KFW ECONOMIC RESEARCH

Emerging Markets Spotlight

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South Africa – still room for more FDI

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Economic situation

- Real growth
- Inflation
- Private consumption

Growth remains weak, inflation will pick up

Massive strikes and worsening energy supply problems seriously affected South Africa's economy in 2014. Consumption in particular decreased as a result of income losses in private households. Growth barely reached 1.5 %, and 2015 will not see much improvement either. Inflation is currently at a four-year low but will pick up in the course of the year when the effect of the declining oil price peters out and tax increases come into force.

Growth financing

- Current account balance
- Ability to access international bond market in local currency
- Budget deficit

Internationally established rand reduces financing risks

The current account deficit is too high, at almost 6 % of GDP. In addition, direct investment on balance is hardly helping to finance the deficit. This makes South Africa dependent on volatile, international portfolio capital. Despite its recent depreciation, the rand is an important asset, having established itself internationally as an investment currency. The government is planning consolidation measures to reduce the budget deficit.

Growth resources

- Investment ratio
- Quality of the education system
- Quality of the electricity supply

Structural problems reduce growth potential

In terms of investment to GDP, South Africa occupies a mid-table position. However, more needs to be done to rise to the challenges in the education system and energy sector. The National Development Plan adopted in 2013 indicates the right way forward. It would also be important to make progress in the fight against AIDS.

Economic relations with Germany

- German share in goods imports
- German share in goods exports
- FDI inflows from Germany

Germany is an important trading partner

In the fourth quarter of 2014, South Africa received more than 10 % of its imports from Germany and sold nearly 5 % of its goods in Germany. This places Germany among the top five for both imports and exports. South Africa is also a favoured destination for German direct investment, with more than EUR 600 million flowing into the country at the Cape in the fourth quarter.

Legend (for detailed explanation of methodology see p. 4)

very good | good | neutral | weak | very weak

Investment climate – assessment by our local experts

South Africa is a land of contrasts. Entrepreneurs can depend on a solid transport and communications infrastructure. Stable and independent public institutions provide a reliable business environment. However, growth prospects remain weak. This is also due to the worsening energy crisis and complex social conflicts. Nevertheless, the retail and energy sector should offer good prospects for foreign investors

Continued on p. 2

Focus: Still room for more FDI

UNCTAD has identified South Africa's high potential as a destination country for direct investment. It is in South Africa's interest to use this potential better than before, also in order to achieve a more stable financing mix for the high current account deficit. One important way to do this is to improve its competitiveness. The passing of the Protection and Promotion of Investment Bill should also be expedited in order to offer foreign direct investors a new, reliable legal framework after the country unilaterally terminated bilateral investment treaties.

Continued on p. 2

Investment climate – assessment by our local experts

In many areas, South Africa is far more advanced than other emerging economies. This includes its infrastructure, which is excellent particularly by African standards. A well-developed road and rail network and modern seaports and airports ensure that logistics within and along its borders remain manageable. Further investment in the upkeep and expansion of transport routes is planned. Mobile communication networks cover nearly 100 % of the national territory. Foreigners planning a long-term stay in the country also do not have to be concerned about education and healthcare services. Both are offered by private providers at European standards but they are expensive. Besides infrastructure, institutions are South Africa's second strength. The independent legal system offers a reliable framework for business activities. The financial sector is fully developed and draws on a long tradition of over 100 years. Furthermore, the independent central bank and banking supervisory authority ensure stability in the financial system.

Still, the energy crisis and socio-economic conflicts are affecting the economy. Power outages have become a part of daily life for South Africans. After years of failure to expand power plant capacities, South Africa no longer has the necessary reserves to cover peak demand or compensate for power plant outages. The situation is not expected to improve significantly before the next 3 to 5 years, when the gigantic power plants of Medupi and Kusile, which each have a capacity of 4800 MW, gradually go online. Moreover, foreign investors must be aware of South Africa's complex social fabric. High unemployment and the inadequate quality of the public education system contribute to distribution conflicts that manifest themselves in, among other things, growing corruption and massive strikes in the industrial sector. The recent outbreaks of violence towards African migrants are another expression of social tensions.

Despite meagre growth, there are opportunities for German companies. South Africa is not a classic emerging economy. Growth will remain moderate for the medium term and the large German enterprises are present in the country already. However, potential definitely exists for engineering and technology firms. The energy sector will continue to require significant funds in the future as well and the segments of renewable energies and energy conservation will continue to be growth markets. Although other countries in southern Africa have caught up, South Africa can still be useful as a stepping stone. This includes the retail sector, for example, where the regional presence of South African enterprises is strong. As is the case in other countries as well, entrepreneurial investors in South Africa are well advised to work with local partners who are locally well connected and familiar with local regulations. This also enables compliance with the legal requirements of Black Economic Empowerment.

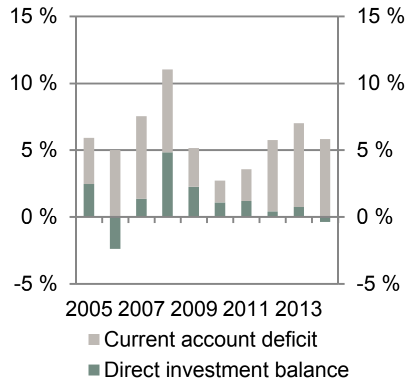
Based on an interview conducted with Michael Fischer (DEG South Africa Office Director) on 17 April 2015. ■

Focus: Still room for more FDI

South Africa has a pronounced current-account deficit and is dependent on foreign capital. The significant and persistent slowdown in emerging economies' growth rates has made international investors more cautious. South Africa is also affected and the exchange rate reflects that. Since early 2013, the rand has lost around 30 % against the US dollar. At the same time, the risk premium on South African government bonds has risen by 100 basis points.

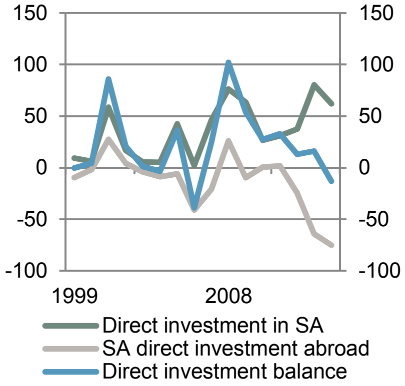
These developments illustrate the benefits of foreign direct investment as a stable and durable source of capital. However, the financing structure of South Africa's current account shows that the contribution of direct investment to cover the deficit is low (see Figure 1). What is striking is that the growth of inflows is unable to keep pace with the momentum of outflows, so that in 2014 the balance actually slipped into negative territory (see Figure 2).

Figure 1: Share of direct investment in financing the current account [in per cent of GDP]



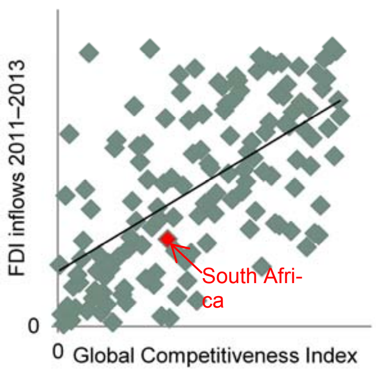
Source: South African Reserve Bank, IMF, own calculations

Figure 2: South Africa – direct investment [in ZAR billions]



Source: South African Reserve Bank

Figure 3: Direct investment vs. competitiveness [ranks]



Source: UNCTAD, World Economic Forum, own calculations.

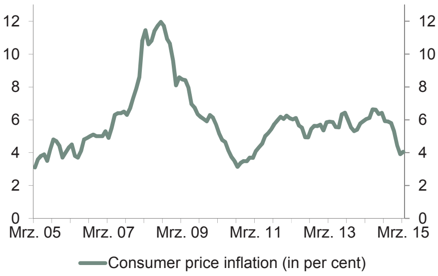
South African enterprises are increasingly investing abroad. Last year, ZAR 75 billion (USD 7 billion) left the country in the form of direct investment. According to reports by UNCTAD, South Africa is the most important source country of direct investment in Africa, with a share of nearly 50 %. As this is primarily taking the form of increasing investment activity in its neighbouring countries, South Africa is thus providing important impetus for regional economic integration. South African tele-communications, financial services, commerce and mining enterprises with cross-border operations can thus benefit from strong growth in the region.

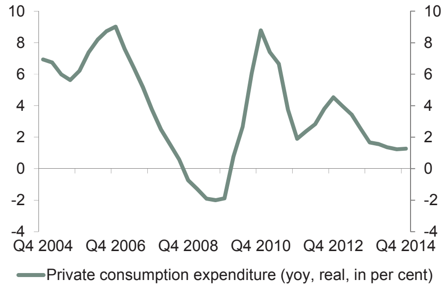
Great potential as a host country for direct investment is still untapped. Together with Nigeria and Mozambique, South Africa can hold its position as a top destination country for direct investment in Sub-Saharan Africa and a high volume of foreign capital has been invested in infrastructure. Nevertheless, this cannot hide the fact that the performance is unsatisfactory. First, only ZAR 62 billion in direct investment reached South Africa in 2014, less than in 2009. Second, measured by the 1.5 % share of direct investment flowing into gross domestic product (mean value of the years 2011–2013), South Africa ranks only 159th out of 206 countries. This result contrasts sharply with the UNCTAD FDI Potential Index, which was last published in 2012. It analysed the attractiveness of 176 countries in the categories of sales market, labour costs and quality, infrastructure and natural resources. Here, South Africa ranked 36th, placing it among the best 25 %.

The key to more direct investment lies in improving competitiveness. Countries that rank high in the Global Competitiveness Index of the World Economic Forum are also able to attract (statistically significant) more direct investment (see Figure 3). In the past years, South Africa has lost significant ground and slipped from rank 35 (2007) to 56 (2015). The public education and health system, public safety and employee/employer relations are in particular need of improvement. In addition, the legislative procedure for enacting the Protection and Promotion of Investment Bill, which has been underway since 2013, needs to be finalised. The purpose of the new act is to replace bilateral investment treaties. South Africa began to cancel the renewal of existing treaties already in autumn of 2012 and this includes the one with Germany. The main reasons for this included uneasiness about international arbitration tribunals, combined with the desire to have the option of applying national law to foreign investments. As South Africa has a well-functioning legal system that should guarantee the protection of property, with limitations in the agricultural sector, the change in regime should not be a cause for major concern to investors. Never-theless, the uncertainty that may have been caused by the unilateral termination of the bilateral investment treaties needs to be removed.

Overview of figures

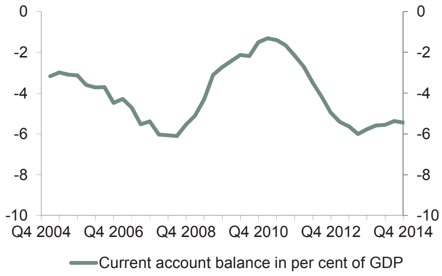
Economic situation

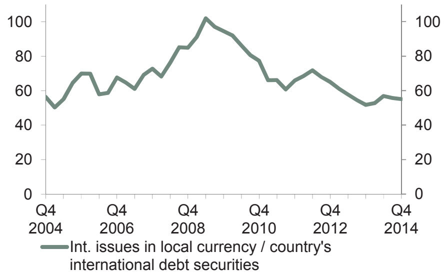


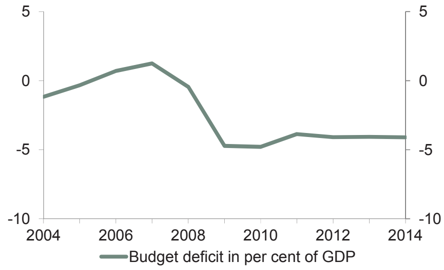


Source: Datastream, OECD, own calculations.

Growth financing

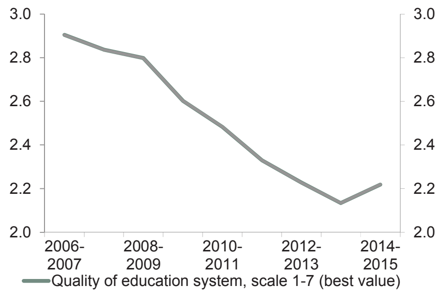


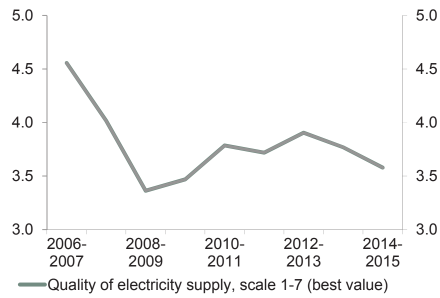




Source: Datastream, SARB, IWF, BIS, own calculations.

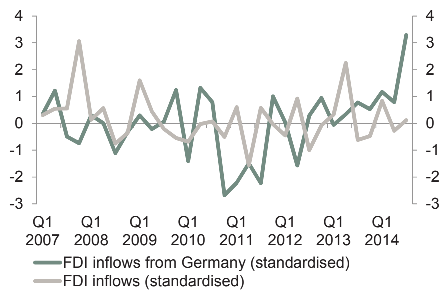
Growth ressources





Source: Datastream, OECD, WEF, own calculations.

Economic relations to Germany



Source: Deutsche Bundesbank, Datastream, IWF, OECD, own calculations.

Methodology

In the Emerging Markets Spotlight, a selected country is analysed based on various macroeconomic indicators. These indicators are grouped into four categories: economic situation, growth financing, growth resources and economic relations with Germany.

The indicators are used to compare the country's situation with its peers. The group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The comparison is based on a quintile ranking in five categories, which are labelled in different colours:

Quintile 1
Quintile 2
Quintile 3
Quintile 4
Quintile 5

The country is assigned to a quintile of the country group for each indicator analysed. The best quintile may be different for each indicator. For example, higher growth rates are better, so here the upper quintile is coloured dark green, but higher debt rates are a negative factor, so here the upper quintile is coloured dark red.

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