficulties in establishing competitive labor-intensive industries. Thus, the industrial sector is relatively capital-intensive and this creates a gap between the productivity level and corresponding wage rate in existing industries and the productivity level of the presently unemployed.

The apartheid regime led to isolation of the country, outflow of resources and stagnation in the economy. The new democratic government in South Africa inherited a highly distorted economy with huge backlogs in human capital accumulation, large internal macroeconomic imbalances and a socially unstable society with few alternative sources of income to formal sector employment other than transfers from family members working in the formal sector, pensions and crime. The transition to democracy was, however, met with enthusiasm and determination to embark on economic reforms following the political transformation. The new government introduced swift economic reforms in the direction of market liberalization. Among the reforms are trade liberalization, labor market reform, privatization, new competition legislation, liberalization in the telecommunication, financial and transport sectors, public sector reform and restructuring of education. These reforms are undertaken within an environment of sound macroeconomic policy,

aiming at reducing the public deficit and bringing down the rate of inflation. The stabilization objectives have been achieved. The public deficit was brought down from 10 percent of GDP in 1993/94 to 2.4 percent in 1999/2000, and inflation has gone down from about 10 percent in 1994 to 5.3 percent in 2000. Stabilization is, however, a necessary but not sufficient condition for growth.

The post-election euphoria has not been sufficient to provide the “big push” towards sustained growth. The Asian crisis was an untimely setback although South Africa weathered the storm better than most emerging markets largely due to its sound financial sector. Even in the absence of this setback, however, foreign capital inflows could not have induced investments on the scale necessary to obtain growth rates around 5-6 percent. Given the low domestic savings rate, this would have required an unsustainable current account deficit. Thus, growth and development need to come from within, and FDI can only contribute to maintaining the momentum once a stronger and more sustained growth record has been established.

Although South Africa has experienced a net inflow of foreign capital since 1994, the net flow of FDI has been negative. We have argued in the study that this reflects structural problems in the South African economy. First, the concentrated ownership structure and the dominance of conglomerates have induced unbundling and outward investments in order to catch up with modern business practices in an open economy. Second, the mismatch between demand and supply in the labor market has constituted a barrier to greenfield investments. Excess supply of unskilled labor is largely due to labor market regulations, both historical and present, while excess demand for skilled labor reflects the relatively large share of GDP stemming from skill-intensive industries and the history of apartheid education policy. Finally, South Africa has a relatively small market and is located far from the major world market. It is therefore of crucial importance that both inward and outward investments contribute to linking South African producers to international supply networks.

We finally note that South Africa only to a limited extent has played a role as a locomotive in the SADC region. With the exception of natural resource-seeking investments, South African investors have been almost as reluctant to invest in the SADC region as overseas investors.

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