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South-South FDI with Focus on Africa

Extent, Determinants and Effects

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Abstract

Foreign direct investment has become the single most important source of foreign capital to developing countries. Traditionally these foreign direct investments originated in developed countries but over the past decade foreign direct investments flows from developing countries have grown faster than from developed countries. These south-south foreign direct investments now constitute one third of foreign direct investment flows to developing countries. This study will examine the importance of foreign direct investment as a source of foreign capital and the factors influencing south-south foreign direct investment. Taking a closer look at Africa, a continent that has done relatively worse than other developing regions, I will try to estimate the extent of south-south foreign direct investments and suggest explanations to the results.

Keywords: Foreign direct investment, south-south fdi, Africa, economic growth, development.

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List of Abbreviations

BIT	Bilateral Investment Treaty
DTT	Double Taxation Treaty
EPZ	Export Processing Zone
FDI	Foreign Direct Investment
GSTP	Global System of Trade Preferences
IIA	International Investment Agreement
ILO	International Labour Organization
IMF	International Monetary Fund
IPA	Investment Promotion Agency
LDC	Least Developed Countries
M&A	Mergers & Acquisitions
OECD	Organisation for Economic Co-operation and Development
PRSP	Poverty Reduction Strategy Paper
PTIA	Preferential Trade and Investment Agreement
UNCTAD	United Nations Conference on Trade and Development

1. Introduction

Summary
This opening and introductory chapter will serve to establish the framework and present the outline of this research. It contains the background, problem discussion and purpose of the study. Furthermore, delimitations and the disposition are presented.

1.1 Background

A new geography for Foreign Direct Investment (FDI) is slowly but surely starting to replace the familiar North-South FDI flows with South-South FDI flows. Over the past decade South-South flows have grown faster than North-South flows. The South-South flows have increased from an estimated $5 billion in the beginning of the 1990s to over $50 billion in 2000,[1] and it seems as if the South is just gaining momentum. 113 developing countries had entered into Bilateral Investment Treaties (BITs) with other developing countries as of 2004, with China, Egypt and Malaysia leading the way with more than 40 South-South BITs each.[2]

This recent trend of South-South FDI is stimulated by the uncertainty surrounding volatile financial flows i.e. portfolio equity flows, the result of various financial crises in recent years (e.g. East Asian financial crisis in 1997) and an increase of capital in certain developing countries. Policy makers in developing countries looked to FDI as a relatively more stable mean of external capital and realized its benefits as a motor for economic growth and development. Some developing countries experienced strong increases in capital accumulation and started looking abroad to invest. Geographic proximity, cultural and ethnic ties, together with a familiarity of the market directed their investments to other developing countries. Cultural and ethnical ties are especially important for Asian firms e.g. large investments in construction and communications in eastern and southern Africa are a result of resident Asian minorities.[3] Developing countries are becoming an increasingly important player in the global economy.

[1] Aykut & Ratha 2003, pp 154-155
[2] UNCTAD 2004d, p 6
[3] Aykut & Ratha 2003, p 170

While Africa as a continent has done relatively worse than other developing regions when it comes to attracting FDI, they too are starting to experience increased inflows of FDI, mainly to the extractive sector, but FDI in manufacturing and services are contrary to common belief slowly evolving into key sectors in a number of African countries. However, although the FDI inflows to Africa are accessible, there is no estimate of the share of South-South FDI flows in Africa.

1.2 Problem Discussion and Purpose

A number of factors and events have coincided to make FDI the most important source of foreign investment in developing countries. However, it is not a total coincidence, since FDI does, under the right circumstances, possess characteristics that have proven to be beneficial to economic growth. Economic growth, though not a guarantee for development, is definitely a requirement for development and poverty reduction. Economic development on several levels is a key factor for developing countries of today when trying to shift people out of poverty.

The purpose of this thesis is to better understand why FDI has become the single most important source of foreign capital for developing countries and why South-South FDI has grown to constitute roughly one third of FDI flows to developing countries. The main focus is to assess the extent, determinants and effects of South-South FDI flows in Africa. The timeframe considered is from 1990 to 2003, depending on data availability slight variations within this period might occur.

1.3 Delimitations and critical assessment

Due to severe data limitations certain delimitations have been necessary. When computing the South-South FDI flows in Africa some kind of categorization of countries had to be made. Due to data availability the estimation of South-South FDI flows were based on registered outflows from 30 OECD (Organisation for Economic Co-operation and Development) countries i.e. any FDI flows originating from other countries than these 30 OECD countries are considered to be South-South FDI flows (*for a list of the 30 OECD countries see Appendix A*).

Since the sources in this study are mainly secondary and sometimes difficult to compare they should be treated with some degree of caution, e.g. the estimation of South-South FDI flows in *chapter 4* is based on the results of one study (Aykut & Ratha 2003). However this is the only study of its kind and widely referred to in e.g. UNCTAD's (United Nations Conference on Trade and Development) World Investment Report and the World Bank's Global Development Finance.

1.4 Foreign Direct Investment

The definition of Foreign Direct Investment used in this study is the same as UNCTAD's official definition:
"Foreign direct investment (FDI) is defined as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)."[4]
FDI has three components: equity capital, reinvested earnings and intra-company loans.

- "Equity capital is the foreign direct investor's purchase of shares of an enterprise in a country other than its own."[5]
- "Reinvested earnings comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates, or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested."[6]
- "Intra-company loans or intra-company debt transactions refer to short- or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises."[7]

[4] UNCTAD 2004c, p 345
[5] Ibid. p 345
[6] Ibid. p 345
[7] Ibid. p 345

1.5 Disposition

The thesis is composed as follows:

1. First, *Introduction*.
2. The second section, *Foreign Investment – kinds and extent*, will provide information on different capital flows to developing countries. Recent events and trends will be presented and explanations as to why FDI became the major source of foreign capital in developing countries will be discussed.
3. The third section, *Foreign Direct Investment – Theoretical considerations,* will aim to establish the importance of attracting FDI for developing countries, its possible benefits and the factors influencing investors in developing countries.
4. In the fourth section, *South-South FDI,* a study of the extent of South-South FDI flows will be presented. Possible explanations to these estimations will be discussed.
5. The fifth section, *South-South FDI flows in Africa,* will estimate South-South FDI flows in Africa using data from OECD and UNCTAD FDI database. Explanations and weaknesses of the results will be debated.
6. Finally, *Conclusion.*

2. Foreign Investment – kinds and extent

Summary

This chapter will present the different types of Foreign Investment available to developing countries. Their characteristics and importance will be presented by referring to present day findings and past experiences. In the concluding discussion section the pros and cons of the different types of foreign investment will be discussed.

Developing countries of today have one thing in common; they all lack the sufficient capital to finance their own domestic investments. The alternative source of capital is from abroad as foreign investments. This external capital is essential in order to achieve economic growth and overcome widespread poverty, but the foreign capital has to be used wisely in order to benefit rather than worsen the current state. "Under the right conditions, foreign capital can help close the gap between capital needs and domestic savings, raise skills in the host economy, contribute to technological transfer, widen market access and improve the quality of socio-economic and corporate governance."[8] Foreign investments have experienced a growth unmatched by neither international trade nor world economic production. Between the years of 1980 and 1998 capital flows, an indication of foreign investments, grew by 25% annually, compared to the 5% annual growth rate of international trade.[9] Foreign investments are characterised by a flow of capital, but they differ a great deal with respects to their purpose and consequently their effects. Below follows the characteristics of the different types of foreign investments and their present as well as past extent.

2.1 What are the different kinds of foreign investment?

Foreign investments can be divided into four main categories:

Commercial bank loans: As the name indicates these foreign investments are commercial loans from banks to foreign enterprises or governments.

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[8] Goldstein 2004, p 7
[9] CSIS Global Connections 2002, p 2

Official flows: To this category belong the different forms of development assistance originating in developed countries and given to developing ones. [10] Official flows also include loans from non-commercial banks e.g. the African Development Bank, Asian Development Bank, International Monetary Fund (IMF) and the World Bank.

Foreign Direct Investment (FDI): "Foreign direct investment (FDI) is defined as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)."[11]

Portfolio Equity Flows: "Portfolio equity flows are distinct from FDI flows that they are motivated not by a long-term interest in controlling the destination firm but by financial returns."[12] "A 10-percent-ownership rule is applied in distinguishing FDI from portfolio equity."[13]

2.2 Characteristics

Once we know the different forms of foreign investment it seems natural to study their extent and the impact they have and have had.

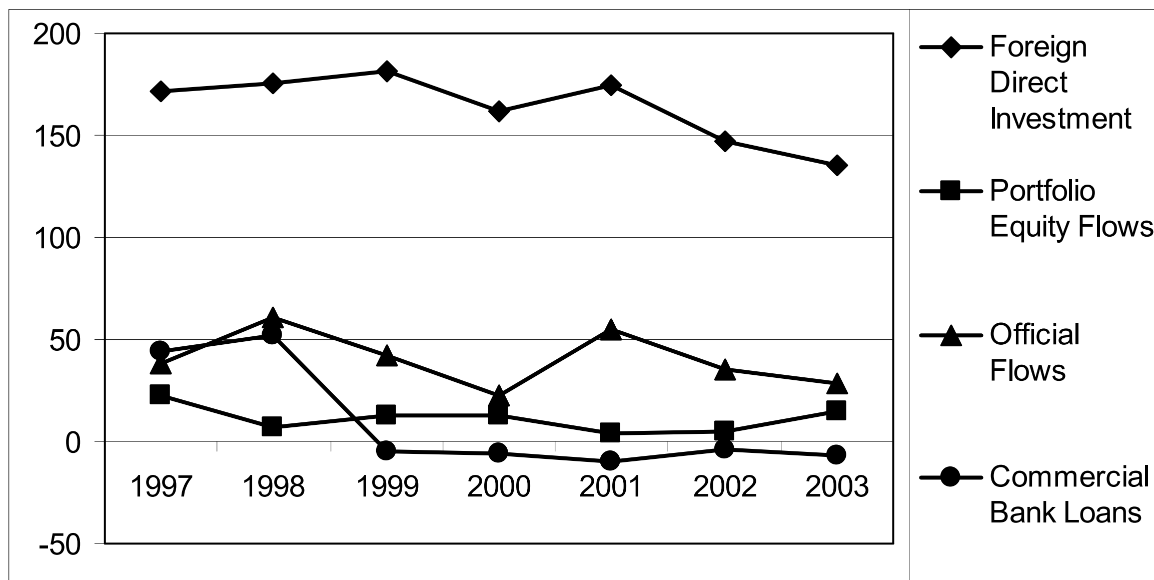
2.2.1 Commercial bank loans

During the 1960s and 1970s many developing countries became heavily indebted to international lenders. The success of oil producing countries led to large deposits of capital in commercial banks. As a result these banks were able to offer loans at relatively low interest rates and without any political restraints as was the case with the loans offered by the IMF and the World Bank. Developing countries were encouraged to borrow on the international market in order to finance their own investments.[14] However, commercial loans were made with focus on generating revenues for the banks rather than their purpose or the borrower's ability

[10] CSIS Global Connections 2002, p 3
[11] UNCTAD 2004c, p 345
[12] The World Bank 2004, p 90
[13] Ibid. p 102
[14] Ngowi 2001, p 3

to repay the loans and much of the money went to corrupt governments and dictators.[15] In the beginning of the 1980s when the result of increased oil prices, higher interest rates and falling global prices on primary commodities started taking its toll, developing countries faced a debt crisis. When Mexico in 1982 as the first of many developing countries announced that they were unable to pay the interest rates and amortizations the crisis was a fact. Mexico, Venezuela, Argentina and Brazil together owed various commercial banks $176 billion, of that amount $37 billion was owed to the eight largest US banks and constituted 147 per cent of their capital and reserves,[16] thus seriously threatening these banks' existence. As a consequence to this debt crisis commercial bank loans to developing countries have been low and have even become negative in the late 1990s (see *figure 1*).

Figure 1 - Foreign Investment (capital flows) to developing countries[17] by type of flow, 1997-2003 (Billion dollars)



Source: The World Bank 2004, p 198 (*see Appendix D, table D.1*)

2.2.2 Official flows

In 1990 official flows to developing countries were roughly $60 billion while FDI flows were estimated at $20 billion, by 1997 FDI flows had increased to $160 billion and official flows decreased to $40 billion.[18] In 2003 official flows were only one sixth of FDI flows[19] and

[15] Colgan 2001, p 1
[16] FDIC 1997, p 191
[17] Based on the World Bank's classification of developing countries.
[18] Hertz 2001, p 37
[19] UNCTAD 2004c, p 5

represent but a fraction of the total capital flows (see *figure 1*). However, the official flows are still a significant part of the capital flows to the 50 Least Developed Countries (LDCs) of the world (*for a list of the 50 LDCs see Appendix B*). Between 2000 and 2002 official flows were larger than FDI flows to LDCs.[20] However, in six LDCs (Angola, Chad, Equatorial Guinea, Myanmar, Sudan and Togo) FDI inflows were larger than official flows.[21] In addition, in 27 out of 50 LDCs FDI inflows rose between 1990 and 2003 while official flows declined.[22] FDI as a source of foreign capital is becoming increasingly important even in LDCs.

2.2.3 Portfolio Equity Flows

In 2003 portfolio equity flows to developing countries rose to $14.3 billion from $4.9 billion in 2002.[23] This amount is still only a tenth of total FDI flows (see *figure 1*) and far from the peaks in 1993 and 1996 when portfolio equity flows were roughly $40 billion and $30 billion respectively.[24] Although these capital flows and investments are to a large extent welcome and much needed, there is reason for governments in emerging markets to be cautious. Portfolio Equity Flows have a high degree of volatility. Investors, in order to increase profits, speculate in emerging economies causing massive inflows or outflows of capital. Large reversals in capital flows can put a country in a state of economic chaos. “Because capital flows can also affect the exchange rate of a nation’s currency, a quick withdrawal of investment can lead to rapid decline in the purchasing power of a currency, rapidly rising prices (inflation) and then panic buying to avoid still higher prices.”[25] This kind of large reversal of capital flows were one reason behind the Asian Economic Crisis that began in 1997. Several other countries have been severely hurt by large reversals in private capital flows in modern time e.g. Mexico (1981-83, 1993-95), Turkey (1993-94), Argentina (1982-83, 1993-94) and Malaysia (1993-94).

In all of the above countries the large reversals of capital flows led to economic difficulties. The lesson to be learned is that governments of developing countries should be extremely careful when structuring their economy around inflows of volatile capital such as portfolio equity, because these inflows may very well be followed by a large reversal.

[20] UNCTAD 2004c, p 5
[21] Ibid. p 5
[22] Ibid. p 5
[23] The World Bank 2004, p 90
[24] Ibid. p 91
[25] CSIS Global Connections 2002, p 4

2.2.4 Foreign Direct Investment

FDI is a type of investment that is less volatile than portfolio equity flows. As the ownership is more directed towards physical assets it is more difficult to pull out capital. Thus leaving investors with a possibly higher incentive to manage their investment rather than pull out at the first sight of trouble. This may provide the host economy with a relatively more stable situation than in the case of Portfolio Equity. As a result it may create a certain security for the host government around which it should be easier to plan and manage the economy.

2.3 Summary and implications

There are only so many ways in which capital can become accessible to developing countries. Presented above are the four different types of foreign investment that together make up the capital flow of $172 billion to the world's developing countries in 2003.[26] Of these four, Foreign Direct Investment (FDI) represents the largest amount ($135,2 billion)[27]. Commercial bank loans as a form of foreign investment are negative ($-6,6 billion)[28]. This is a result of the enormous debts accumulated by the developing countries up until the 1980s. It should be remembered that these loans were encouraged by the developed countries and that one of the alternatives to commercial bank loans was FDI. It was argued that FDI would be one of the most expensive ways to finance this capital accumulation.[29] These loans, supported by the developed countries, resulted in economic crisis for a number of developing countries. The reason for the crisis was an increase in oil prices, falling prices on commodity goods such as minerals and agricultural goods and a huge increase in interest rates. This increase in interest rate was brought about by a tight money policy in the United States[30] and resulted in the failure of a number of countries to keep up with their interest payments and amortizations of their loans. It seems both the developing countries and the commercial banks had to learn the hard way; commercial bank loans as a mean of foreign investment is clearly not the way to go.

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[26] UNCTAD 2004c, p 3
[27] The World Bank 2004, p 198
[28] Ibid. p 198
[29] Ngowi 2001, p 3
[30] Stiglitz 2002, p 239

Official flows are still a significant part of capital flows to LDCs. However, at $28 billion in 2003[31] they have decreased by 53 per cent since 1990. Even when looking at LDCs the official flows are in many aspects of the same character as FDI. Today a significant part of official flows go to the private sector of developing countries,[32] rather than earlier when donor countries and institutions earmarked capital for certain projects. This has to do with the Poverty Reduction Strategy Papers (PRSPs) implemented by the LDCs to meet the Millennium Goals. The intention of these PRSP is to get the LDCs to identify the regions and sectors within the country in most need of support. In this aspect official flows are preparing countries that are not yet attractive to investors by capacity building i.e. improving infrastructure, communications and education. Of course official flows are also meant to aid those millions of people that live under extreme poverty, but as the hunt for profit is becoming increasingly important foreign aid is decreasing. With the fall of communism foreign aid also lost its strategic importance, aid was one way for developed countries to ensure loyalty and obedience from strategically chosen developing countries.[33]

Due to the risks and uncertainty that accompanies Portfolio Equity Flows ($14,3 billion in 2003),[34] developing countries have become intimidated by this mean of foreign investment. The turbulence caused by Portfolio Equity Flows, most recently in East-Asia, has affected the policy makers in many developing countries to become more careful when structuring their economy on Portfolio Equity Flows. In addition, the stock markets in developing countries are often technologically inferior to developed markets, which further increases the insecurity and discourages investors.[35] In order to achieve steady economic growth and development, a government needs some kind of stability; this is something which Portfolio Equity Flows can not yet offer. FDI on the other hand, is considered to be a relatively more stable source of foreign capital. Its importance as a major source of foreign investment is generally accepted, the following chapter will further develop the theories of Foreign Direct Investment.

[31] The World Bank 2004, p 198
[32] Hertz 2001, p 38
[33] Ibid. p 37
[34] The World Bank 2004, p 198
[35] Ibid. p 95

3. Foreign Direct Investment – Theoretical considerations

Summary

In this chapter Foreign Direct Investment will be more thoroughly examined. As an engine for economic growth and development it can be valuable, this will be shown. Furthermore, the incentives for investors will be presented as well as the factors influencing their decisions to invest. This in turn should give us a hint of what developing countries can do to attract FDI. The role of so called Export Processing Zones (EPZs) will also be presented. In the closing discussion the idea of quality rather than quantity when it comes to FDI in developing countries will be discussed.

3.1 FDI as an engine for economic growth and development

As previously suggested developing countries often lack sufficient domestic capital to finance their investments. Insufficient domestic investments result in a lack of job opportunities leaving part of the population unemployed.[36] Employment, and formal sector employment in particular, is an important factor in moving people out of poverty.[37] With inadequate levels of domestic savings there is not enough capital to finance the required domestic investments. Foreign investment is needed to fill the gap between domestic savings and required domestic investments.[38] The declining levels of Official Flows, the scepticism towards Commercial Loans and Portfolio Equity, as a result of various financial crises, encouraged policy makers in developing countries to seek relatively more stable direct investments.[39] While FDI does not guarantee poverty reduction and development it is commonly believed that FDI, under the right circumstances, can bring benefits to a country, which in turn can lead to poverty reduction and development.[40] The advantages of FDI as a form of foreign investment and as a mean of lifting a country out of poverty are discussed below.

[36] Jenkins & Thomas 2002, p 11
[37] Ibid. p 11
[38] Ibid. p 11
[39] Kobrin 2005, p 7
[40] Jenkins & Thomas 2002, p 11

3.1.1 Economic growth

Economic growth is considered to be a prerequisite for development. FDI is supposed to lead to economic growth in the host economy through an inflow of foreign capital and through crowding in.[41] This implies that a foreign investment increase of one dollar leads to total investment increase in the host economy of *more* than a dollar.[42] Crowding in takes place when foreign investment generates new domestic investment. This might be the case when the foreign firm requires suppliers or when the foreign firm enters a previously unknown industry creating incentives for domestic firms to follow. FDI can also lead to crowding out, which implies that a foreign investment increase of one dollar leads to total investment increase in the host economy of *less* than a dollar."[43] Crowding out takes place when the foreign investor enters an industry where domestic firms are already present. This may force the domestic firms to exit the industry because they are out conquered by the foreign firm. It may also spur the local enterprises to improve their efficiency in order to match the new rival. Naturally FDI is not all positive, worst case scenario would be that a one dollar increase of foreign investment crowds out more than a dollar of domestic investment, resulting in negative total investment.[44] However, this is considered to be rather unusual and the benefits of FDI usually are believed to outweigh the negative effects.[45]

3.1.2 Job creation and Technology transfer

One of the most direct effects of FDI is the creation of job opportunities. By creating jobs, FDI helps tackle the problem of unemployment. Apart from reducing overall unemployment the creation of job opportunities in the formal sector seem to also offer women an opportunity to access formal work and experience the benefits of a personal income that was not previously available.[46] As it is has been stated that an increase of women's income has a direct positive correlation with the quality of life for the family, this might prove valuable when fighting poverty.[47]

Through the creation of new job opportunities, new skills will also be transferred to the domestic market. However, the host economy's capacity to absorb new skills i.e. their present

[41] Jenkins & Thomas 2002, p 12
[42] UNCTAD 1999a, p 171
[43] Ibid. p 171
[44] Ibid. p 171
[45] Jenkins & Thomas 2002, pp 12-13
[46] Ibid. p 13
[47] Cotton & Ramachandran 2001, p 2

human capital, decides how much they will profit from the new skills introduced and in turn how much it all will contribute to economic growth.[48]

The transfer of technology to the host economy depends on how well equipped it is to absorb it.[49] The higher level of technology already present in the host country the more receptive it is to new technology. It is also argued that high level technology might not be suitable in developing countries that are mainly labour-abundant.[50] Capital intensive FDI does not employ as many people thus not creating the much needed job opportunities.

3.1.3 Additional benefits

The presence of FDI will provide the host economy with tax revenues.[51] These revenues can be used to fund domestic investments or other projects that aim to reduce poverty. The presence of FDI will also supply the domestic market with a valuable access to international markets[52] e.g. the foreign firms' distribution channels can be used by domestic firms.

In short, FDI under the right circumstances can contribute to economic growth, which in turn can lead to development and poverty reduction. This can be done by creation of job opportunities, transfer of technology, know-how and an increase of efficiency and competitiveness of local enterprises.[53] Nevertheless, FDI can also lead to negative effects such as the crowding out of local producers e.g. the numerous local soft drink producers around the world who have been forced to give in to Coca-Cola or Pepsi.[54] FDI may also have other negative effects such as lowering domestic savings or draining assets from the host economy.[55]

3.2 Factors influencing Foreign Direct Investment

The main objective for Foreign Investors when entering a new market is of course to generate profit. However, there are several factors that influence the investor on the choice of host

[48] Borensztein, de Gregorio & Lee 1998, p 123
[49] Jenkins & Thomas 2002, p 13
[50] Ibid. p 13
[51] Ibid. p 14
[52] Ibid. p 16
[53] Kobrin 2005, p 7
[54] Stiglitz 2002, p 68
[55] Kobrin 2005, p 7

economy. Before taking a closer look at some of these factors it might be valuable to make a distinction between two types of FDI; market-seeking FDI and non-market seeking FDI.

Market-seeking FDI: Market-seeking FDI has as its main objective to supply the domestic market. [56] Rather than exporting goods, the goods are produced and sold in the same market. This is done in order to escape various transaction costs e.g. transport costs, tariffs and trade barriers. An important factor that influences this type of FDI is the domestic demand i.e. market size and domestic income. This suggests that very poor countries should be relatively low on market-seeking FDI.

Non-market seeking FDI: Non-market seeking FDI has as its main objective to produce products in the host economy and then to export them. [57] In this case domestic demand is of less importance, restrictions and regulations on exports are of more significance. FDI in natural resources and extractive industries are typical examples of non-market seeking FDI.

Although the factors influencing the above mentioned types of FDI are very different e.g. availability of natural resources or domestic demand, there are certain factors that influence both types of FDI. Generally many of the determining factors are the same for developing countries as for industrialised countries, but there are certain additional factors that have been proven to be of importance when decisions are made concerning FDI in developing countries.[58] Most of these factors are directly related to uncertainty and/or risk. This causes a major problem for many developing countries when trying to attract FDI.

3.2.1 Economic Stability

Unstable inflation, large external debt burdens, especially short-term debts and an unstable real exchange rate all create an uncertainty and consequently have a negative effect on investments.[59]

[56] Asiedu 2002, p 109
[57] Ibid. pp 109-110
[58] Jenkins & Thomas 2002, p 4
[59] Ibid. p 4

3.2.2 Infrastructure Development

In the case of non-market seeking FDI where firms are focused on exporting their products, the traditional infrastructure i.e. roads and availability of seaports are important. When it comes to market-seeking FDI, infrastructure is important in that it decides how well the firm can supply the domestic market. Furthermore, a reliable infrastructure when it comes to power supply and telecommunications is crucial to any kind of FDI.

3.2.3 Human Resources

The labour resource is a key factor when attracting FDI. Comparatively low costs and appropriate labour skills are typical factors deciding FDI inflow to a region.[60] Developing countries with abundance of low-cost labour and a labour force that is skilled tend to attract FDI.[61] Depending on the sector the investor is entering, low cost unskilled labour or higher skilled labour might be sought after. While basic education is always important, skills in high-level technical subjects can be an important asset when attracting FDI.[62] Naturally, further training, such as high-level technical training, should be more effective when basic education already exists.

3.2.4 Openness of Host Economy

Usually foreign investors are more involved in trade than local firms. They might import supplies or export finished products. This makes these firms more sensitive to the trade conditions in the host economy e.g. tariffs or custom regulations.[63] Furthermore, should the host economy be open to trade, it gives potential investors an indication that the policy makers have realized the positive benefits of connections to the world economy and would encourage further investments.[64]

3.2.5 Political Situation

An instable political situation with conflicts and corruption creates an uncertainty for foreign investors. Having to pay bribes is the same as having to pay taxes, but with more uncertainty.[65]

[60] Ngowi 2001, p 6
[61] Jenkins & Thomas 2002, p 13
[62] te Velde 2002, p 7
[63] Ibid. 2002, p 9
[64] Kobrin 2005, p 11
[65] te Velde 2002, p 9

3.3 Export Processing Zones (EPZs)

EPZs are specific zones in countries that through fiscal and financial inducement aim at attracting FDI. These zones are separated from the country's normal custom's barriers and normally there are no taxes on e.g. imported raw materials, equipment and intermediate goods, provided the produced goods are exported.[66] Wage levels are relatively low, infrastructure well developed and administration procedures simple. EPZs have mainly attracted labour-intensive manufacturing industry e.g. electronics assembly, garments and textile industry. EPZs are one way of attracting foreign investors and by doing so reducing unemployment, attracting know-how and new technology. In the case of developing countries EPZs are a good alternative since overall infrastructure and administration is often poor and it is easier to provide attractive investment-zones rather than reform the whole country at once. EPZs have been successful to the extent that they have created employment and stimulated exports.

3.4 Summary and implications

"FDI inflows have increased in importance during the 1990s, becoming the single most important component of total capital flows to developing countries."[67] In addition to being a relatively stable mean of foreign investment FDI has positive effects on a country's economy, workforce, technology and efficiency. Through various trickle down mechanisms this encourages development and can shift the population away from poverty. Although the positive effects of FDI might sound very hopeful they are just potential benefits. There are many factors that have to coincide for a developing country to absorb the positive effects of FDI. To begin with there is the matter of attracting FDI and in what form. During the past ten years a large part of FDI flows to developing countries has been in the form of Mergers & Acquisitions (M&A).[68] FDI in the form of M&A is not believed to create as many new employment opportunities and increase productivity as would for instance a greenfield investment.[69] However, in the case of privatizations M&A is the only possible mean of investment and this has resulted in important improvements when modernising strategic industries.[70] The question still remains, what type of FDI should a developing country try to

[66] Johansson 1994, pp 388-390
[67] UNCTAD 1999a, p 160
[68] The World Bank 2004, p 79
[69] Jenkins & Thomas 2002, p 15
[70] Ibid. p 15

attract? "FDI in the extractive industry may help to achieve the objective of exploiting natural resources for economic development; attracting FDI in the textile industry helps achieve the objectives of low-skill job creation and exports; and attracting FDI in the high-tech industry can lead to further innovation, exports and high-skill job creation."[71] In order to be able to make a wise decision the country should examine its endowments and consider what it is they wish to achieve. Is it a resource rich country, has it got high-skill or low-skill labour, is it looking to create jobs, reduce poverty or finance a currant account deficit? After assessing and analysing their advantages and after defining their goals the country should set up an Investment Promotion Agency (IPA) that would contacts foreign firms matching the country's FDI strategy. Costa Rica, Ireland and Singapore are examples were this strategy has had positive effects.[72]

By using EPZs as a first step to attracting FDI some developing countries have been able to expand from textile and garments industry to more advanced manufacturing industries. Costa Rica and Singapore together with Malaysia are examples of countries that have experienced success in setting up EPZs.

To further complicate the matter many developing countries have to deal with disturbing factors such as political instability, poor infrastructure and widespread corruption. This creates an uncertainty that negatively affects investments. However, investments in the extractive industry tend to take place in any case since they have no choice but to locate where the natural resources are. Another problem is that in order for the host economy to benefit and absorb spillovers in form of technology and know-how the host country has to be at a relatively high level of development.[73] If the "gap" i.e. the level of skills and technology between foreign investor and local firm is too great, possible advantages and positive effects are not fully absorbed.[74] As wealthier developing countries together with resource rich developing countries have attracted relatively more FDI than poorer developing countries (LDCs attract roughly 3 per cent of total FDI flows to developing countries)[75] they have been able to absorb skills and technology. This has given these countries capital and incentive to invest outside the home market. With a geographic proximity, a smaller gap with respects to

[71] te Velde 2002, p 3
[72] Ibid. p 8
[73] Kobrin, 2005, p 10
[74] Ibid. p 10
[75] The World Bank 2004, p 78

technology, culture and skills as well as a higher tolerance level when it comes to poor infrastructure, corruption and political hassle, other developing countries were a natural choice. This has given rise to a shift in FDI flows, i.e. from traditional North-South FDI flows a new geography has emerged with an increasing number of South-South FDI flows. This will be treated in the following chapter.

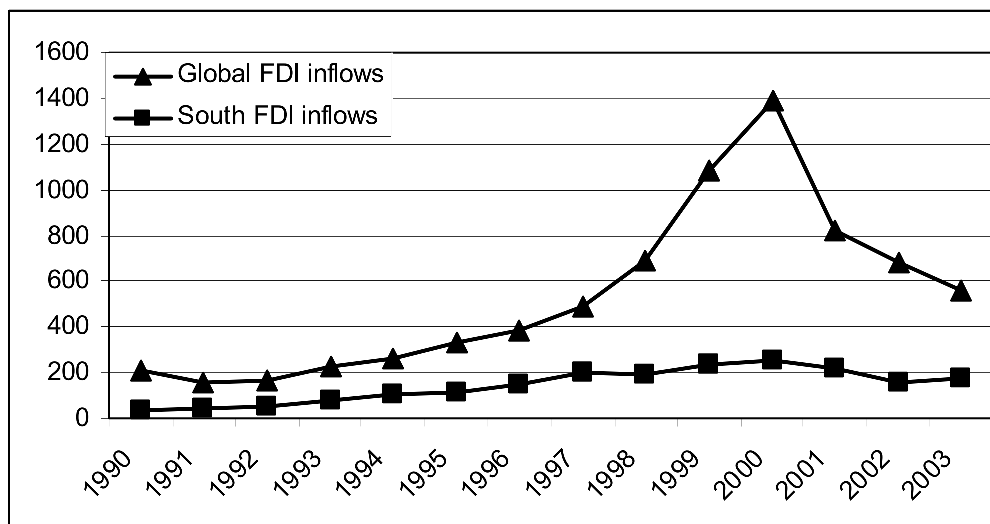
4. South-South FDI

Summary

This chapter will look at the major trends of South-South FDI during the past decade. It begins by assessing the extent and present trends of South-South FDI by presenting quantitative and qualitative facts and figures, then moves on to examine the possible explanations to these trends. The discussion section will deal with the importance of recognizing the South as a major source of FDI and an important factor in the world economy.

The developing countries or the South[76] has emerged as an important player in the global economy. Using UNCTAD data on global FDI inflows and FDI inflows to developing countries, calculations show that approximately one third of global FDI inflows in 2003 have the South as destination. This is to be compared to the share in 1990 which was roughly one fifth[77] (see *figure 2*).

Figure 2 - Global and South FDI inflows 1990-2003
(Billion dollars)



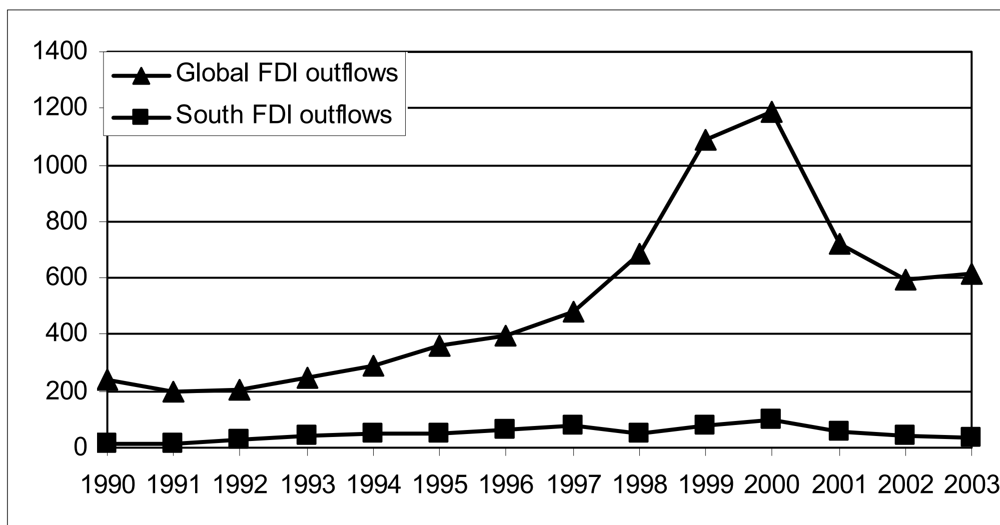
Source: UNCTAD FDI database (*see Appendix D, table D.3*)

[76] If nothing else is mentioned the South refers to UNCTAD's classification of developing countries.
[77] UNCTAD FDI database

FDI outflows from the South, insignificant until the beginning of the 1990s, today constitute 6 per cent of global FDI outflows[78] (see *figure 3*). Bear in mind that due to restrictions on capital and foreign exchange as well as preferential treatment of non-resident investment the FDI outflows from developing countries are very often underreported and therefore less reliable than reported FDI inflows to developing countries.[79]

Figure 3 - Global and South FDI outflows 1990-2003

(Billion dollars)



Source: UNCTAD FDI database (*see Appendix D, table D.3*)

Interestingly, inflows to the South seem to have been less affected by the global downturn in FDI inflows after 2000. Global FDI inflows have dropped 60 per cent between 2000 and 2003, compared to a 32 per cent drop in South FDI inflows. Considering the global fall in FDI outflows after 2000 and the relatively mild effect it had on the FDI inflows to the South it seems reasonable that a significant share of FDI inflows to the South originated in regions that were less affected by this global downturn. Adding the fact that FDI outflows from the South have grown from $16 billion in 1990 to $36 billion in 2003 (119 per cent) a realistic assumption is that the share of FDI between countries in the South i.e. South-South FDI has grown. This assumption is consistent with a number of studies (Dunning, 1979, 1993; Narula, 1995) that show that firms from the South have improved their technological skills as well as

[78] UNCTAD FDI database
[79] The World Bank 2003, p 90

their specific advantages and expanded their market to other countries.[80] Unfortunately it is not easy to estimate the extent of South-South FDI and only very few studies have been made.

4.1 Estimation of South-South FDI

Presented below are the findings of *Aykut & Ratha 2003:*
Before presenting the results it might be appropriate to give some background to the data and method that was used by *Aykut & Ratha 2003* when estimating South-South FDI flows. Using data from the World Bank, IMF, OECD and UNCTAD *Aykut & Ratha 2003* estimated FDI flows to the South by initially dividing countries into three groups, the South, the North and the High-income non-OECD group (see *Appendix C*). These groups were defined as follows:

- "The South is defined as the 31 developing countries for which reasonably detailed FDI data are available. These countries account for almost 90% of the total flows to developing countries."[81]
- "The North compromises 22 high-income OECD member countries."[82]
- "The High-income non-OECD group compromises the 30 high-income economies that are not members of the OECD."[83]

Using an inflow-outflow matrix South-South FDI flows were indirectly computed by subtracting inflows from the North and from High-income non-OECD from total FDI inflows to the South, thus leaving the FDI inflows to the South that originated in the South. The results are presented below:

[80] Aykut & Ratha 2003, p 150
[81] Ibid. pp 151-152
[82] Ibid. p 152
[83] Ibid. p 152

Table 1 - Estimation of South-South FDI flows 1994-2000

(Billion dollars)

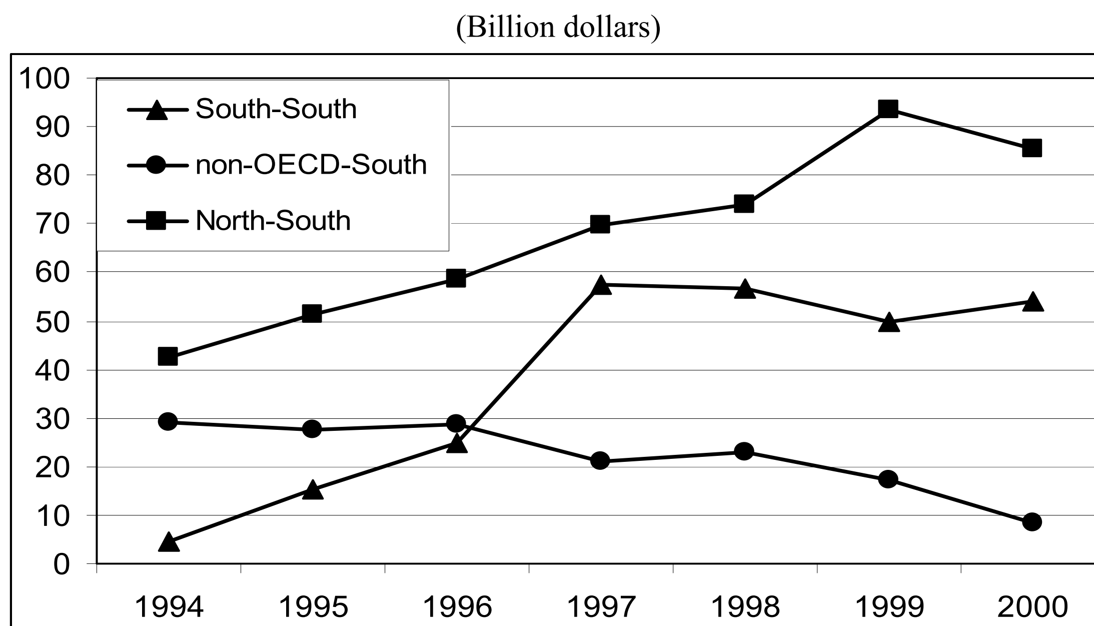
	1994	1995	1996	1997	1998	1999	2000
FDI inflows to the South:							
From all countries (1)	76,4	94	112,4	148,4	153,7	160,6	148
From the North (2)	42,7	51,3	58,8	69,8	74,1	93,6	85,5
From other than the North (1) - (2)	33,7	42,7	53,6	78,6	79,5	66,9	62,5
From High-income non-OECD (3)	29,1	27,4	28,6	21,2	23	17,2	8,6
South-South FDI (1) - (2) - (3)	**4,6**	**15,3**	**25**	**57,4**	**56,6**	**49,8**	**53,9**
Share of total FDI flows to the South (%)	6,0%	16,3%	22,2%	38,7%	36,8%	31,0%	36,4%

Source: Aykut & Ratha 2003 p 154

According to these findings South-South FDI flows rose from $4,6 billion in 1994 to $53,9 billion in 2000 an increase of over 1000 per cent (see *figure 4*).

Figure 4 - FDI flows to the South, by origin 1994-2000

(Billion dollars)



Source: Aykut & Ratha 2003 p 154

Not only did South-South FDI flows increase, but their share of total FDI flows to the South increased from 6 per cent in 1994 to 36,4 per cent in 2000.[84] While the share of FDI flows to the South from the North seem to have been stable around 50-60 per cent of total FDI flows, the share of FDI flows originating in High-income non-OECD countries bound for the South have decreased from 38 per cent to 6 per cent.[85] Though North-South FDI flows are still the

[84] Aykut & Ratha 2003, p 154
[85] Ibid. p 154

most important it seems that the South has replaced FDI flows from High-income non-OECD countries with FDI flows from other developing countries.

4.2 Accuracy of results

There is reason for some critique concerning the results and according to *Aykut & Ratha 2003* their estimates of South-South FDI flows may have some weaknesses. Some of them are presented below.

4.2.1 Underreporting of FDI outflows and inflows

As discussed previously outflows from developing countries are very often underreported. However, FDI inflows can also be underreported. One explanation for this is that some countries e.g. India and Indonesia do not have the same definition of FDI as IMF or UNCTAD (for definition see *3. Foreign Direct Investment*). In these countries reinvested earnings and intra-company loans were not included in FDI statistics, thus lowering the total amount of FDI inflows. [86]

4.2.2 Round tripping

To encourage FDI many developing countries offer foreign investors favourable treatment concerning taxation, land rights and exchange controls. This might encourage domestic investors to take capital out of the country in the form of e.g. bank deposits and return it as FDI inflows. [87] Although no net inflow has been made to the developing country the FDI inflow will be included in South-South FDI should the country used for round tripping be another developing country.

4.2.3 FDI routing

When a firm from the North through one of its affiliates in a developing country invests in another developing country the FDI flow is included in South-South FDI flows. [88] It is difficult to decide whether this is a South-South flow or actually a form of North-South flow,

[86] Aykut & Ratha 2003, p 162
[87] Ibid. pp 162-163
[88] Ibid. p 167

in any case it is very difficult to exclude this effect when estimating South-South flows. The effect is nonetheless an increased global economic integration.

4.3 Explanations to the increase in South-South FDI flows

The results of *Aykut & Ratha 2003* indicate that South-South FDI flows have increased faster than North-South flows during the 1990s. By 2000 South-South flows accounted for roughly one third of total FDI flows to developing countries. There are several factors behind this increase in South-South FDI flows; “push” factors that give firms from the south incentives to invest abroad, “pull” factors from other developing countries that attract their investments. These push and pull factors are similar to those push and pull factors that influenced North-South investments and can be divided into structural, cyclical and policy factors. These factors will be discussed more thoroughly below.

4.3.1 Push factors

The major push factor that enabled this increase of South-South flows was the increase of capital brought about by a rising wealth in some of these developing countries. In search of higher returns and faced with increased competition, higher labour costs and limited market growth in the domestic market firms turned to the markets of other developing countries. [89] Another push factor that is the result of an increase in economic growth in these countries is the increased demand for raw materials. To be able to satisfy the domestic needs of e.g. oil, gas, iron ore and steel developing countries such as China, that have experienced a strong increase in demand for natural resources, invest in resource rich countries e.g. Chile (pulp), Peru (iron ore and steel), Angola (oil) and Sudan (oil).[90] With improved technology and telecommunications the sharing of information became easier and transaction costs sunk something which further encouraged foreign investments.

Another incentive for investments in developing countries was the higher growth compared to developed countries. Instead of investing in developed countries where interest rates were low and economic growth relatively slow developing countries were encouraged to diversify their outflows towards faster growing developing countries.

[89] Aykut & Ratha 2003, p 168
[90] Ibid. p 169

Among the policy factors that encouraged foreign investment were capital account liberalization that permitted domestic firms to invest abroad and encouragement from governments to increase the outflow of investments e.g. China promotes outward FDI by offering loans at attractive terms, tax discounts and investment insurance.[91]

4.3.2 Pull factors

The most important pull factors should be the low labour costs and abundance of raw materials. Specific pull factors for South-South FDI are knowledge of local business environment e.g. through trade relations, geographic closeness, ethnic and cultural ties. [92] As reliable information about foreign markets can be difficult and expensive for relatively small firms to acquire, they usually invest in neighbouring countries where they have either ethnic or cultural ties or they have gained knowledge through previous trade relations. A major policy that has attracted South-South FDI is the permission of foreign ownership of domestic firms.[93]

Another factor that has worked as a push as well as a pull factor is the implementation of various policies to encourage South-South FDI. This has been achieved through a substantial increase of South-South International Investment Agreements (IIAs) which includes 653 Bilateral Investment Agreements (BITs), 312 Double Taxation Treaties (DTTs) and 49 Preferential Trade and Investment Agreements (PTIAs).[94] The BITs work to protect and promote foreign investment flows, the DTTs work to avoid having to pay taxes for the same income in two or more countries and PTIAs work to create preferential market access and increase economic integration between member states.[95]

In addition to above mentioned push and pull factors the creation of EPZs has served as a breeding ground for several firms from developing countries, especially Asian firms. In many cases investments in EPZs were the first major international projects undertaken by firms from developing countries in Asia.[96] Fiscal incentives and competitive wages together with limited expansion possibilities in the domestic market made EPZs attractive. As EPZs reduced

[91] Aykut & Ratha 2003, p 169
[92] Ibid. p 169
[93] Ibid. 171
[94] UNCTAD 2004b
[95] Ibid.
[96] Johansson 1994, p 390

some of the risks connected to foreign production they thereby helped recently established firms from developing countries grow in a protected investment environment.[97]

Through projects such as the Global System of Trade Preferences among Developing Countries (GSTP) South-South cooperation is further accentuated something which has a positive effect on FDI.[98] Between 1990 and 2000 South-South trade has grown by an annual average of about 10 per cent compared to 6 per cent for world trade.[99] Trade preferences have led to FDI in the textiles and clothing industry especially in EPZs. In Mauritius it takes the form of "triangular manufacturing", capital from China, cheap labour, access to cloth and quota freedom in Mauritius and later quota allocations for the United States and the EU.[100] This kind of operation which resembles the *maquiladora* in Mexico and the Caribbean is widespread in Lesotho, Malawi and Swaziland.[101]

4.4 Summary and implications

It is important to recognize the South as an important source of FDI for various reasons. First of all it is important because it indicates that something is working, an investment-cooperation between a South-East Asian developing country and an African country is today a possibility. This indicates that the financial cooperation and integration between developing countries is rather extensive, something which is further proved by the numerous investment agreements between developing countries. Another important aspect of South-South FDI flows is that they might respond differently to external shocks or crises. As mentioned above South FDI flows seem to have been less affected than flows between developed countries by the global downturn in FDI flows in 2000-2001. It might very well be so that South-South FDI flows manage shocks and crises better. This might have to do with the fact that firms from developing countries often have lower overhead costs and tend to have local managers to a larger extent.[102] This gives them an advantage when dealing with local political and economical conditions. Combined, this development should encourage developing countries to target not only firms from the developed world but to a larger extent also firms from other

[97] Johansson 1994, p 390
[98] Smith 2005, p 23
[99] UNCTAD 2004a, p 9
[100] Goldstein 2004, p 75
[101] Ibid. p 75
[102] Aykut & Ratha 2003, p 151

developing countries. By examining the numerous investment agreements that developing countries are involved in and the rapidly growing number of agreements it appears that more and more developing countries are beginning to realize the benefits of South-South IIAs. The developing countries are using these agreements as a mean of attracting investment flows from each other and it seems to be working. The countries that have signed the most BITs e.g. China, Republic of Korea, and Malaysia are also the countries with the largest FDI outflows, China and Malaysia are also among those countries that have signed more BITs with developing countries than with developed ones.[103] The degree to which South-South investment agreements specifically focus on development issues varies.[104] However, it is cooperation between developing countries, covering several different areas, with the aim of achieving development.[105]

However, it is important to remember that economic growth and development is spread very unevenly across the developing world. Asia alone represents 68 per cent of South-South BITs, 58 per cent of FDI outflows from developing countries originate in nine countries.[106] Africa only receives a fraction of FDI flows and host 34 of the worlds LDCs. The following chapter will examine FDI flows in Africa in general and South-South FDI flows in particular.

[103] UNCTAD 2004b
[104] Ibid.
[105] Ibid.
[106] Ibid.

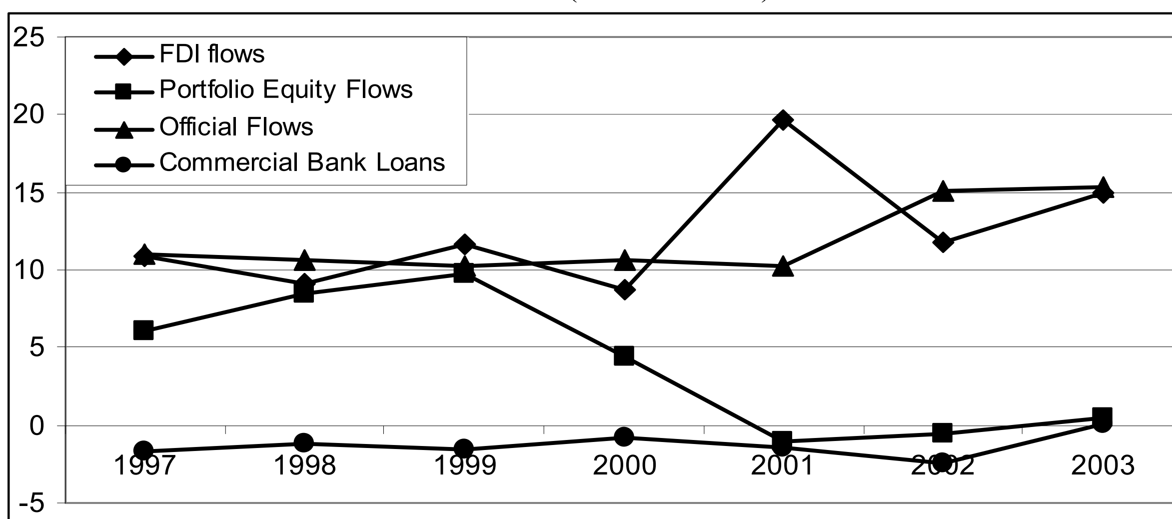
5. South-South FDI flows in Africa

Summary

This chapter will start by giving a brief introduction to the current economic situation in Africa by presenting recent data on capital inflows. It will move on to present recent FDI trends and using OECD and UNCTAD data on FDI flows an estimation of South-South FDI flows in Africa will be made. The results and their implications will be discussed.

Africa has for a long time been characterised by weak economic performance and slow development. The continent has not done as well as other developing regions and this is among other things reflected by the low inflow of FDI. The image of Africa as a continent plagued by war, famine, deadly diseases and general disorder has given many investors a negative impression of Africa. Though this impression unfortunately is the bitter truth for some countries it is not an accurate image of most African countries. This is fortunately something which investors are beginning to realize. In 2003 FDI constituted half of the resource flows to Africa ($15 billion), Official Flows account for the other half (see *figure 5*).

Figure 5 - Foreign Investment (capital flows) to Africa by type of flow, 1997-2003 (Billion dollars)



Source: The World Bank 2004 & UNCTAD FDI database (*see Appendix D, table D.2*)

Still FDI flows to Africa only constitute 3 per cent of global FDI flows and roughly 8 per cent of FDI flows to developing countries.[107] Commercial Bank Loans are negative and the Portfolio Equity Flows decreased drastically following the East-Asian crisis. With regards to FDI outflows Africa still remains a minor player, South-Africa alone account for 60 per cent of FDI outflows at $720 million in 2003.[108]

The inflow of FDI to Africa is a relatively new phenomenon, it was not until the mid 1990s that Africa started to attract significant amounts of FDI, from an annual average of $1,9 billion between 1983-1987 to $3,1 billion between 1988-1992 and $6,0 billion between 1993-1997.[109] Africa is now the fastest growing region when it comes to FDI inflows. Inflows to Africa increased by 25 per cent from $12 billion in 2002 to $15 billion in 2003, which is higher than for any other region, developed or developing.[110] However, the amount was still lower than the peak of $19 billion[111] in 2001 but notable is that the investments were distributed over more countries, 22 countries received more than $0,1 billion compared with 16 in 2001.[112] In addition, among the top ten recipients were several LDCs e.g. Angola, Chad, Equatorial Guinea and the Sudan.[113]

Investments in natural resources attract the majority of FDI but liberalizations of FDI policies and EPZs (Africa has a total of 67 EPZs[114]) have encouraged FDI inflows to other sectors. One example is Mauritius, by setting up an EPZ they hope to attract FDI in services such as call-centres, back-office services and programming with the aim to serve francophone Africa.[115] Kenya's EPZs target the same type of FDI e.g. IT services and software development and attract firms from developing countries like Pakistan and India.[116] In 2004 Africa had a total of 20 EPZs that target services as opposed to traditional manufacturing activities.[117] The theories of FDI and the push and pull factors of South-South FDI hint that Africa might be a region attracting South-South FDI.

[107] UNCTAD FDI database
[108] UNCTAD 2004c, p 24
[109] UNCTAD 1999b, p 2
[110] UNCTAD 2004c, p 40
[111] UNCTAD FDI database
[112] UNCTAD 2004c, p 40
[113] Ibid. p 40
[114] ILO's database on EPZs
[115] UNCTAD 2004c, p 202
[116] Ibid. p 203
[117] ILO's database on EPZs

5.1 Estimation of South-South FDI in Africa

To estimate the extent of South-South FDI in Africa is not simple, certain delimitations have to be made due to lack of data. In this particular estimation the South is defined as all non-OECD countries (*for a list of the 30 OECD countries see Appendix A*) which to a large extent matches UNCTAD's definition of developing countries but not completely. The implications of this definition will be discussed thoroughly in 5.*4 Accuracy of Results*.

5.2 Data and methodology

The data used in this study comes from UNCTAD's FDI database and OECD's International Direct Investment Database and spans from 1990 to 2003. Data on FDI inflows to Africa were collected from UNCTAD's FDI database and data on FDI outflows were collected from OECD's International Direct Investment Database.

Though there is a risk that FDI outflows from OECD countries are underreported the risk should be considerably smaller than in the case of underreporting of outflows from African countries. Using an inflow-outflow matrix (*see table 2*) the South-South FDI flows in Africa were then computed as the difference between the total FDI inflows to Africa and the registered FDI outflows from the OECD countries to Africa. Thus leaving the FDI inflows that originated from other countries than the 30 OECD countries i.e. South-South FDI. The calculations are presented below:

Table 2 - Inflow-outflow matrix

Outflows/inflows	OECD	South	Africa	Outflows
OECD	OECD-OECD	OECD-South	OECD-Africa (a)	Total FDI outflows from OECD
South	South-OECD	South-South	South-Africa (b)	Total FDI outflows from South
Africa	Africa-OECD	Africa-South	Africa-Africa (c)	Total FDI outflows from Africa
Inflows	Total FDI inflows to OECD	Total FDI inflows to South	Total FDI inflows to Africa (d)	Total Flows

Source: based on Aykut & Ratha 2003

South-South FDI flows in Africa compromises both *South-Africa (b)* FDI flows and *Africa-Africa (c)* FDI flows. In this matrix *South-South FDI flows in Africa* can be calculated using the inflow equation (1).

(1) *"Total FDI inflows to Africa (d)" = "OECD-Africa (a)"+"South-Africa (b)"+"Africa-Africa (c)"*

Out of these four variables only two are known, total FDI inflows to Africa and OECD outflows to Africa. As both "South-Africa (b)" flows and "Africa-Africa (c)" flows are South-South FDI flows the following simplification can be made:

(2) *"South-South FDI inflows to Africa" = "South-Africa (b)"+" Africa-Africa (c)"*

Following this simplification there are only three variables in the equation out of which two are known. This leaves an equation that can calculate the South-South FDI flows in Africa by subtracting FDI outflows from OECD countries from the total FDI inflow to Africa. This final equation looks like this:

(3) *"South-South FDI flows in Africa" = "Total FDI inflows to Africa (d)" - "OECD-Africa (a)"*

By using data on total FDI inflows to Africa and OECD outflows to Africa for different years the South-South FDI flows in Africa can then be calculated. The following section will present the results and attempt to offer an explanation to the findings.

5.3 Results

The results of South-South FDI flows in Africa for the period 1990-2003 are presented in *table 3*.

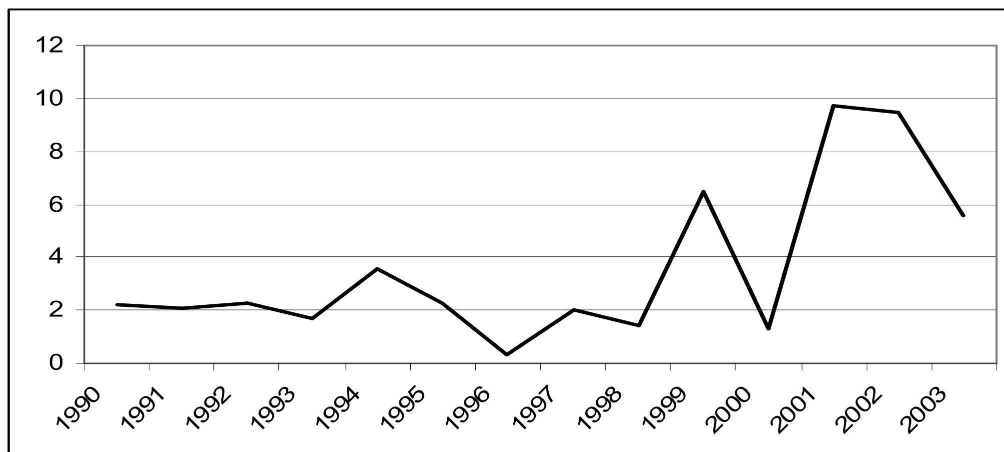
Table 3 - Estimation of South-South FDI flows in Africa, 1990-2003
(Billion dollars)

FDI inflows to Africa	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
from all countries (1)	2,4	3,1	3,5	4,7	5,8	5,4	5,3	10,9	9,1	11,6	8,7	19,6	11,8	15
from OECD (2)	0,2	1	1,2	3	2,2	3,1	5	8,9	7,7	5,1	7,4	9,9	2,3	9,4
South-South FDI (1)-(2)	2,2	2,1	2,3	1,7	3,6	2,3	0,3	2	1,4	6,5	1,3	9,7	9,5	5,6
Share of total FDI to Africa %	92%	68%	66%	36%	62%	43%	6%	18%	15%	56%	15%	49%	81%	37%

Source: author's estimations based on UNCTAD's FDI database and OECD's International Direct Investment Database.

The results obtained are very wide-ranging and although the South-South FDI flows have risen during the period the flows are very fluctuating (see *figure 6*).

Figure 6 - Estimated South-South FDI flows in Africa 1990-2003,
(Billion dollars)



Source: author's estimations based on UNCTAD's FDI database and OECD's International Direct Investment Database.

In order to understand these results a more thorough examination of the FDI inflows to Africa has to be made. This should reveal the nature of the FDI inflows and help explain the results.

When examining the FDI inflows to Africa over the period 1990-2003 the immediate positive development hides some important details (see *figure 7*). The sharp increase of FDI inflows in 1997 is dominated by one deal, the partial privatisation of Telkom, a South African telecom operator, which led to a purchase of a 20 per cent combined share by SBC (the United States) and Telkom Malaysia Berhad.[118] The sharp increase of FDI inflows in 2001 is also dominated by two deals, partial privatizations in Morocco and an unbundling of cross-shareholding between London-listed Anglo American and De Beers of South Africa.[119]

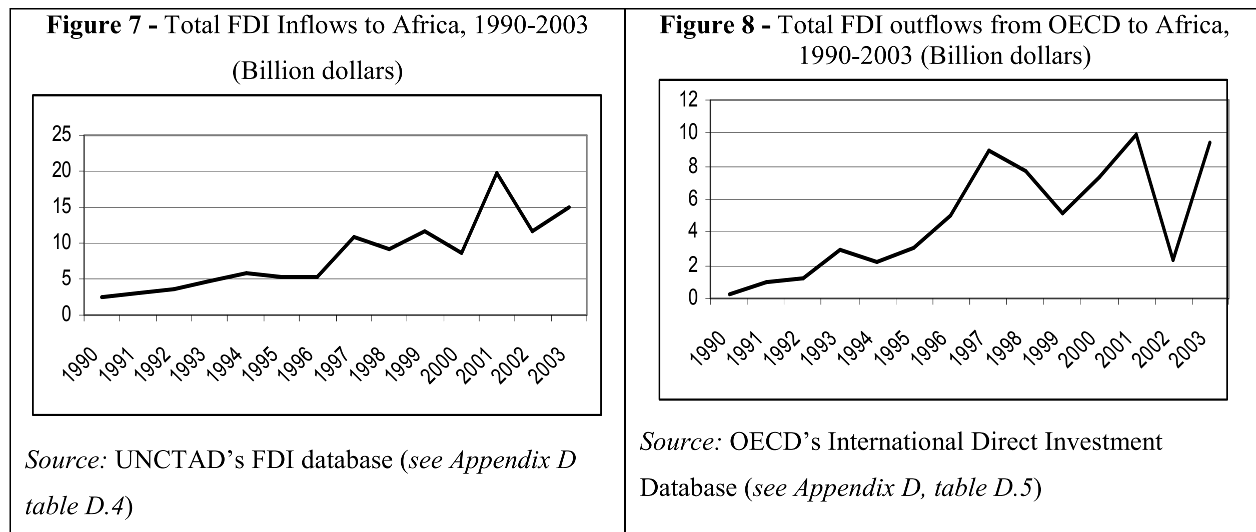


Figure 7 - Total FDI Inflows to Africa, 1990-2003 (Billion dollars)

Source: UNCTAD's FDI database (*see Appendix D table D.4*)

Figure 8 - Total FDI outflows from OECD to Africa, 1990-2003 (Billion dollars)

Source: OECD's International Direct Investment Database (*see Appendix D, table D.5*)

With this in mind it seems reasonable to assume that the fluctuations are caused by big one-time investments. By studying the outflows from OECD countries (*table 3* and *figure 8*) the investment by SBC in 1997 is reflected by a $3,9 billion increase in OECD outflows. The decrease in outflows between 1997 and 1999 is most likely a result of the East-Asian financial crisis and the sharp downturn in 2001 is part of a global trend following September 11th. On the other hand the sharp increase of inflows to Africa in 2001 is not reflected by a significant increase in OECD outflows which could imply a South-South FDI.

An interesting observation is that the estimated South-South FDI flow is not affected by the global fall in FDI flows from 2001 to 2002. The fall in FDI inflow to Africa from 2001 to 2002 is matched by an almost identical fall in FDI outflow from OECD. This implies that the global downturn that caused OECD countries to decrease FDI outflows did not affect the

[118] Goldstein 2004, p 39
[119] Commission on Capital Flows to Africa 2003 , p 13

countries investing almost $12 billion in Africa in 2002 thus leaving South-South FDI unchanged.

In short, South-South FDI flows in Africa have experienced an increase between 1990 and 2003, albeit with strong fluctuations. These fluctuations could be the result of large one-time investments e.g. privatizations and investments in natural resources.

5.4 Accuracy of Results

The major weakness in this study lies in the definition of the South. To consider all non-OECD countries to be developing countries is not completely accurate. But due to the circumstances some kind of classification had to be made and this was the most sensible. In addition to this there are the previously discussed weaknesses:

- Underreporting of FDI outflows from OECD countries
- Underreporting of FDI inflows by African countries
- Round tripping of FDI; since there has not yet been extensive preferential treatment of foreign investors in Africa, there has been little incentive for round tripping, but such cases may exist.
- Routing of FDI through a developing country or through an offshore financial centre (none of which are classified as OECD countries). The possibility that investments from developed countries to Africa are routed via other developing countries exists and the problem of separating this effect persists.

5.5 Explanations to the increase in South-South FDI flows in Africa

There are a few factors that have influenced the increase in South-South FDI flows in Africa. To begin with investments within the continent have been encouraged by push factors like amplified competition and limited growth prospects in the domestic market e.g. South-African retailing and brewing companies that have expanded into neighbouring countries.[120] Privatization programmes have also attracted South-South FDI both from the continent and from elsewhere e.g. South African Breweries purchased Cervejas de Moçambique when it

[120] Aykut & Ratha 2003, p 168

was privatized and they are now present in 11 African countries[121] and Telkom Malaysia Berhad were involved in the purchase of South-Africa's telecom operator Telkom when they were privatized.[122] The liberalization of FDI regimes and simplification of administrative procedures is one of the major reasons why a country like Morocco has become an attractive destination for FDI.[123] South-South IIAs are also increasing; out of the 35 BITs signed in 2003 13 were between African countries, 9 DTTs were also signed 5 between African countries.[124] Investments in the extractive industry also attract South-South FDI e.g. China's investments in Angola and Sudan and Malaysian state-owned Petronas' investments in South-Africa.[125] Trade preferences also play an important role e.g. Asian FDI in the textile industry in countries like Mauritius, Lesotho, Malawi and Swaziland. In these countries it takes the form of "triangular manufacturing" with capital from Asia, cheap labour and raw materials in Africa and quota allocations to the United States or Europe. Malaysia has emerged as an important source of FDI in Africa and demonstrated an interest in South-Africa for a number of politically related reasons.[126] These reasons include the positive reactions South-African economists and activists have shown for the Malaysian efforts to empower the native Malay and the strategy of the Malaysian government to intensify its interest in South-Africa.[127] In short many of the push and pull factors discussed in the previous chapter have encouraged South-South FDI e.g. increased competition, procurement of raw materials, policy regimes and the geographic proximity together with cultural and ethnic ties. Most importantly is probably the increase of FDI inflows to markets like South-Africa and Morocco that lead to an increase in capital and make them regional growth poles.

5.6 Effects of the increase in South-South FDI flows in Africa

It is very difficult to estimate the specific effects of South-South FDI flows. First of all it is very difficult to separate the specific effects of South-South FDI with regards to North-South FDI should there be any. Secondly the FDI flows are distributed very unevenly over the continent with a few countries receiving lions' shares and other countries receiving very little. The top ten recipients of total FDI inflows in 2003 together received $12,1 billion while 44

[121] UNCTAD 1999b, p 14
[122] Goldstein 2004, p 39
[123] UNCTAD 1999b, p 12
[124] UNCTAD 2004c, p 42
[125] Aykut & Ratha 2003, p 169
[126] Goldstein 2004, p 49
[127] Ibid. p 49

countries share the remaining $3 billion.[128] In 2003 Morocco alone received roughly 15 per cent of total FDI inflows to Africa while Sudan, Angola, Equatorial Guinea and Nigeria received approximately 10 per cent each.[129] South-Africa, another major recipient of FDI only received 5 per cent of total FDI flows in 2003 compared to 35 per cent in 2001.[130] For an overview of the geographic distribution of FDI flows to Africa (see *Appendix D, table D.6)*. Considering the extent of this study it is hard to tell specifically what effects South-South FDI has had in these countries. However, it seems as if FDI to a country like South-Africa has led to further FDI flows. South-Africa alone account for 60 per cent of FDI outflows in Africa, followed by Liberia at 10 per cent of FDI outflows.[131] It seems reasonable that at least some of this FDI outflow has other African countries as destinations. Nearly all of the major South-African firms have invested heavily in the surrounding countries and elsewhere in Africa (e.g. CS Holdings in Tanzania and Addis Ababa, Italtile in Namibia, Botswana and Swaziland and Pick'n Pay a supermarket with 342 stores in South-Africa and 471 in the rest of Africa)[132], thus contributing to South-South FDI flows. Under the condition that a country has reached a certain level of economic growth e.g. South-Africa, FDI inflows have the effect of giving domestic firms incentive to invest in its geographic proximity due to limited growth possibilities in the domestic market. This is in line with the theories discussed in the previous chapter. Similar trends may exist in other African countries but are not as clearly distinguishable as in the case of South-Africa. In short the increased South-South FDI flows to South-Africa have resulted in e.g. an increase of investments by South-African firms in surrounding countries as well as in the rest of Africa.

5.7 Summary and implications

As FDI flows to Africa picked up during the 1990s the flows were dominated by investments in the extractive industry. This has resulted in an uneven geographic distribution of FDI flows within the continent. However, contrary to common belief FDI to the service sector is becoming increasingly important in many African countries. As a result of EPZs countries like Mauritius and Kenya attract FDI flows, though relatively small, that are concentrated to the service sector. The estimated South-South FDI flows in Africa have increased over the period 1990-2003, although there have been strong fluctuations. However, both the total FDI

[128] UNCTAD 2004c, p 41
[129] UNCTAD FDI database
[130] Ibid.
[131] Ibid.
[132] Goldstein 2004, p 51

inflows to Africa and the registered FDI outflows from OECD countries to Africa display strong variations. These fluctuations can possibly be explained by large one time investments e.g. investments in natural resource projects and investments following privatizations. Although the FDI inflows to Africa have increased as have the South-South FDI flows it is difficult to point at the specific effects of this increase in South-South FDI. Due to the extent of this study it is not possible to study each country individually in order to examine the effects of an increase in FDI inflows. Nonetheless, some effects can be distinguished. South-Africa is one of the major destinations for FDI in Africa and also the major source of FDI outflows in Africa. South-South FDI by e.g. Malaysian firms has contributed to the increase in South-South FDI flows to South-Africa. This has resulted in an economic growth and given domestic firms the incentive to expand to surrounding countries.

6. Conclusion

The aim of this study was to better understand why FDI has become such an important source of foreign capital to developing countries and the reason why South-South FDI has grown to account for roughly one third of all FDI flows to developing countries. In addition an estimation of the South-South FDI flows in Africa was made.

The theoretical framework behind the increased importance of FDI as a source of foreign capital was based on its beneficial characteristics as a factor for economic growth and thus indirectly as a factor for development and poverty reduction. Furthermore, the incentives for profit-seeking investors were discussed i.e. the reasons why investors choose to invest in developing countries. Concerning the South-South FDI trend the theoretical framework was based on push and pull factors influencing firms in developing countries to invest abroad.

The reason why FDI has become the most important form of foreign capital to developing countries can be explained by; past failures of other means of foreign capital e.g. Commercial Bank Loans and Portfolio Equity Flows, the search for profit by firms in developed countries and the fact that policy makers in developing countries realized the positive effects FDI could have on economic growth and consequently on development and poverty reduction. As developing countries became increasingly aware of the importance of attracting FDI measures were taken to attract foreign investors. Measures were also taken to attract the right type of FDI i.e. FDI that could help the country achieve their goals whether it be increased employment or access to technology.

The development of South-South FDI is influenced, to a large extent, by the same factors that influenced North-South FDI. As developing countries experienced economic growth domestic firms faced increased competition in the local market and looked abroad to increase profits. In search of competitive wages and influenced by geographic proximity other developing countries were the natural choice. Furthermore, less advanced technology compared to developed countries, cultural ties and a familiarity of the market made the transition smoother. As an increasing number of developing countries are experiencing economic growth it is only natural that South-South FDI flows increase. Improved communications and transports have also contributed to making developing countries more financially integrated.

The estimation of South-South FDI flows in Africa revealed an increase in flows over the period 1990-2003, albeit with strong fluctuations. The fluctuations could to a certain extent be explained by large one time investments following privatizations e.g. the privatization of South-Africa's telecom company Telkom. The South-South FDI trend in Africa can be explained by similar push and pull factors that influence South-South FDI flows in general e.g. increased competition, privatizations, procurement of raw materials and liberalizations. The effects of South-South FDI flows in Africa have so far been modest. FDI contributed to the economic growth and development of South-Africa which has resulted in an increased investment of South-African firms in other African countries. This effect of increased FDI outflows has so far been most apparent in South-Africa.

In conclusion, South-South FDI flows are increasing faster than North-South FDI flows. However, FDI flows are unevenly distributed. Africa only receives 8 per cent of total FDI flows to developing countries and even within the continent a few countries receive lions' shares as the majority of FDI flows to Africa are concentrated to natural resources. Further research is needed to assess the specific geographic and sector distribution of South-South FDI. Further research is also needed to study the spillover effects of FDI and specifically the spillover effects of South-South FDI. As the gap between developing countries is smaller than between developed and developing countries it might be possible that the ability to absorb e.g. new skills and technology is higher between developing countries than between developed and developing countries, i.e. the spillover effects resulting from South-South FDI are stronger than the spillover effects resulting from North-South FDI.

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Database:

OECD's *International Direct Investment Database*

UNCTAD's *FDI database*

ILO's *Database on EPZs*

Appendices

Appendix A

Table A. 1 - The 30 OECD countries

1. Australia	16. Japan
2. Austria	17. Korea
3. Belgium	18. Mexico
4. Belgium-Luxembourg	19. Netherlands
5. Canada	20. New Zealand
6. Czech Republic	21. Norway
7. Denmark	22. Poland
8. Finland	23. Portugal
9. France	24. Slovak Republic
10. Germany	25. Spain
11. Greece	26. Sweden
12. Hungary	27. Switzerland
13. Iceland	28. Turkey
14. Ireland	29. United Kingdom
15. Italy	30. United States

Source: OECD's International Direct Investment Database

Appendix B

Table B. 1 - The world's 50 LDCs

1. Afghanistan	2. Madagascar
3. Angola	4. Malawi
5. Bangladesh	6. Maldives
7. Benin	8. Mali
9. Bhutan	10. Mauritania
11. Burkina Faso	12. Mozambique
13. Burundi	14. Myanmar
15. Cambodia	16. Nepal
17. Cape Verde	18. Niger
19. Central African Republic	20. Rwanda
21. Chad	22. Samoa
23. Comoros	24. São Tomé and Principe
25. Congo, Dem. Rep. of	26. Senegal
27. Djibouti	28. Sierra Leone
29. Equatorial Guinea	30. Solomon Islands
31. Eritrea	32. Somalia
33. Ethiopiaa	34. Sudan
35. Gambia, The	36. Tanzania
37. Guinea	38. Timor-Leste
39. Guinea-Bissau	40. Togo
41. Haiti	42. Tuvalu
43. Kiribati	44. Uganda
45. Lao PDR	46. Vanuatu
47. Lesotho	48. Yemen, Rep. of
49. Liberia	50. Zambia

Source: UNCTAD 2004c

Appendix C

Table C. 1 - Classification of countries according to *Aykut & Ratha 2003*

Developing Countries	High-income OECD countries	High-income non OECD economies
Algeria	Australia	Andorra
Argentina	Austria	Aruba
Brazil	Belgium-Luxembourg	Bahamas
Bulgaria	Canada	Barbados
Chile	Denmark	Bermuda
China	Finland	Brunei
Colombia	France	Cayman Islands
Costa Rica	Germany	Channel Islands
Czech Republic	Greece	Cyprus
Egypt	Iceland	Faeroe Islands
Hungary	Ireland	French Polynesia
India	Italy	Greenland
Indonesia	Japan	Guam
Iran	Netherlands	Hong Kong, China
Korea, Rep. Of	New Zealand	Israel
Libyen	Norway	Kuwait
Malaysia	Portugal	Liechtenstien
Mexico	Spain	Macao, China
Morocco	Sweden	Malta
Panama	Switzerland	Monaco
Philippines	United Kingdom	Northern Mariana Islands
Poland	United States	Nertherlands Antilles
Romania		New Caledonia
Russian Fed.		Qatar
Saudi Arabia		Singapore
Slovakia		Slovenia
South Africa		United Arab Emirates
Thaiand		Virgin Islands (US)
Turkey		Taiwan Province of China
Ukraine		
Venezula		

Source: Aykut & Ratha 2003

Appendix D

Table D. 1 - Foreign Investment Flows to Developing Countries by type 1997-2003 (Billion dollars)

Developing countries	1997	1998	1999	2000	2001	2002	2003
FDI flows	171,1	175,6	181,7	162,2	175	147,1	135,2
Portfolio Equity Flows	22,6	6,6	12,6	12,6	4,4	4,9	14,3
Official flows	38,5	60,9	42,2	22,8	54,8	35,3	28
Commercial Bank loans	43,9	52,4	-5,1	-5,8	-10,2	-3,9	-6,6

Source: The World Bank 2004

Table D. 2 - Foreign Investment Flows to Africa by type, 1997-2003 (Billion dollars)

Africa	1997	1998	1999	2000	2001	2002	2003
FDI Inflows	10,9	9,1	11,6	8,7	19,6	11,8	15
Portfolio Equity Flows	6,1	8,5	9,7	4,4	-1	-0,6	0,5
Official Flows	11	10,6	10,2	10,6	10,3	15,1	15,4
Commercial Bank Loans	-1,7	-1,2	-1,6	-0,8	-1,5	-2,4	0,1

Source: The World Bank 2004 & UNCTAD FDI database

Table D. 3 - Global and South FDI inflows/outflows 1990-2003 (Billion dollars)

	FDI	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
World	Inflows	209	159	166	226	261	336	389	488	691	1087	1388	818	679	560
	Outflows	242	199	202	244	287	358	397	481	687	1092	1187	722	596	612
South	Inflows	38	43	55	81	109	116	152	199	194	232	252	220	158	172
	Outflows	16	12	25	40	47	53	63	80	53	75	99	60	44	36

Source: UNCTAD FDI database

Table D. 4 - FDI inflows to Africa 1990-2003 (Billion dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
FDI inflows to Africa	2,4	3,1	3,5	4,7	5,8	5,4	5,3	10,9	9,1	11,6	8,7	19,6	11,8	15

Source: UNCTAD FDI database

Table D. 5 - FDI outflows from OECD to Africa 1990-2003 (Billion dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
FDI outflows from OECD	0,2	1	1,2	3	2,2	3,1	5	8,9	7,7	5,1	7,4	9,9	2,3	9,4

Source: OECD's International Direct Investment Database

Table D. 6 - Distribution of total FDI inflows to Africa among the top receivers 1990-2003 (per cent of total FDI inflows to Africa)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Algeria	2%	3%	1%	0%	0%	0%	5%	2%	5%	4%	5%	6%	9%	4%
Egypt	30%	8%	13%	26%	20%	11%	12%	8%	12%	9%	14%	3%	5%	2%
Libyan Arab Jamahiriya	7%	3%	3%	1%	-1%	-2%	-2%	-1%	-1%	-1%	-2%	-1%	-1%	5%
Morocco	7%	10%	12%	11%	10%	6%	6%	11%	5%	7%	2%	14%	4%	15%
Sudan	-1%	0%	0%	0%	2%	0%	0%	1%	4%	3%	4%	3%	6%	9%
Tunisia	4%	6%	16%	14%	9%	6%	5%	3%	7%	3%	9%	2%	7%	4%
Angola	-14%	21%	8%	6%	3%	9%	3%	4%	12%	21%	10%	11%	14%	9%
Chad	0%	0%	0%	0%	0%	1%	1%	0%	0%	0%	1%	2%	9%	6%
Côte d'Ivoire	2%	1%	2%	4%	2%	4%	5%	4%	4%	3%	3%	1%	2%	3%
Equatorial Guinea	0%	1%	0%	0%	0%	1%	5%	0%	3%	2%	1%	5%	3%	10%
Nigeria	24%	23%	25%	29%	34%	20%	30%	14%	12%	9%	11%	6%	11%	8%
South Africa	-3%	8%	0%	0%	7%	23%	15%	35%	6%	13%	10%	35%	6%	5%

Source: UNCTAD FDI database