CHAPTER TWO

THE IMPORTANCE OF FDI FLOWS

2.1 INTRODUCTION

During the past decade, the importance of FDI has become one of the hottest topics in the global economy and has growth to encompass global set of issues, with strategic implications for both host countries and foreign investors (Elizabeth, 1998). In the word of economists FDI "is viewed as a major stimulus to economic growth in developing countries. Its perceived ability to deal with major obstacles such shortages of financial resources, technology, and skills has made it the center of attention for policy makers in developing countries such as Africa". (Ntwala, 2003, pp.1).

FDI is one of the three pillars of globalization. The other two are international trade and capital flows. In this sector, the study begins by discussing direct foreign investment flows throughout the world, with an emphasis in developing world, especially within Africa.

2.2 FDI IN THE GLOBAL ECONOMY

Considering the importance of FDI for the global economy, some countries are pushing by an ongoing liberation or promotion of FDI regimes. The FDI is an intrinsic part of the ongoing globalization process and a rapid growth has been observed in the global economy. According to UNCTAD's world investment report (UNCTAD, 2004), the number of transnational corporations almost doubled from 37,000 in 1990 to over 60,000 in 2001. Annual global inflows of FDI grew from US$ 208,674 million in 1990 to

US$ 653 billion in 2003, corresponding to an annual growth trend of 85.5 per cent, after two consecutive declines from US$ 1, 4 trillion in 2000 to US$ 824 billion in 2001 and US$ 652 billion in 2002.

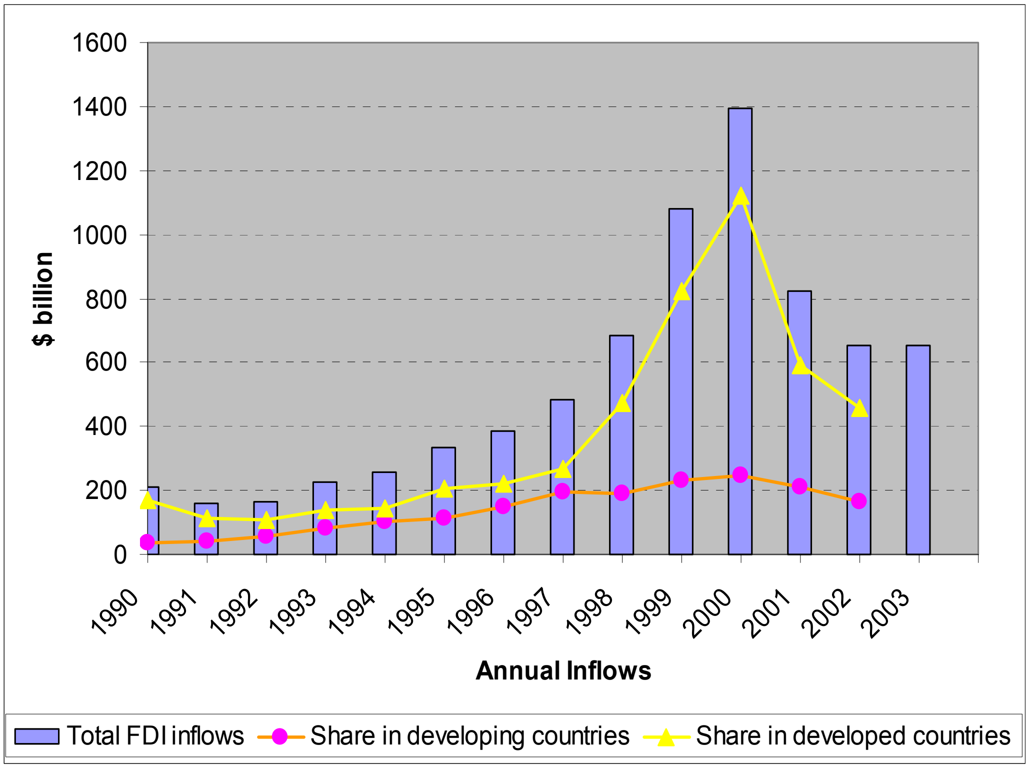

Figure 2. 1: Foreign Direct Investment (FDI) Inflows and their share in the Developing Countries (1990-2003)

Source: UNCTAD, FDI/TNC database (2003)

An important explanation for the rapid growth in FDI in the period 1996-2000 include the change in foreign regimes, the political transformation, market liberalization and the privatization as well as the developing countries' need to increase exports income which have increased the global reach and influence of the private sector (Otto, 2002). The size and reach of individual companies also grew during this period, which resulted in the world's largest corporations have sales greater that the Gross Domestic Products of many nation states (UNCTAD, 2003).

Countries seek FDI to help them grow and develop and their national policies are keys to attracting FDI and increasing benefits from it. As seen from Table 2.1, countries around the world are changing their investment environment regimes in order to attract foreign investors and promote FDI. The number of the countries that have introduced changes in their investment environments has increased from 1999 to 2002. In 1999, 65 introduced changes in 114 investment regimes, and of 98 (or 85.9%) changes were in the direction of investment liberalization and promotion, while in 2002, the number of countries were 70. They introduced 248 changes in investment regimes, and here of 236 changes (or 95.2%) were in the direction of investment liberalization and promotion. Only 12 changes (4.8%) were in the direction of control (UNCTAD, 1997).

Table 2.1: Changes in FDI laws and regulation, 1996-2002

Item	**1996**	**1997**	**1998**	**1999**	**2001**	**2001**	**2002**
Number of countries that introduced changes in their investment regimes	65	76	60	63	69	71	70
Number of regulatory changes of which:	114	151	145	140	150	208	248
More favourable to FDI[a]	98	135	136	131	147	194	236
Less favourable to FDI[b]	16	16	9	9	3	14	12

Source: UNCTAD, 2003

Note: [a] Including liberalizing changes which increased incentives

[b] Including changes aimed at increasing control as well as reducing incentives

Other reason why the global FDI came under increased scrutiny is the growing inequities between countries from the developed region and countries from the developing region which become more visible during this period. Since FDI is becoming more important in total investment, more developing countries and economies in transition are following the developed countries in removing restrictions to FDI entry. The developed countries still account for the main part of the FDI inflows, as shown in Figure 2.2. Just 74% of all FDI inflows go to developed countries (82% in 2001).

"*The great majority of FDI was invested by multinationals from the developed countries, in other developed countries, reports UNCTAD. The remainder of Global FDI took place in the developing countries-invested in these poorer regions***"** (UNCTAD, p. 5, 2002).

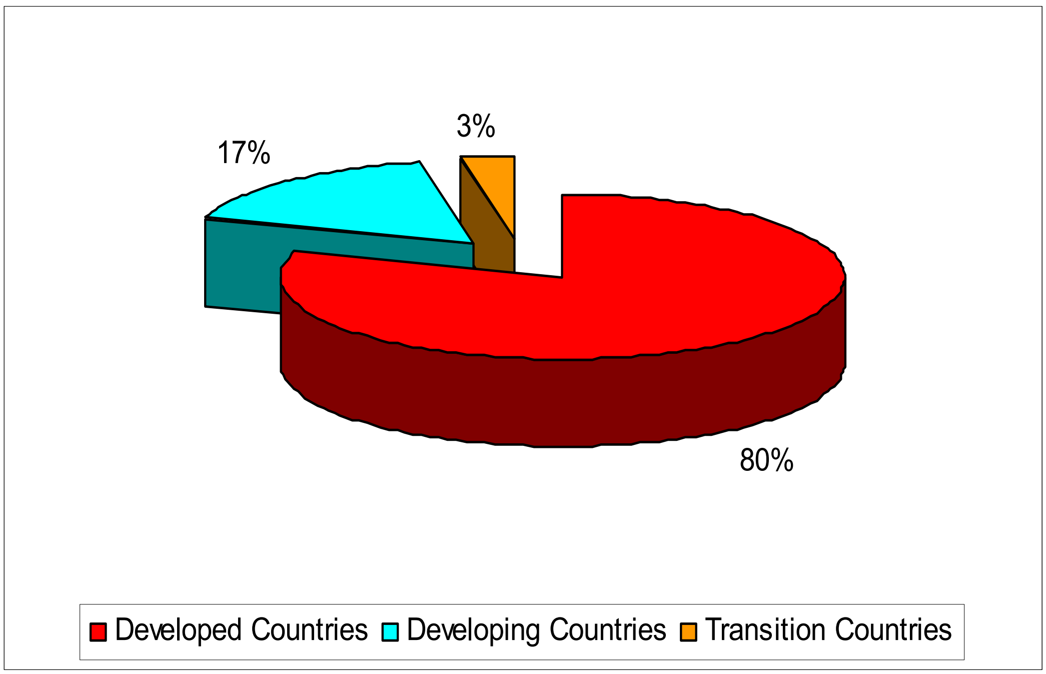

Figure 2.2: Foreign Direct Investment: 2000 (Recipient Countries)
Source: UNCTAD, 2000

Foreign direct investment in the developing region may below good and regulated conditions; FDI lead positively to the development of the national economies. Countries are in great need for large capital inflows to develop their economy. The developing countries have derivative attitudes towards the issue. FDI to developing countries decreased from US $193.2 billion to US $ 162.1 billion, between 1997 and 2002.

A group of developing countries including (in order of importance) China, Brazil, Singapore, Indonesia, Mexico, Malaysia, Argentina, Peru, Chile and

Columbia have attracted the major share of FDI inflows. FDI flows are thus very unevenly distributed among countries and are in fact concentrated to a handful of fast growing economies Asia and Latin America.

The reasons differ from country to country. With regard to the Asia/Pacific region, it should be noted first that this region has been the first example of recent phenomenon of outward FDI from developing countries. This accounts for the vast majority, (or 88 per cent), of FDI outflows from developing countries. China has been receiving an increasing share of investment flows to developing countries. FDI to China increased from US $35.4 billion in 1998 to US $ 53.5 billion in 2003, corresponding to 18.5 per cent to 31.1 per cent of the total FDI inflows in developing countries during the same period. This makes China the world's largest recipient of foreign direct investment. China has significant competitive advantages include a large market, high economic growth and good infrastructure.

Most of the FDI goes to other countries within the Asia/ Pasific region. Intraregional investment remains the principal FDI source for the region, despite the fast growth of FDI by transnational companies based in developed countries. For the major Asian developing economies, the FDI stock attributed to other Asian developing economies, at nearly 40 per cent, is still larger that that from either Europe, Japan or the United States (UNCTAD, 1997).

"*FDI flows to developing countries surged in the 1990s and became their leading source of external financing. In Africa, the main attractions of FDI are market-related, notably the size and the growth of the local market and access to regional markets. In China and India, the biggest attractions are the size of the domestic markets. In Latin America, investment has been attracted by profitable opportunities from privatization. Most new investment inflows go into non-tradable service and manufacturing* *industries producing mostly for domestic market. Investment flows to Africa have declined steadily."* (Ntwala, pp.11, 2003).

World Investment Report (WIR, 2003) notes that FDI to Africa declined from US$12.3 billion in 1999 to US$8.5 billion in 2000. African share of world FDI fell below 1 percent in 2000. African share within the developing region has declined largely from 1998 to 2002. In the 1998, FDI to African countries accounted for US $8.9 billion, corresponding to 4.7% of foreign direct investment to developing countries. In 2000 it only received 3.5% of the total of FDI to the developing region. While in 2002, it received 6.8 % of the total of FDI to the same region (UNCTAD, 2003), see Figure 2.3.

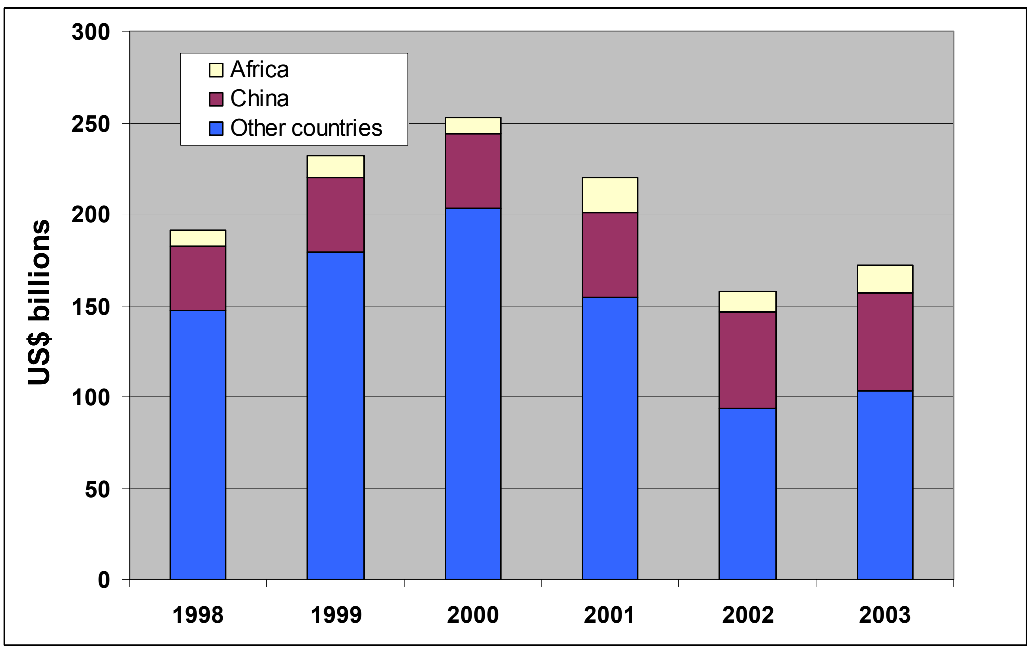

Figure 2. 2: Foreign Direct Investment (FDI) inflows to Developing Countries, selected years (1998-2003)

Share of Africa and China by years FDI to the Developing Countries

Year	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Africa (%)	4.7	5.3	3.4	8.5	7.0	8.7
China (%)	18.5	17.4	16.1	21.3	33.5	31.1

Source: UNCTAD, 2000

In earlier years, South Africa, Angola, Morocco, Nigeria and Egypt were viewed as the most attractive African investment locations. They have attempted to improve their economies to promote private investment by developing strategy, which aims to enhance investment opportunities. In the 2002s, countries getting relatively large flows of FDI include Angola, Nigeria, South Africa and Sudan. As seen on Table 2.2, Angola ranks on top with $ 1.312 billion during that period, Nigeria accounted at US$ 1.281 billion, South Africa with US$ 754 million and Sudan accounted at US$ 681 million. Privatization played an important role in Africa during the last decade in the attraction of Foreign Direct Investment. The large share of privatization during period from 1985s to 2002s went to South Africa with $ 2.099 billion as annual average of FDI (Frick, 2002).

The rest of Africa region experienced a fall inflows in 2000. However, countries like Mauritius and Lesotho experience strong increases in FDI whereas others, for example, Zimbabwe experienced a significant drop from US$ 444 million in 1998 to US$59 million in 1999 and only US$ 30 million in 2000. South Africa investment in Africa represents close to 20% of total FDI in the African's continent, commented the Development Bank of Southern Africa (DBSA) from his Development Report of 2003. Dianna (2003) noted that in 2001, the South African's investment in Africa was listed as the second biggest investment in the SADC region with investment accounted of R14.8 billion, trailing multi-state deals at R27 billion with the next highest country investment being the UK at R3.98 billion. In 2002, the South African's investment in Africa was at the top of the list, Dianna said.

" *Among the big deals in the SADC region in 2001 and 2002 were: a new investment of US$ 1.1 billion by Sasol in the Pande & Temane gas fields in Mozambique; a US$ 860 million investment by BHP Billiton, the IDC and Mitsubishi in the expansion of Mozal II; a US$ 142 million investment by Vodacom in Tanzania and a further US$ 139 million investment in the DRC; US$ 56 million by Sun International in its hotel in Zambia; US$ 139 million by Pretoria*

Portland Zimbabwe in merger activity in Zimbabwe; US$ 6 billion by power parastatal Eskom Enterprises in the Inga project in the DRC; and US$ 20 million by South African Airways for its stake in Air Tanzania. Increasingly, South African companies are going into joint ventures with large international companies for big projects on the continent", (Dianna, pp. 6, 2003).

Table 2.2: FDI inflows to the top 10 recipient African economies (1998-2002)

In million of US dollars

	Countries	1998	1999	2000	2001	2002	1985-2002 (Annual average)
1	South Africa	561	1,502	888	6,789	754	2098.8
2	Angola	1,114	2,471	879	2,146	1,312	1584.4
3	Morocco	417	1,376	423	2,808	428	1090.4
4	Nigeria	1,051	1,005	930	1,104	1,281	1074.2
5	Egypt	1,076	1,065	1,235	510	647	906.6
6	Tunisia	670	368	779	486	821	624.8
7	Sudan	371	371	392	574	681	477.8
8	Mozambique	235	382	139	255	406	283.4
9	Cote d'Ivoire	315	279	235	44	223	219.2
10	Gabon	211	200	-43	169	123	132.0
Total Africa		8,928	12,231	8,489	18,769	10,998	11,883.0

Source: UNCTAD, 2000

2.2.1 Future investment flows

Countries failing to attract a good part of FDI in their national economies have likely opportunities in growth in the coming years. It expected an increase in FDI over the next four years. According to UNCTAD, bearing in mind the severity of the recent downturn in FDI, the extent of optimism surrounding prospects for increased FDI in the near term (2004-2005) as well as in the medium term (2006-2007) is striking. Investment promotion agencies (IPAs), for example, worldwide are optimistic about FDI prospects for an increase in FDI flows with 91 per cent of the respondents believing that these will improve. Prospects are considered positive for almost all industries.

The United States, Germany, the United Kingdom, and France are viewed as the leading source of FDI, followed by China and Japan. The survey from IPA found that competition for attracting FDI is becoming more intense and more competitive, including through greater use of incentives and ongoing liberation, as well as the use of targeting[2.1] as an investment promotion instrument.

The United States is still expected to be the largest investing country followed by Germany, United-Kingdom, and France (Figure 2.4). Good news for the developing Asia/Pacific region is that China is now among the top five investing countries just after France. China replaces Japan, which traditionally has been significant source country for FDI in the developing world. Many countries believed that China could rank second after the United States as an expected source of FDI during year 2003. Among the major determinants which motive investors to invest in China are the large market size, low labour costs as well as the high returns in natural resources. Countries such as South Africa and Spain are added to the list of expected top 10 source countries for FDI (UNCTAD, 2002).

[2.1] *The WIR (2002) defined targeting in different ways. In principle, targeting involves the focusing of promotional resources to attract a defined sub-set of FDI flows, rather than FDI in general. Some countries have used targeting export-oriented FDI during a period with success. However, it is only recently that the word targeting has become a more widely accepted tool among many IPAs (Ntwala, pp7, 2003).*

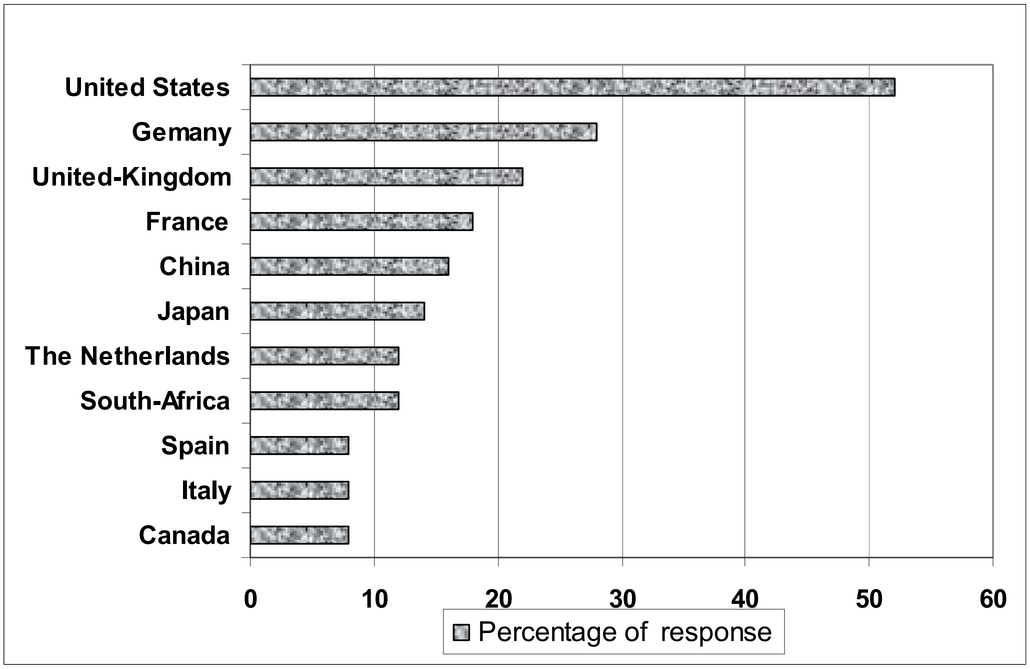

Figure 2. 3: Leading sources of FDI in 2000
Source: UNCTAD, 2000

Although growth in FDI is expected in the short term as well in the medium term, the response will be less pronounced in some developing countries. Those countries will still experiment short of the growth rates needed to meet the current global economic climate, necessary to improve performance in global economy. A report from the World Bank found that the developing countries will continue to growth faster than developed countries. Despite signs of recovery, countries from developed region are expected to record a meagre 0.8 per cent growth in 2002. However, risks in African countries remain large (Carlos, 2002)..

The World Bank's report indicated that many developing countries have had small capital inflows due to increased uncertainty among investors, a global decline in lending, and increasing willingness to reduce risk. Others are putting in place policies, institutions and governance needed to achieve sustained growth. This offers opportunities for the developed countries to demonstrate their support for these efforts by continuing to open their markets and by substantially increasing aid, commented the World Bank's report. Some countries from developing world have become increasingly integrated into the global economy. They face policy challenge including how to deal with improve environment for business.

2.3 FDI FLOW AND THE MINING INDUSTRY

2.3.1 Introduction

The mining industry remains a vital foundation for economic growth and development of the economy, and a source of employment opportunities for local communities for many countries. It is recognised that the mining industry also could generate substantial export and tax earnings, stimulate development, contribute to the transfer of technologies and create industrial infrastructure (Georges, 2002).

The attitude to foreign investment in mining has changed dramatically over the past couple of decades, partly as a consequence of more favourable investment conditions in many countries, partly as a result of the structural transformation of the international mining industry and improved financing conditions (United Nations, 1992). In addition, the mechanisms for setting disputes have been made more acceptable to foreign investors. There has been significant liberalization in many countries. The last decade was a better period for a number of countries. Many countries have therefore given new priority to attracting foreign investors to mineral development. Clear investment policies and competitive fiscal regime have been put into place in the mineral environment. Although there are some countries that are facing major challenges to improve competition.

Reasons for governments wanting to attract FDI in mining industry are:

- FDI is seen as an important source of capital
- It is argued that FDI will lead to generate employment, and raise productivity,
- The transfer of technologies because foreign companies will bring technology from home country,
- The transfer of management skill to local managers,
- Enhance exports by increasing competitiveness,
- Contribute to the long-term economic development of the host countries.

2.3.2 Review of worldwide Investment in Mining

The global investment in mining during the period 1992-98 amounted to some US$ 18.934 billion, with 4.1 billion in 1997. In 1998, world investment accounted to some US$ 2.825 billion, corresponding to a decline of 31% over the year. The developed world accounted US$15.88 billion, with Canadian companies in the top place with US$ 4.955 billion corresponding to 26.2% of the total investment (Metals Economics Group, 1999).

"*In 1997, the largest Canadian mining companies (which invest more than US$ 3.0 million per year in mineral prospecting) invested some US$ 300 million in their own country, as well as US$ 800 million outside it. It should be noted that total Canadian investments in mining throughout the world amounted to US$ 1.1 billion, represented 28% of total global investment by Canadian companies***"** (Eduardo, p.4, 1999).

Australian companies rank in second place at US$ 4.695 billion or 24.8% of the total investment, followed by American companies at US$ 3.398 billion (17.9%), by European companies at US$ 2.832 million (15.0%)

during the same period. The developing world accounted US$ 3.054 billion or 16.1 % of the total investment over the same period: African companies were around US$ 1,715 billion (9.0%), followed by Latin American companies at US$ 837 million (4.4%), and Companies from Asia at US$ 500 million (2.7%), as shown on Table 2.3 .

The main African countries in which South African's companies are being invested are Ghana, Angola, Tanzania, Zimbabwe, the DRC, Namibia, Mozambique, Mali and Guinea (Mining Journal, 2004).

Table 2.3: World Foreign Investment in Mining (Large companies-1992-98)

US$ million

COUTRIES		**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**Total**	**%**
Developed	Canadian	385	427	524	610	1,037	1,166	806	4,955	26.2
	Australian	310	383	598	799	878	1,010	697	4,695	24.8
	American	308	361	417	534	603	696	479	3,398	17.9
	European	270	356	360	342	510	590	404	2,832	15.0
Developing	African	85	245	207	255	330	350	243	1,715	9.0
	Latin American	64	75	75	128	171	192	132	837	4.4
	Asia	42	64	68	85	83	96	64	502	2.7
Total		**1,464**	**1,911**	**2,249**	**2,753**	**3,632**	**4,100**	**2,825**	**18,934**	**100**

Source: Metals Economics Group data (1999).

2.3.3 Determinants for FDI flows

The unpredictability of FDI flows has generated a substantial research effort to identify their major determinants, but the lack of reliable data makes the research difficult (Mwilima, 1995**)**. Rather to consider industry-specific factors, this part of study is mainly concerned with host-country determinants as factors influencing the determination of the investment, including factors such as:

- Geological potential
- market potential
- Infrastructure
- security of tenure
- Incentives and operating conditions
- Privatization
- Economic and Political stability

This last point is an important issue for our study as the foreign company is confident of being able to operate profitably without undue risk to its capital and personnel. Failing to recognise and to identify this point can lead to disputes between investors and host country.

Survey carried out by the Metals Economics Group (1999) has rated Latin America as the world's most attractive investment destination for mineral exploration and mining with countries such as Chile, Argentina, Peru, Brazil and Bolivia accounted for 43.5% of all investments in this region. While less attractive Bolivia, Mexico, Venezuela and Panama may be added to this list, (Eduardo, 1999).

For the period 1992-98, US$ 4.955 billion, or 26.2% of global investment of 18.936 billion by largest mining companies in the world was directed towards Latin America. As a result, such investment grew at an average annual rate of around 24% between this period. Outside the region, South Africa, Indonesia and New Guinea also have attractive mining prospects, reported the Mining Journal (2000).

Eduardo commented that the large mining corporations continued to invest significant amounts in their home countries, such as Canada (13.2% of total), Australia (9.0%) and the United States (12.1%), particularly in copper, gold, zinc and nickel. The same was observed with regard to South Africa, and certain pacific South East Asia countries. Taken as a whole, Africa, Asia, Europe accounted for almost 30% of investment in mining during the period 1992-98.

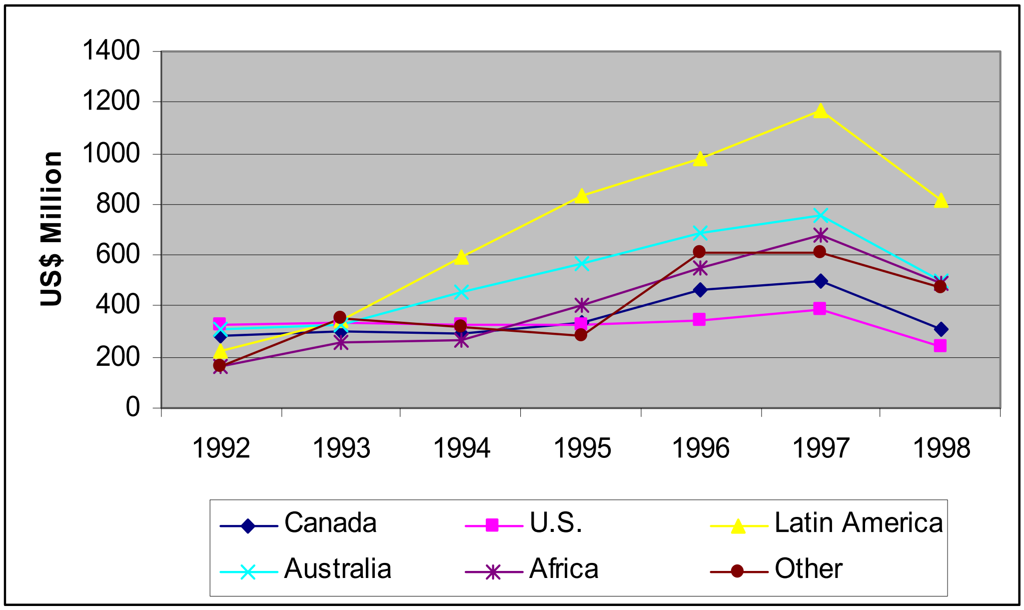

Figure 2. 4: Destination of Worldwide Investment in Mining (Large Sector Corporation- 1992-98)
Source: Metals Economics Group (1999)

2.3.4 Future flow of FDI in mining sector

Optimism prevails for medium term prospects for mining projects. "*For the period 1997-2007, there is evidence that around 20 copper extraction projects are under study/in the process of implementation, representing investments of approximately US$ 12 billion; gold prospecting projects account for investments of US$ 3.1 billion, non-ferrous metal projects for US$ 1.3 billion, and iron ore projects for US$ 1.9 billion*". (Eduardo, 1999, pp.10).

The panel of Experts from the Global Investment Prospects Assessment, UNCTAD carried out a survey in 2004. They find that the mining sector will grow differently by region during the following years. Overall, 83% of experts are optimistic about the prospects for FDI in Latin America and the Caribbean's region, followed by 56% in Central and Eastern Europe's region, 43% in Asia and the Pacific's region, 29% in Africa's region, 0% in the developed's region, as shown on Figure 2.6 (Passow, 2004). Globally, 35% of experts are more optimistic about mining sector.

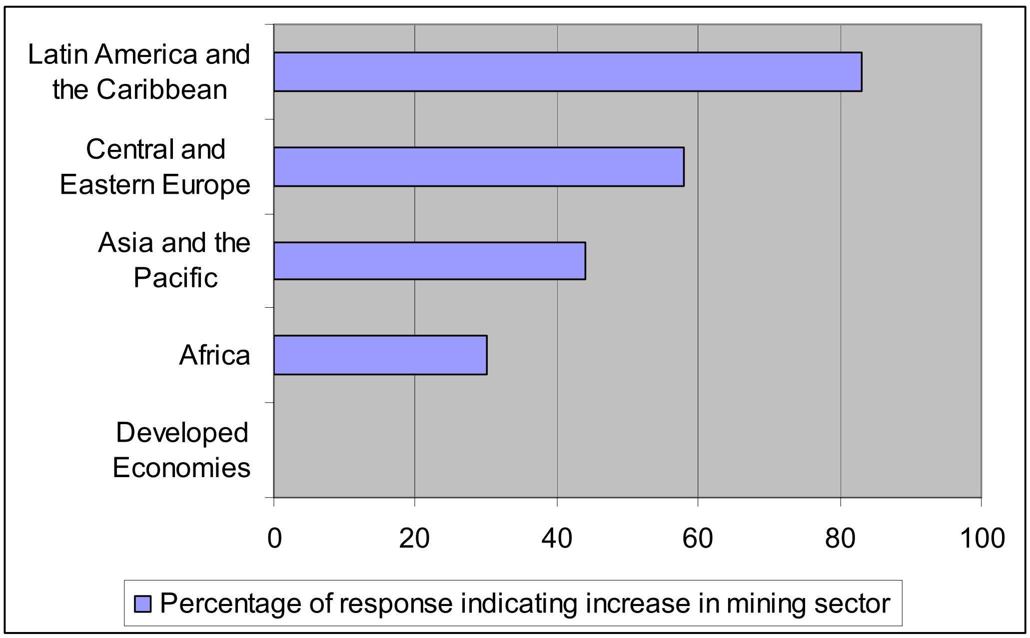

Figure 2. 5: The most attractive locations for FDI in Mining in 2004-2007, by Regions
Source: UNCTAD, 2004

2.4 SUMMARY OF THE IMPORTANT ISSUES

Despite the liberalization of many countries from Asia and Africa regions, opening of trade has not led to increased FDI inflows because of economic factors. Investors, for example, may find the investment environment risky or deficient.

The most common reason given as to why Africa does not attract much FDI in mining sector, for example, is the image that Africa is an unfavourable investment location. Africa is painted as a continent of civil unrest, starvation, deadly diseases, and economic disorder. According to UNCTAD, the bad publicity the African continent gets has played a big role in discouraging foreign investors from investing (UNCTAD, 1999).

Hudger Odenthal (2004) from UNCTAD noted that determinants for decisions to invest abroad are:

- The policy framework for FDI such as political and social stability, rules about treating operations of affiliates of foreign companies, and International FDI agreements.
- Economic determinants for FDI that seeks natural resources.
- Economic determinants which are relevant for FDI that seeks efficiency, such as cheaper costs for infrastructure or intermediate products.
- Business affiliation provisions such as investment incentives which are mostly considered to be important determinants but they are not, except in case of choice between two equally attractive locations.
- Privatization programmes have become a reason for attracting FDI.

Investors want to achieve the greatest return on investment for the minimum amount of risk after spending their capital. Returns equal total revenues less total costs, all adjusted for risk and other imponderables (Figure 2.7).

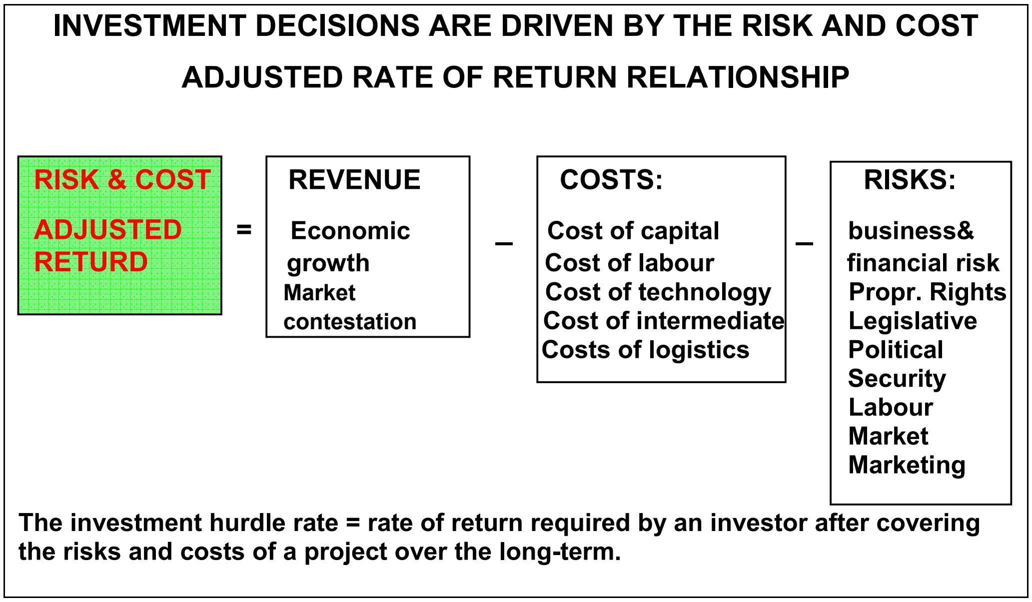

Figure 2. 6: Chamber of Mines
Source: Chamber of Mines, p.18, 2002

Foreign investors in mining have increased over the past several years. Reasons for these changes include more favourable investment conditions in many countries as well as the attitude to foreign mining investors has changed dramatically in most developing countries. According to an estimate, current annual expenditure by the mining on exploration, mergers/acquisitions and capital projects is about US$27.000 million (Mining Journal, 1999). An indication of the order of magnitude of the growth in mining-related FDI can be obtained from the fact that the FDI stock in mining from five major countries – Australia, Canada, Germany, Japan and the United States- increased at an annual average rate of 5-6 per cent from 1980 to 1990.

The reason for the relatively low rate of growth in some developing countries is likely to be the lack of a strong policy and regulatory regime, and political and economic stability.

Chapter 2 analysed the growth of FDI in mining industry over the last decade, partly as a consequence of more favourable investment conditions in many countries around the world, partly as result of the structural transformation of the international mining industry. Some developing countries with attractive endowment of mineral resources have created a conductive environment to attract FDI, but FDI flows are still on decline. This showed the contradiction to the complaint "the conductive environment and attractive endowment of mineral resources are critical for FDI".

Thus it can be concluded that is not conducive environment or attraction endowment of mineral resources, that attracts FDI, but that FDI decides on where to invest based on other criteria, commentated Mwilima from the conclusion of his work (Mwilima, 1995). One of the criteria, the most important in developing countries, is the political and social stability of the country. The next section is going to see the risks face by investors in developing countries.