

Drivers of Regional Integration:

Value Chains, Investment and
New Forms of Co-operation



© Economic Policy Forum (EPF) and South African Institute of International Affairs (SAIIA)

December 2015

Design, Concept Layout & Typesetting

Gerry Guy Design

Tel: +27 83 519 3526

Email: gerryguy@gmail.com

Economic Policy Forum

Köthener Str. 2, 10963 Berlin

Phone +49-30-338424-356

www.economic-policy-forum.org

secretariat@economic-policy-forum.org

SAIIA

Jan Smuts House, East Campus, University of the Witwatersrand

Braamfontein 2017,

Johannesburg,

South Africa

Tel: +27 (011) 339-2021

Email: info@saiia.org.za

www.saiia.org.za

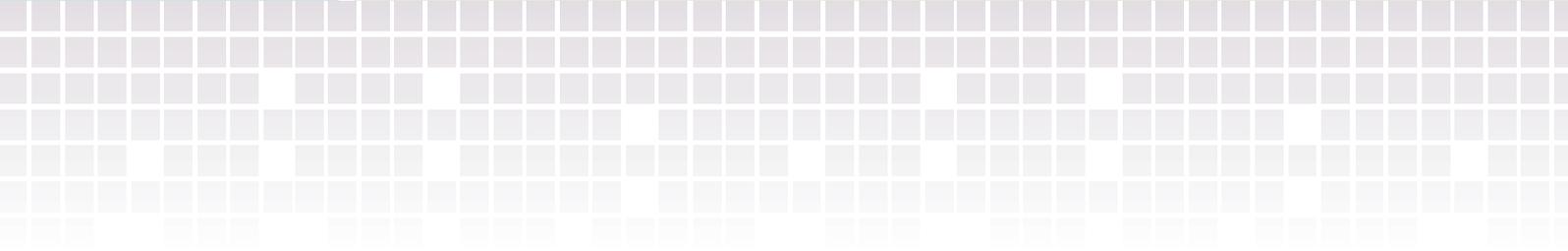


Acknowledgements

The Economic Policy Forum Emerging Economies Think Tank Alliance for High Quality Growth (EPF) is a global network of the world's leading political economy 'think tanks' from emerging and industrial economies. EPF facilitates dialogue between them on economic policy challenges of emerging economies and attempts to promote better-informed policy making. Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), the German agency for international co-operation, initiated EPF and acts as its co-ordinating secretariat.

This collection of papers is a combined initiative of EPF member think tanks and is the result of two round-table discussions under the Regional Integration research stream. The first event, 'Drivers of Regional Integration', took place in Cape Town, 25-27 November 2014; the second, 'Regional Integration and Regional Value Chains' was held in Moscow, 21 May 2015.

The project group at SAIIA gratefully acknowledges the support and commitment of the GIZ Economic Policy Forum team. We thank all authors and their respective institutions for their contributions; in addition the project team expresses its appreciation to Alexandra Begg for steering this volume through publication.





Contents

Contributors	v
Abbreviations & Acronyms	viii
Introduction:	01
Regional Integration and Global Value Chains: Tensions and Convergences Renato Flores	
Paper 1:	09
Trade and Production Integration in South America: A Role for Brazil? <i>Ivan Tiago Machado Oliveira & Flavio Lyrio Carneiro</i>	
<p>This paper addresses two related questions. The first is whether or not there is a process of regional production-sharing and creation of regional value chains taking place in South America that is similar to those in other regions. The second question is whether or not Brazil could become the hub country that leads the region towards productive integration.</p>	
Paper 2:	29
Energy Industries as Drivers of Regional Integration: The Case of SADC <i>Shingirirai Mutanga & Thokozani Simelane</i>	
<p>Access to energy remains a challenge for most SADC countries. The paper maps SADC's electricity access, role players, energy technologies and technological investment within the bounds of its industrial policy; and suggests ways in which the electricity generation industry might support efforts toward regional integration.</p>	

Paper 3:

45

Regional Dimension of Foreign Direct Investment in Russia

Igor Makarov & Alexandra Morozkina

Over the past decade Russia has become one of the key actors in the global foreign direct investment market. This paper explores the three main regional aspects of Russia-related investment flows: inflows from and outflows to European countries; outflows to the countries of the Eurasian Economic Union and inflows from the Asia-Pacific region.

Paper 4:

73

Diversion and Agglomeration: Regional Dimensions of South Africa's Investment Promotion Policies

Christopher Wood

South African investment policy has potential both as a catalyst for investment flows into Southern Africa and to divert investment from regional partners. The paper investigates this duality and explores trends in South African investment, the three pillars of South Africa's investment policy, and the regional impact of those policies.

Paper 5:

107

The Challenges of Sustaining Regional Integration in South America: The Case of Mercosur

Matshaba Mothiane

This paper explores the tensions and sustainability of the South American integration project, focusing on the future of Mercosur. The first part reviews the history of integration in South America; the second examines some of the challenges facing Mercosur; the third offers a few case studies on how these challenges have played out and the fourth presents some conclusions.



Contributors

Renato Galvão Flôres Junior is a professor in the Post-graduate School of Economics at the Getúlio Vargas Foundation in Rio de Janeiro, and a former research director and international academic relations co-ordinator for the foundation. He has acted as consultant or adviser to various leading national and international organisations, including WTO and Unesco, and is the author of many books, papers and other material on issues of special interest primarily in the field of development economics.

Ivan Oliveira is co-ordinator of international economic studies at the Institute of Applied Economic Research, Brasília. In 2010 he was a visiting research fellow in the Globalisation and Development Strategies Division at the UN Conference on Trade and Development (UNCTAD). He holds PhD and MSc degrees in Management (Public Policy) from the Federal University of Bahia (Brazil), an MPhil in Latin American Studies from Complutense University of Madrid and a BSc (Econ) from the Federal University of Bahia.

Flavio Carneiro is a researcher at the Directorate of International Studies at the Institute of Applied Economic Research. He holds an MSc (Econ) from the University of Brasília and a BSc (Econ) from the Federal University of Santa Catarina and is a former foreign trade analyst at the Secretariat of Foreign Trade in the Brazilian Ministry of Development, Industry and Foreign Trade. His current research centres on international economics, international trade, and trade policy analysis.

Shingirirai Mutanga is a researcher in applied geographical information systems, remote sensing and systems analysis. He is a research specialist under the Science and Technology programme of the Africa Institute of South Africa and a PhD candidate at the University of Pretoria Industrial Engineering Department. He has an MSc in Geo-Information Science and Earth Observation for environmental modelling and management from a consortium of ITC (Netherlands), Lund (Sweden), Southampton and Warsaw universities and an Honours degree in Geography and Environmental Science from Midlands University, Zimbabwe.

Thokozani Simelane is a chief research specialist: science and technology for the Africa Institute of South Africa. He holds a PhD from Nelson Mandela Metropolitan University and is finalising a doctorate on Industrial Engineering through the Durban University of Technology. His research interests relate to complex system analysis; biodiversity and environmental management; science and technology; industrial engineering, intellectual property development and management; renewable energy and standardisation.

Igor Makarov is an associate professor at the Department of World Economy at Moscow's National Research University – Higher School of Economics (HSE), a research fellow at its Center for Comprehensive European and International Studies and academic supervisor of its bachelor level World Economy education programme. He is a PhD in Economics. His research interests cover international economics, environmental economics and Asia-Russia relations.

Alexandra Morozkina is one of the heads of the Structural Reforms Division at the Economic Expert Group and a PhD student at the HSE. Her current research focuses on international finance, in particular BRICS countries' investment and financing issues. She holds an MA in Financial Economics from Moscow State University.

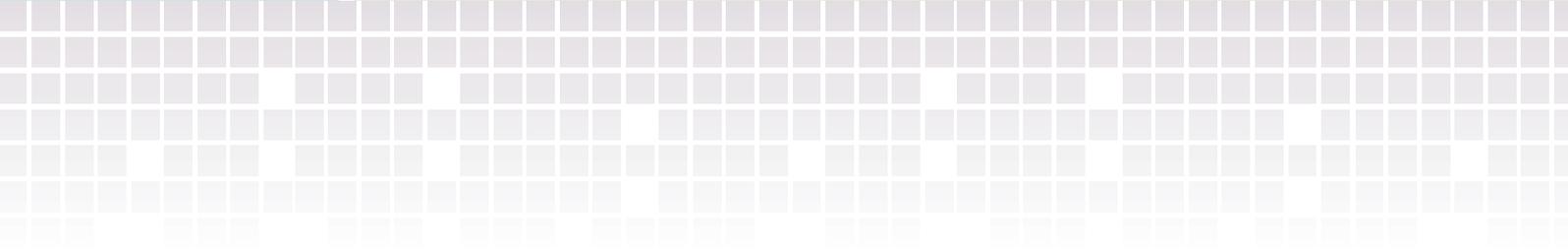
Christopher Wood is a researcher in Economic Diplomacy at SAIIA. He holds an MA in Development Studies from the University of the Witwatersrand and a Bachelor of Social Science in Economics and Political Science from the University of KwaZulu-Natal. His research interests include global economic governance (with particular focus on the BRICS Development Bank), trade and investment and finance (particularly the Basel III Accord).

Matshaba Mthiane is a junior researcher in the BRICS Research Centre at the Human Sciences Research Council (HSRC). Before joining the HSRC she was based at the BRICS Policy Centre in Rio de Janeiro as a research fellow in the SAIIA Economic Diplomacy Programme. She is an MA in Political Science from the University of the Witwatersrand.

Abbreviations & Acronyms

APR	Asia–Pacific region
BEE	black economic empowerment (South Africa)
BIT	bilateral investment treaty
BLNS	Botswana, Lesotho, Namibia and Swaziland
CNT	National Confederation of Transport
dti	Department of Trade and Industry (South Africa)
EEU	Eurasian Economic Union
EAEC	Eurasian Economic Community
FDI	foreign direct investment
FIP	Financial Services Investment Protocol (SADC)
GDP	gross domestic product
GVC	global value chain
IMEMO	Institute of World Economy and International Relations of the Russian Academy of Science
IORA	Indian Ocean Rim Association
Irena	International Renewable Energy Agency
ISDS	Investor–State Dispute Settlement
ITAC	International Trade Administration Commission (South Africa)
LAFTA	Latin American Free Trade Association

LAIA	Latin American Integration Association
Mercosur	Southern Common Market (Mercado Común del Sur)
MIDP	Motor Industry Development Programme (South Africa)
Model BIT	Model Bilateral Investment Treaty (SADC)
MoU	Memorandum of Understanding
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development
PICE	Programme for Economic Integration and Co-operation (Programa de Integración y Cooperación Económica Argentina–Brasil)
RCIF	Russia–China Investment Fund
RDIF	Russian Direct Investment Fund
RISDP	Regional Indicative Strategic Development Plan
RVC	Regional value chain
SAPP	Southern Africa Power Pool
SEZ	special economic zone
TFTA	Tripartite Free Trade Area (Africa)
TiVA	OECD-WTO Trade in Value-Added Project
TPP	Trans-Pacific Partnership
TTIP	Transatlantic Trade and Investment Partnership
Unasur	Union of South American Nations (Unión de Naciones Suramericanas)
UNCTAD	UN Conference on Trade and Development





Renato G. Flôres Jr.

Introduction

An adaption of the keynote address presented at the EPF Regional Integration and Regional Value Chains Seminar, Moscow, May 2015.

In European medieval folklore, the unicorn is said to be such a wonderful and unique creature that, if by chance appearing, it risks disregard, given how unusual it looks. This false paradox can be applied to many instances in real life, and – with more propriety – to concepts and theoretical constructs derived from the so-called real facts.

The case for regional integrations provides a good example.

After a linear, and very successful evolution during most of the past century, the concept somewhat stalled in the last years of the same century. A major reason for this was a set of problems that slowly emerged in the flagship project of the idea: the European Union. The new century, with more complex and, at the same time, more elusive geopolitical geometries, added perplexity to and then a void in the source for innovative thoughts on regional integrations.

As usual, many groups continued to blindly pursue the classical path, as if nothing had happened, and the many questions challenging the procedures, methods and economic analyses so useful and successful until then, would eventually vanish into thin air, thanks to their perseverance and faith in the traditional approaches.

But the unicorn was around already. As warned, very few had noticed it. More than a thought-not-regional grouping like the BRICS, or the interesting question about the limits of an integration experiment, whose trajectory becomes highly non-linear the closer it gets to a fusion of states, the unicorn resided in the ways and means that a changed world order, almost dominated – for good and evil – by the liberal credo, required making integration come true.

It is hard to avoid the global commons cliché, but cyclical climate alterations, pandemic threats – together with more pedestrian no-boundaries health problems – distributed and encompassing energy systems, immaterial though not-less-worrying or at least far-reaching cyber issues (beyond, though including, security) and the curious divide between the food, energy and raw materials providers on one side and technology and high-level innovation creators in the other, demand new forms of association, new ways to apprehend the regional dimension and, most naturally, more than a revamping, new foundations for the ‘regional integration meme’.

But there was something else. An elephant in the room that, though slowly and peacefully treading since the mid-eighties, nobody had paid due attention to: the production fragmentation process and the connected method of global value chains (GVCs) creation.

Eventually, GVCs themselves became so hyped that they invaded all narratives, oftentimes with sheer neglect to common sense. Politicians, top civil servants and officers, fancy entrepreneurs, international bureaucrats, media pundits, small businesses, and both desperate and conscientious housewives started to talk about value-added creation, splintering of tasks and shrewd outsourcing. Not bad, perhaps; debatably useful though.

Fragmentation of industrial processes began in the car industry. Progressively – combining the increasing sophistication of the service sector, sharper and more detailed design and planning techniques, and the myriad of possibilities opened by the Information Technology and Communications galaxy – it spread to other sectors and, more importantly, it abandoned proximity. Outsourcing, in principle, could take place in any location of the planet – hopefully the ones that, transportation included, would offer the lowest cost – assembling hubs being equally defined by cost and convenience, something that would change according to the nature of the final good and its destination markets.

All this is an old song. However, implicit in the lyrics is the destruction of the black box to which economics associated the ‘production function’. Actually, the flows of parts, components and semi-manufactured alongside that of final goods jeopardised the meaning of classical trade statistics, classical production analyses and classical comparative advantages accounting. If

a shift takes place from the final good to its several parts, one's former competitiveness may disappear; he (she) may even be left out in the cold, presenting no business attraction to any of the parts of the decomposition.

Also, and far from least, it sabotaged one of the pillars of the old regional integrations concept: the creation of a joint productive space that would, profitably and sensibly, interact with the outside, by this meant, among other things, other production clusters that would trade with the newly created one. Never more, said the fragmentation forces. Trade creation and diversion, the warhorses of the economic analysis of any proposed integration, became if not much less relevant, vapid figures whose correct calculation presented novel, greater difficulties.

Was then this last unicorn, much more than those previously cited, a disruptive force, to end up with the classical concept? How can something that to a great extent abolishes contiguity contribute to the integration of the contiguous? And further, beyond disregarding the logic of the regional, doesn't it also leave aside that of integration, as outsourcing becomes more volatile and my next supplier can be an antipode of the previous one?

Answers are neither crystal clear nor point in the same direction.

To build up an argument to solve the above riddles, we must go back and look at the question from above; while at the same time pondering over what would amount to modern regional integration.

Going back, we discover that the most successful recent experience of GVCs creation took place in China, triggered by a heavy and well planned – both from the side of the receiver and from that of the outsourcer – movement abroad of tasks, firms and technology from Japan and South Korea. The two economies discarded lower manufacturing stages to the unbeatable cost structure then prevailing in China. For the same reasons, the US, and later the EU, joined in, mostly by transferring plants to China. As the process evolved, China started to shed the same lower value-added tasks to South-Eastern Asian countries, while domestically ascending in the interior of the chains.

This dynamics continues to evolve, and it brings back, though in a partial, incomplete mode, the regional dimension. The entrance of the US – a kind of world economic attractor – was unavoidable, but forgetting it for a moment, the whole phenomenon was perhaps unthinkable outside the geographical realm composed by South-East Asia, Japan and South Korea: all around China. If, for sure, this is not the only explanation, it undoubtedly played – and still plays – a major role in the process.

Looking from above, we perceive that fractures existed already in the classical landscape of integration. Wider spaces, not to say global problems, demand more uniform regulations, creating a never-ending tension between the urge for universal norms and the requirements of local groups, be they backed by idiosyncrasies, tradition or really distinctive features. The history of the travails of the European project, definitely since the Europe 92 initiative by M. Jacques Delors, is perhaps the best example of this. In the same vein, matching the different parts and components, the several pieces that make up the final good as a harmonious and functioning form requires common standards and protocols that, once agreed, should be adopted by all participating or willing to in the chain.

As for the regional integration concept, we rather stress three important points that must add to the new visions, whatever they might be.

First, (geo)political motivations aside, the number and variety of driving forces for the integration has significantly increased. More specifically, the standard trade imperative does not need any more to be the key motive for the process. Secondly, the linear sequence epitomised by the European experiment has been blown out; the logical chain – composed of a free trade agreement, then a customs union, next a common market for goods, services, labour and capital, and then very likely a common currency – is over. Or rather, it is one among several different sequences of steps conducive to integration. Thirdly, the classical dilemma between sovereignty and supra-nationality, the latter turned concrete in specific institutions and rules for the juridical persona of the integration, has proved insoluble. As the ideal midpoint is a fiction, the nowadays trend reverts the one predominant in the previous century, greater care being demanded at any further attempt of pushing for more supra-nationality.

The points above, together with the two other looks, allow us to identify a couple of statements that may help to build up our answers:

Though global, value-chains creation can benefit from a regional dimension. This can become even more attractive in the case of transport costs, given their high energy consuming and polluting character become relatively more expensive.

The GVCs process is one of the triggers of the move for international standards and norms in all productive sectors. Though highly technical at its core, this has far reaching consequences, configuring a supra-nationality if not similar to the heavy formats found in the EU, probably more encompassing and, in some cases, more disturbing. No wonder apostles of a new world of seamless GVCs preach for the creation of a 'new' WTO, entirely dedicated to the formulation of these global rules and norms.

Taking these statements into account, how can the GVCs phenomenon interact with the new formats for regional integrations?

To begin with, it makes sense to develop, in a regional perspective, value chains. The region would usually have to be of commensurate size, like South-East Asia, the South American continent or the Southern part of Sub-Saharan Africa. The pursuit should not be too encompassing at first, being wiser to identify sectors and abilities where there would be scope for joint, or integrated production ventures. It shouldn't be closed in itself: if certain inputs or parts are already better supplied elsewhere, in principle they should not be duplicated inside the region, but procured outside to compose with other, locally produced, parts and components, or even a final assemblage.

This is far from easy, but not impossible.

The difficulties inherent to such an effort remind us that GVCs are no panacea, and many times they might not be the optimal solution. Notwithstanding, there are activities in developing and emerging economies where one can find room for innovative pursuits. The whole agricultural sector is the classical example, though other niches in manufacturing, like that of renewable energy, can also qualify as candidates. Actually, the list of possibilities is more restricted by imagination than by technological constraints.

The interesting spill-over of these efforts is that they would, with great probability, oblige the countries involved to fine tune their trade policies. Be it in the tariff structure, or in a re-orientation of partners, markets and the corresponding logistics, or on how to better exploit existing trade facilities and association mechanisms. Nevertheless, this would always be within a very clear focus, and not lost in the costly and endless negotiations for a free trade area or a customs union, for instance.

At another level, the deepening of shared, complementary production, naturally also requires the perfecting and harmonisation of the corresponding standards and norms. In this way, a bottom up, meaningful pressure is created for closer, practice-oriented interactions favouring the evolution of a regional view on the guidelines for the manufactures and services procedures akin to the chosen sector.

In order that all this does not become a fairy tale, keeping an open view is mandatory, be it because either many standards will unavoidably be dictated from outside, or the region itself may choose to adopt one of the existing alternatives worldwide, instead of sticking to a local one.

A standards and norms war is already taking place, and one of the purposes of a few mega, trans-oceanic agreements that have been put on the table, disguised as trade agreements but really, deeply geopolitical projects, is to advance the process of universal standards conforming to those of the developed economies. Instead of qualifying how good or bad this trend is, the right way to deal with it is to prepare oneself to have better judgement and positioning in the unavoidable choice of rules and parameters that sooner or later, in nearly all aspects of human activities, one will be forced to choose. Regional value chains can help in this strategy.

A third effect relates to technology. The mantra of technology transfer is well-known and its concrete results highly debatable. Within the realm of regional production integration, technology exchanges make more sense, and can lead to joint ventures or transfers that will enhance the global competitiveness of the chain.

The fact that different processes in different units will be conducted in the 'common space' may, together with the deepening of technological relations, pose questions of labour mobility, forcing, once again, common understandings on this always delicate issue.

It seems to be clear at this point that the establishment of a global value chain heavily based in a given region will provide plenty of motives for raising – always in a targeted mode, with neatly identified results – several issues important in a regional integration context, be it under a classical or more innovative fashion. At the same time, keeping an open external posture will create new connections for the region with the outside, again through specific trade, investment and technology exchanges channels, not dependent of higher or elaborate political manoeuvres.

Unicorns are not only marvellous, but complex creatures as well. Historical and dynamic perspectives must be added to the above. In a world of failed, striving or partially successful regional integrations, how does the above fits with reality?

For established projects, like the EU, there is room for fresher, and especially less protectionist stances in the theme. In others, like Mercosul and many of those prevailing in Africa, eyes should be wider open, and the possibilities of joining forces with neighbours beyond the original members should be seriously considered.

Countries struggling to reposition themselves in the world distribution of labour could use it as a strategy for helping such an effort and finding new partners.

Again, it must be stressed that the combination of the two concepts does not produce a miraculous elixir. Nations, economic spaces and firms are not kindly invited to be part of a

GVCs unless they present really attractive characteristics, or make sense within the logic of the chain, they'll be carefully kept outside the game. Competition, as always in the capitalist world, is the buzz word.

Room must be found, insertions must be hardly fought for, and significant doses of patience, persistence and innovation are required for what amounts to the likely more profitable strategy: the creation of new chains.

The dynamic perspective brings new issues. Coming back to the Chinese case, China is undoubtedly the hub of the region where the phenomenon took place. No matter how technologically (more) advanced Japan and South Korea are, without the pivot role of China, a significantly different process would develop itself.

In any given region where similar endeavours would take place, in all probability a hub will naturally emerge, sometimes from the very start. Tensions may then ensue, depending on how this leadership will be recognised and accepted.

Finally, it is impossible to talk about dynamics without referring to the future, even if in a short term horizon. The question then recurs: will the alliance here proposed actually be a contributor to an enduring reshaping of regional integration or, in a way or other, will it eventually lead to their disintegration?

The full answer requires the introduction of the (geo)political dimension, which has been deliberately absent of the discussion. How the political forces now at stake will evolve and interact with the international patterns of dependence and domination is a tremendously vast subject, but two rather schematic scenarios can be outlined, to complement the reasoning previously developed.

In a 'business as usual' situation, where the US-China opposition will be roughly as it nowadays presents itself, with a 'Western bloc' defined approximately as today, two interactions seem feasible. In the global exchanges side, the Asian, China-centred mesh of GVCs will continue to gain momentum, strengthening their mutual dependencies, expanding their complementarities, while keeping their relations with the Western GVCs. The relative contribution of the latter in the Asian output will however decrease. In the West, convergence of all galaxies of chains towards a US hub will coexist with a struggle for autonomy from off-centre GVCs, notably in South America and Africa. Within this reality, the fight for universal, i.e. developed economies standards will set the tune, the TTIP (Transatlantic Trade and Investment Partnership) standing as the symbolic, highly representative attempt in this line.

Curiously, the regional integrations cum GVCs recipe may successfully strive amidst this complex combination of tensions.

The second stylised scenario admits an increasing state of flux, with economic globalisation forces, together with the growth of regional poles of power, blurring the roughly defined West/Asia divide of the previous one. Multiple interactions occur all around the planet; still two main US and Chinese hubs will be more dependent on the rest. A huge mesh of regional and global GVCs, interacting in a variety of ways, will be formed; competition among standards will be more unbridled, efficiency and sometimes urgently practical reasons being the motors for sectoral unifying efforts.

A weakening of the sheer idea of regional integrations will prevail though something of the sort may remain around certain local poles. Nevertheless a decoupling of them from the GVC concept – at least as an integrating tool – will be very likely.

The future telling exercise cannot be complete without a glimpse at uncontrollable and often unexpected technology developments.

Condensing massive considerations, the essence of this dimension may be summarised in two indicators. GVCs bear a key interaction with the availability and cost of energy, given the compression of space they operate. Roughly, the costlier energy becomes, the less spread the chain will be. At the side of this, several innovations, the 3D printer being one among a dozen ones, trigger a compactification movement, allowing to shed away links formerly key to one or several GVCs. A strong trend towards their disappearance or rather the creation of a new production Gestalt in which GVCs would side with sophisticated local and nearly autonomous productions may take place. In this scenario, value added would travel from the chain to the emerging (high-level working) class of algorithms designers.

The reader can combine the technological with the geopolitical dimensions, in a forecasting Lego that would suit his tastes and beliefs. In most of them, waning is the word for the integration concept, transformation that for GVCs.

In the following pages, different, more concrete and specific aspects of this debate will be addressed. A higher level view is however necessary, to frame any current issue or promising development into a bigger, ever changing picture.

As stated in the beginning, the worst mistake in this area is not the adoption of a perhaps unfortunate policy, but the lack of awareness that new forms, shapes and visions have already changed the reality in which the policy had been conceived.



Trade and Production Integration in South America:

A Role for Brazil?

EXECUTIVE SUMMARY

This paper addresses two related questions. The first is whether or not there is a process of regional production-sharing and creation of regional value chains (RVCs) taking place in South America that is similar to those in other regions. There is evidence that the answer would be negative: production-sharing in South America seems less prevalent than elsewhere and the region lacks a clear 'hub country' – such as Germany in the EU or the US in the North American Free Trade Agreement (NAFTA) – capable of leading this process. The second question is whether or not Brazil could become that hub country and lead the region towards productive integration. A number of obstacles are identified that may hinder Brazil's ability to perform this role. They range from the historically closed nature and vertical integration bias of its economy to the absence of adequate infrastructure, both physical (especially trade- and transport-related) and institutional (ranging from inefficient customs procedures and excessive bureaucracy to the lack of trade arrangements, and their shallowness).

Production-sharing in RVCs creates a demand for an integrated economic space so that cross-border production processes can function without friction. South America is still far from arriving at such a position; there are a number of obstacles that can – and do – cause frictions and interruptions. A precondition for leadership in such a process of integration would be that

Brazil effectively tackles these obstacles to its own efficient functioning. Among the necessary conditions for that task are, for example, developing more and better-quality transport and trade-related infrastructure; improving customs efficiency and reducing bureaucracy and red tape at border procedures; and deepening trade and economic integration arrangements in order to enhance regulatory coherence and harmonisation of trade- and production-related rules and standards, especially with Brazil's South American neighbours.

INTRODUCTION

Over the past few years there has been a proliferation of studies stressing the growing trend toward global and regional production-sharing and its contribution to enhancing regional competitiveness and developing productive capacities, especially in developing countries. This phenomenon, often referred to as 'international production fragmentation', increasingly is assuming a central role in the development of global production; especially of manufactures, in which the production of goods (and often services) increasingly overcomes national frontiers and is carried out through GVCs; that is, with the participation of a number of companies located in several countries, rather than one company in a single country.

An important conclusion of this literature is that the process of international production fragmentation is not spread evenly across the globe; on the contrary, there is a rather clear pattern of regional concentration in which the main production networks are centred in North America, Europe and East and South-East Asia, leaving many countries in Africa and South America, for example, in large part out of the process.¹ Similarly, Baldwin² points out that supply-chain trade is regionalised and geographically distributed in a hub-and-spoke pattern around the 'four manufacturing giants [Germany, US, China and Japan]', creating regional production blocs or 'regional factories'.

Because much of the world's production dynamism, especially in manufacturing industries, arises from those networks, staying out of this process may jeopardise the developmental prospects of regions that lie outside them. South America is an example: as the commodity boom of the past few years that benefited the region fades away, the challenge of developing productive capabilities becomes even more urgent.

Against this background this paper tries to identify the possibilities – and obstacles – that South American countries face in the task of developing an integration framework that could spur production-sharing and value-chain formation across the region. It focuses especially

1 Estevevadeordal A, Blyde J & K Suominen. *Are global value chains really global? Policies to accelerate countries' access to international production networks*. Washington: ICTSD (International Centre for Trade and Sustainable Development) & IDB (Inter-American Development Bank), 2013.

2 Baldwin R, 'Global Governance of Supply-Chain Trade', CEPR (Centre for Economic Policy Research) Policy Insight, 64. London: CEPR, 2012.

on Brazil which, as the region's largest country endowed with a relatively developed and diversified productive structure, could be regarded as a possible regional hub.

The paper is divided into five sections. The second section discusses whether or not there is a process of production-sharing developing in South America. The third analyses the role of Brazil as a possible regional hub and the fourth presents some obstacles that might lie in the way of this process, with a special focus on inadequate infrastructure. The fifth and final section offers some concluding remarks.

PRODUCTION-SHARING IN SOUTH AMERICA

The first – and central – question underlying this study is whether or not it is possible to talk about a process of regional production-sharing in South America similar to those in, for example, East Asia, North America or Europe. Another way of putting this question is to ask whether or not there are RVCs established or in the course of formation that connect South American countries. Evidently the answer is less than straightforward, especially using aggregate or sectoral data. A number of articles try to circumvent this limitation by analysing very specific sectors using case studies;³ the downside to this approach is that it misses the 'big picture' – that is, the degree to which these individual processes are present throughout the regional production environment.

Answering the question in a definitive way, therefore, goes beyond the scope of this short (or indeed any single) paper; instead, it is necessary to try to gather a number of pieces of information which, when analysed together, build a relatively clear picture that suggests that the answer to the question is mostly negative. Among South American countries regional production-sharing is rare, or at least less intense than in regions such as East and South-East Asia, North America or Europe.

The first indicator that can be used to proxy the existence of production-sharing is the relative intensity of production goods (ie, intermediate and capital goods). The rationale for this is straightforward: a region with intense production fragmentation should show intense trade among its partners in goods used in production such as semi-finished inputs or machinery, thus reflecting the shared nature of production processes.

Collating and analysing the data, however, are less straightforward. This is not only because identification of what constitutes intermediate or capital goods is not a simple process, given normal trade data classification protocols, but also because the information is not

³ See, for example, Hernández, R, Martínez-Piva M & N Mulder (eds), *Global Value Chains and World Trade: Prospects and Challenges for Latin America*. Santiago: ECLAC (Economic Commission for Latin America and the Caribbean), 2014.

shown in value-added terms, which tends to over-estimate the trade value of downstream goods.⁴ Such information therefore should be taken with a grain of salt.

Tables 1–4 show the relative intensity of Brazil’s intermediates and capital goods trade⁵ with its South American partners, and compare it with examples in other regions (Chinese trade with a sample of Asian partners, US trade with NAFTA and German trade with a sample of European countries).

The patterns are not very clear, although it is noticeable that Brazilian trade in production goods with regional partners represents, on average, a significantly smaller share of total imports and exports than that observed in China’s trade with its neighbours. The comparison with Europe and NAFTA is even less clear: the shares of US trade with Mexico and Canada are similar to those of Brazil with Argentina, the second largest country in the region, whereas on average the production goods shares observed in German trade with selected European countries are higher than in the Brazilian case but less strikingly so when compared with China.

It should again be stressed that these figures are based on traditional trade statistics and therefore should be taken with caution. One way of avoiding at least some of the problems involved in the use of trade data for analysing production fragmentation is to use value-added data such as that provided by the Trade in Value Added (TiVA) project undertaken jointly by the Organisation for Economic Co-operation and Development (OECD) and the WTO.⁶ This programme provides a number of indicators arrived at by considering the value added by each country in the production of goods and services consumed worldwide; they are therefore better suited for analysing production-sharing processes. As yet, however, the coverage of the database is limited both geographically (the only South American countries included are Brazil, Argentina and Chile) and in time (the latest available year is 2009), which limits the scope of the analysis.

The first TiVA indicator that can be used to assess the degree of participation of a given country in shared production processes is the share of re-exported intermediates in total intermediates imports. Among the sample of South American, NAFTA, Asian and European countries shown in Figure 1, Brazil has the smallest indicator, suggesting a very low degree

4 For a detailed exposition of these (and other) caveats, see, for example, Park A, Nayyar G & P Low, *Supply Chain Perspectives and Issues: A Literature Review*. Geneva & Hong Kong: WTO (World Trade Organization) & Fung Global Institute, 2013.

5 In order to identify the intermediate and capital goods, data from UN Commodity Trade Statistics (UN/Comtrade) was classified according to the Broad Economic Categories (BEC) Classification using the World Integrated Trade Solution (WITS) system developed by UNCTAD and the World Bank. Considered ‘intermediate goods’ were those classified under BEC codes 111 (Food and beverages, primary, mainly for industry), 121 (Food and beverages, processed, mainly for industry), 2 (Industrial supplies not elsewhere specified), 42 (Parts and accessories of capital goods), and 53 (Parts and accessories of transport equipment), and ‘capital goods’ were considered to be those under codes 41 (Capital goods, except transport equipment) and 521 (Other transport equipment, industrial).

6 OECD (Organisation for Economic Co-operation & Development), ‘Implications of global value chains for trade policy’, in *Interconnected Economies: Benefiting from Global Value Chains*, Synthesis Report. Paris: OECD, 2013

Table 1: Brazil: Intermediates/capital trade with South America

Imports											
	Argentina	Bolivia	Chile	Colombia	Ecuador	Paraguay	Peru	Uruguay	Venezuela	Mercosur	Total
Intermediates (except fuel)	37.8%	2.4%	82.1%	53.5%	39.5%	74.7%	72.0%	61.2%	44.5%	41.7%	45.1%
Capital	17.0%	0.0%	0.4%	1.9%	3.7%	0.4%	0.1%	3.5%	0.2%	14.9%	9.4%
Other	45.2%	97.6%	17.5%	44.6%	56.7%	24.9%	27.9%	35.3%	55.3%	43.3%	45.5%

Exports											
	Argentina	Bolivia	Chile	Colombia	Ecuador	Paraguay	Peru	Uruguay	Venezuela	Mercosur	Total
Intermediates (except fuel)	52.8%	52.7%	35.6%	64.9%	62.7%	55.4%	48%	38%	52%	52%	51%
Capital	16.7%	20.2%	17.7%	16.0%	22.2%	19.1%	32%	16%	17%	17%	18%
Other	30.5%	27.1%	46.7%	19.1%	15.2%	25.5%	20%	46%	31%	31%	31%

Source: UN/Comtrade data (for methodological details, see footnote 8)

of value chain trade. The other two South American countries exhibit higher indices than Brazil but fare much worse than most of the Asian and European countries analysed (and are also lower than NAFTA countries other than the US).

Another TiVA indicator that leads to similar conclusions – reaffirming the impression that production fragmentation is less intense in South America than in the other regions analysed – is the share of foreign value-added embedded in each country's gross exports. Again, Brazil shows the lowest indicator and Argentina and Chile are below most of the other countries (see Figure 2).

Table 2: China: Intermediates/capital trade with Asia

Imports										
	Hong Kong	Indonesia	Japan	Korea, Rep. of	Malaysia	Philippines	Singapore	Thailand	Vietnam	Total
Intermediates (except fuel)	77.6%	59.7%	66.9%	72.0%	81.8%	71.4%	61.1%	68.1%	55.8%	69.5%
Capital	6.7%	3.0%	25.2%	19.7%	9.1%	24.4%	14.2%	22.9%	17.4%	19.2%
Other	15.7%	37.4%	7.9%	8.3%	9.1%	4.2%	24.7%	8.9%	26.8%	11.3%

Exports										
	Hong Kong	Indonesia	Japan	Korea, Rep. of	Malaysia	Philippines	Singapore	Thailand	Vietnam	Total
Intermediates (except fuel)	42.6%	49.0%	37.1%	57.6%	46.6%	51.8%	40.9%	55.0%	57.6%	45.1%
Capital	38.8%	27.0%	22.2%	25.1%	22.3%	15.7%	36.7%	26.8%	17.3%	30.4%
Other	18.6%	24.0%	40.7%	17.2%	31.1%	32.5%	22.4%	18.1%	25.1%	24.5%

Source: UN/Comtrade data

Table 3: US: Intermediates/capital trade with NAFTA

Imports				Exports			
	Canada	Mexico	Total		Canada	Mexico	Total
Intermediates (except fuel)	37.4%	34.2%	35.9%	Intermediates (except fuel)	49.1%	64.7%	55.6%
Capital	6.3%	25.9%	15.3%	Capital	19.0%	10.1%	15.3%
Other	56.3%	39.9%	48.8%	Other	31.9%	25.2%	29.1%

Source: UN/Comtrade data

Table 4. Germany: Intermediates/capital trade with Europe

Imports									
	Austria	Belgium	Czech Republic	France	Italy	Netherlands	Poland	UK	Total
Intermediates (except fuel)	68.3%	59.9%	60.3%	49.8%	56.0%	47.2%	59.2%	50.5%	54.7%
Capital	12.2%	5.2%	15.2%	26.3%	12.3%	8.3%	8.1%	10.5%	12.9%
Other	9.5%	34.9%	24.4%	23.9%	31.7%	44.4%	32.7%	39.0%	32.4%

Exports									
	Austria	Belgium	Czech Republic	France	Italy	Netherlands	Poland	UK	Total
Intermediates (except fuel)	46.4%	51.1%	63.1%	47.4%	50.9%	55.3%	59.7%	43.1%	50.7%
Capital	15.3%	12.8%	17.3%	26.9%	16.3%	13.5%	16.3%	17.1%	18.0%
Other	38.3%	36.1%	19.6%	25.7%	32.9%	31.2%	24.0%	39.8%	31.4%

Source: UN/Comtrade data

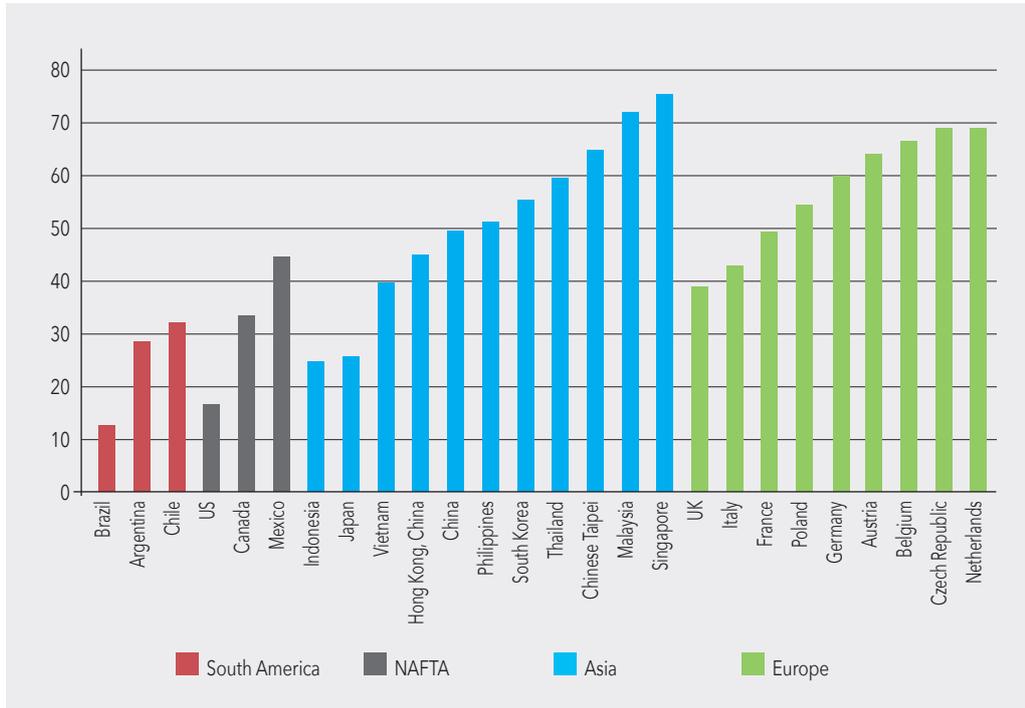
For the purpose of this study, however, these two indicators have one important downside: they are not bilateral in nature and provide information for a standalone country. Fortunately the TiVA database contains an essential indicator that does provide bilateral information, allowing better assessment of the regional aspect of production-sharing: that is, the foreign value-added shares of each country's exports, broken down by origin. This information permits a clearer evaluation of the intensity of regional production-sharing but also enables us to identify those countries that function as hubs, taking the central role in RVCs.⁷

As Table 5⁸ shows, North America, Europe and East and South-East Asia each have at least one country that provides a substantial amount of the value-added in the exports of the

⁷ This point is stressed in Baldwin R, *op. cit.*

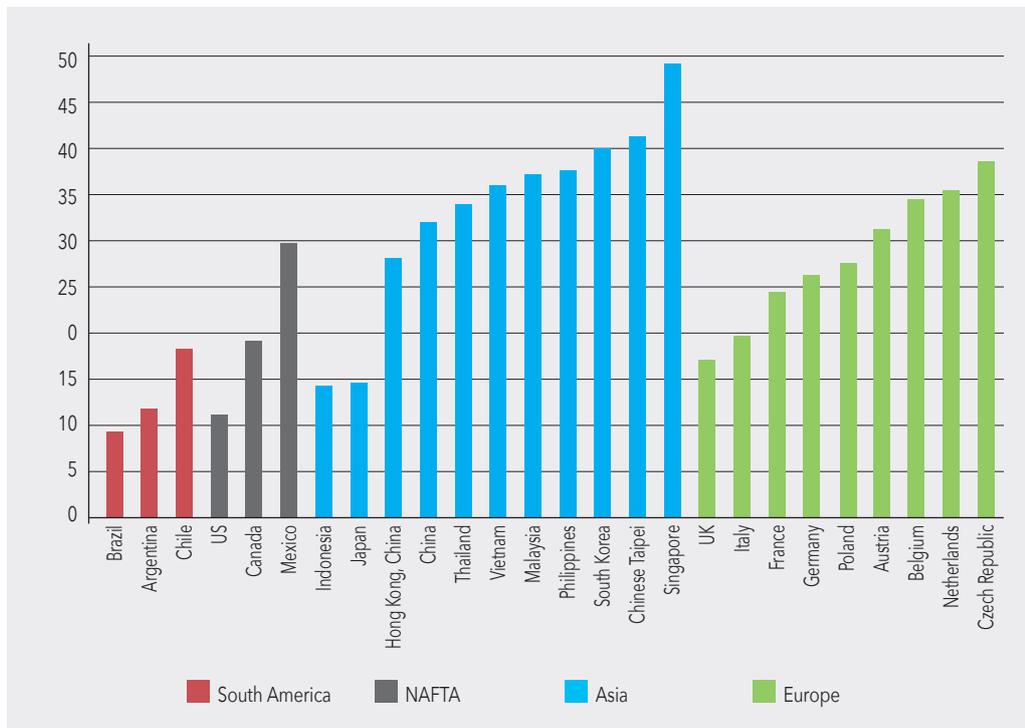
⁸ The tables are colour-coded to facilitate understanding: cells with values between 1% and 3% are marked in light blue; values between 3% and 5% are medium blue; values that exceed 5% are darker blue.

Figure 1: TiVA database: Re-exported intermediates (% of intermediate imports, 2009)



Source: OECD/WTO, TiVA database, http://stats.oecd.org/Index.aspx?DataSetCode=TIVA2015_C1

Figure 2: TiVA database: Foreign value-added shares of gross exports (% , 2009)



Source: OECD/WTO, TiVA database, http://stats.oecd.org/Index.aspx?DataSetCode=TIVA2015_C1

regional partners. The US is clearly a hub for the other NAFTA countries, contributing 9% and 13% of the value of Canadian and Mexican exports respectively. The same goes for Germany in Europe; its contribution to the value-added of its neighbours' exports ranges from 2% to 9%. The Asian case is peculiar, with Japan and China seemingly sharing the role of hub country.

In South America, however, there is no clear hub country: the contribution of each country to the value of its neighbour's exports is meagre at most. This is true even for the relationship between Brazil (the largest country in the region) and Argentina (the second largest), which not only share similar productive structures and a common frontier but are also major partners in the region's most important trade arrangement, the Southern Common Market (Mercado Común del Sur, or Mercosur). Even if the US is included as a possible 'extra-regional hub' the figures are not much higher (1.7%, 2.1% and 3.7% for Argentina, Brazil and Chile respectively).

Given these disparate pieces of information, the picture that emerges is relatively clear. Compared with countries in Asia, Europe and NAFTA, South American countries seem to have (i) a smaller share of trade in intermediates and capital goods; (ii) a smaller share of re-exports of imported intermediates; (iii) a smaller share of foreign value-added in their exports; and (iv) no clear hub for RVCs. All these conclusions suggest that production-sharing in South America is at the very least much less than in the other regions analysed.

DEVELOPING RVCs: BRAZIL AS A SOUTH AMERICAN HUB COUNTRY

As noted in the previous section, South America seems to lag in the development of RVCs. One key aspect of this poor performance is the absence of a hub country capable of organising the process of regional production-sharing on the subcontinent. As the largest country in the region, endowed with the most sizeable and most diversified manufacturing sector among its partner and neighbouring countries, it could be argued that Brazil stands as a natural candidate for the role. Such a prospect, however, faces a number of obstacles that cloud the likelihood of its realisation.

The first and most obvious challenge standing in the way of a nascent regional industry led by Brazil lies in the fact that the latter's history shows a tendency towards a closed, inward-looking economy with relatively weak ties to the global and regional economy and in which the centripetal force generated by its large internal market is in many ways reinforced by a series of institutional and bureaucratic obstacles to internationalisation. These range from clear protectionist measures, such as tariffs and non-tariff barriers, to other transaction costs that (intentionally or not) hinder external competitiveness.

Table 5: Foreign value-added shares of exports (by origin)

	Value added origin		
	Canada	Mexico	US
Canada	0.0%	0.5%	9.2%
Mexico	0.9%	0.0%	13.0%
US	1.5%	0.8%	0.0%

	Value added origin								
	Austria	Belgium	Czech Republic	France	Germany	Italy	Netherlands	Poland	UK
Austria	0.0%	0.6%	0.8%	1.3%	9.0%	2.2%	0.7%	0.5%	1.1%
Belgium	0.4%	0.0%	0.3%	3.7%	4.4%	1.3%	3.8%	0.3%	2.3%
Czech Republic	1.0%	0.7%	0.0%	1.7%	8.4%	1/8%	1.1%	2.1%	1.3%
France	0.3%	1.1%	0.2%	0.0%	3.8%	1.8%	0.8%	0.3%	1.1%
Germany	1.1%	0.8%	0.7%	1.9%	0.0%	1.7%	1.3%	0.8%	1.8%
Italy	0.5%	0.5%	0.2%	1.5%	2.8%	0.0%	0.6%	0.3%	0.7%
Netherlands	0.3%	1.7%	0.2%	1.6%	4.6%	0.9%	0.0%	0.3%	3.3%
Polands	0.5%	0.5%	0.8%	1.4%	5.2%	2.0%	0.8%	0.0%	1.0%
UK	0.1%	0.4%	0.1%	1.0%	2.1%	0.7%	0.7%	0.2%	0.0%

Value added origin											
	Japan	South Korea	China	Chinese Taipei	Hong Kong, China	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
Japan	0.0%	0.6%	1.7%	0.5%	0.1%	0.6%	0.3%	0.1%	0.2%	0.3%	0.1%
South Korea	5.1%	0.0%	4.8%	1.1%	0.3%	1.1%	0.9%	0.3%	0.8%	0.4%	0.2%
China	4.4%	2.9%	0.0%	2.2%	0.5%	0.5%	1.1%	0.4%	0.6%	0.7%	0.1%
Chinese Taipei	6.7%	2.5%	5.4%	0.0%	0.4%	1.3%	1.2%	0.4%	0.9%	0.5%	0.1%
Hong Kong, China	2.1%	0.9%	5.7%	0.9%	0.0%	0.4%	0.6%	0.2%	1.1%	0.4%	0.1%
Indonesia	1.4%	0.6%	1.4%	0.3%	0.2%	0.0%	0.6%	0.1%	0.9%	0.4%	0.1%
Malaysia	4.2%	1.7%	3.3%	1.3%	0.2%	1.0%	0.0%	0.3%	1.9%	1.1%	0.3%
Philippines	4.6%	3.0%	4.4%	2.8%	1.0%	0.6%	1.7%	0.0%	2.3%	1.1%	0.4%
Singapore	3.9%	1.8%	3.0%	1.5%	0.5%	1.2%	2.2%	0.5%	0.0%	0.8%	0.3%
Thailand	5.3%	1.5%	3.5%	1.3%	0.4%	0.7%	1.9%	0.4%	1.0%	0.0%	0.3%
Vietnam	3.9%	2.9%	5.8%	2.2%	0.5%	0.9%	1.0%	0.2%	1.1%	1.4%	0.0%

Value added origin			
	Chile	Argentina	Brazil
Chile	0.0%	2.0%	0.9%
Argentina	0.2%	0.0%	2.7%
Brazil	0.2%	0.4%	0.0%

Source: OECD/WTO, TiVA database, http://stats.oecd.org/Index.aspx?DataSetCode=TIVA2015_C1

One possible historical cause for the closed nature of its economy stems from Brazil's industrialisation in the 20th century, which was based on import substitution and in which the development of fully vertically integrated industrial sectors was an explicit goal.⁹ Despite initiatives towards greater openness that came about in the late 1980s and especially in the 1990s, there is still a strong bias towards industry protection and vertical integration; manifested, for example, in a growing number of local content requirements in industries considered 'strategic'¹⁰ and in anti-dumping measures and other trade remedies.¹¹ One striking example of this vertical integration bias is the identification among the main guidelines of the federal government's latest industrial policy initiatives such as the Productive Development Plan and the Brasil Maior Plan, of the need to enhance national production chains, reduce import penetration and increase local value addition.¹²

A further example of the consequences of the closed nature of the Brazilian economy for the possibility of regional integration is the recent performance of Mercosur which, despite the 2012 addition of Venezuela as a full member, struggles with internal conflicts and seems unable to deepen integration or even completely to fulfil its role as a customs union.¹³ In fact, it increasingly functions de facto as an extended space of protection for Brazilian companies, which enjoy the benefits of the relatively high common internal tariff (although recently China has posed a serious threat to this equilibrium).

Another, arguably related, example is the relative freeze in bilateral trade negotiations as Brazil apparently focuses on the multilateral level. Although the number of trade agreements in the world has boomed in the past two decades, Mercosur has signed deals only with other countries within the region or with smaller counterparties such as Egypt or Israel. Negotiations for an agreement with the EU started in 1999 but are still incomplete. More importantly, both the Mercosur agreement and other trade deals in which Brazil participates are 'shallow'; that is, they consider only trade in goods and do not extend to areas such as services, investment or regulatory coherence that are generally considered crucial for the development of RVCs and production-sharing.¹⁴ Brazil has absented itself from the two 'mega-regional' arrangements at present under negotiation – the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP) – although this is primarily for geographical reasons.

9 For a brief analysis of the Brazilian industrialisation process, see for example 'Origens e consequências da substituição de importações: 40 anos depois', in Bacha E & M Bolle, *O futuro da indústria no Brasil: desindustrialização em debate*. Rio de Janeiro: Civilização Brasileira, 2013.

10 Araujo Júnior J, 'Fragmentação da produção e competitividade internacional: o caso brasileiro'. *Breves Cindes* 73, 2013.

11 Szpak C & D Tussie, 'Policies and instruments employed by Argentina and Brazil', in Evenett S (ed.), *Not just victims: Latin America and Crisis-Era Protection – the 13th GTA report*. London: CEPR, 2013.

12 See, for example, <http://www.desenvolvimento.gov.br/pdp/index.php/sitio/conteudo/setor/145> and <http://www.brasilmaior.mdic.gov.br/conteudo/153>.

13 Rios S & L Maduro, Mercosul: é hora de rever o modelo?, *Breves Cindes*, 86, 2014.

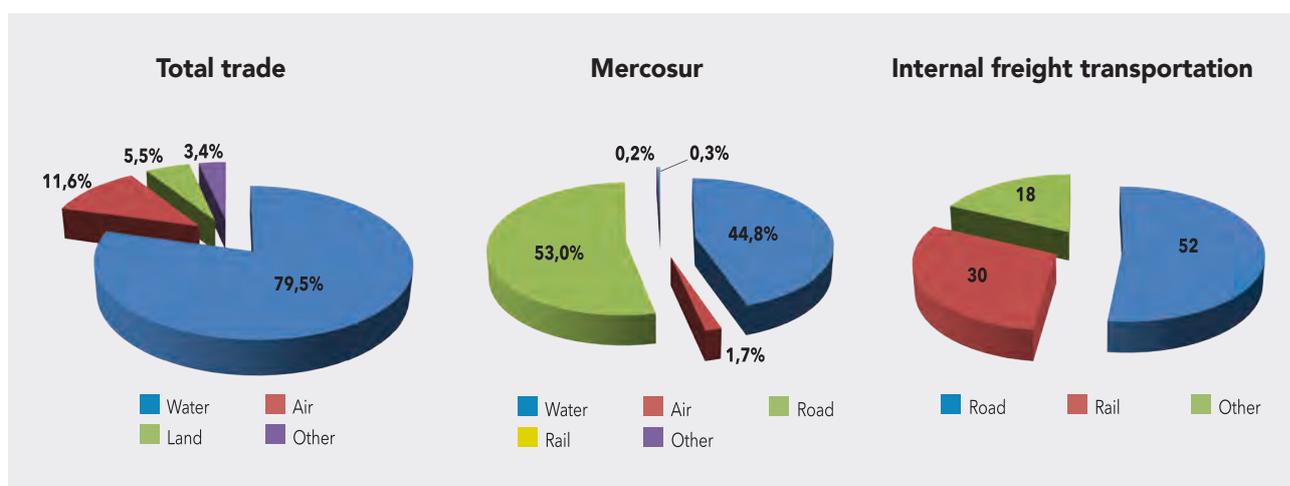
14 On the importance of these subjects for value chain trade, see, for example, OECD, *op. cit.*, or Baldwin R, *op. cit.*

INFRASTRUCTURE: OBSTACLE TO INTEGRATION

One crucial obstacle to the possibility of developing RVCs with Brazil as a hub is the current status of its infrastructure, particularly transport and trade-related elements. The difficulties facing Brazil in this area are well documented. Investments in infrastructure have been diminishing since the severe domestic fiscal and external debt crises that the country suffered in the 1980s; even with some recovery in the 2000s, levels are still low.¹⁵ Recent estimates indicate that Brazil's investment in infrastructure in 2013 was 2.45% of its gross domestic product (GDP), whereas for Chile and Colombia, the regional leaders in this sector, the figures are 6–7% of GDP; in countries such as China and Vietnam they may reach 10%.¹⁶ More importantly, Brazil's estimated spend is below the minimum investment necessary to cover depreciation of the country's existing capital stock, estimated at 3% of GDP.¹⁷

One defining aspect of the Brazilian transport infrastructure is its reliance on land-based transportation modes (especially road transport) in both regional trade (53% of trade with Mercosur partners is by road freight) and internal freight transport, of which 52% is by road.

Figure 3: Brazil: Transportation modes in foreign trade and domestic freight



Source: Left and centre: SECEX/MDIC (Foreign Trade Secretariat of the Ministry of Development, Industry and Foreign Trade). Right: SPNT/MT (National Transportation Policy Secretariat of the Ministry of Transportation).

15 Moreira M et al., *Too Far to Export: Domestic Transport Costs and Regional Export Disparities in Latin America and the Caribbean*. Washington, DC: Inter-American Development Bank, 2013.

16 Silva B, 'The challenges of infrastructure investment in Brazil: the issue of funding', *Revista Paradigma*, XVIII, 22, pp. 141–162.

17 Frischtak C & K Davies, 'O investimento privado em infraestrutura e seu financiamento', in Frischtak C & A Pinheiro (eds), *Gargalos e soluções na infraestrutura de transportes*. São Paulo: FGV (Fundação Getúlio Vargas), 2014.

Even so, as the low investment figures would lead one to expect that the quality of existing roads is poor; a 2012 study by the National Confederation of Transport (CNT) concluded that 46% of paved roads have 'pavements in insufficient conditions' [sic].¹⁸ The extent of the road network is also inadequate. In 2011 road density was only 20km/100km², less than half that of the US (46km/100km²).¹⁹

The lack of adequate transport infrastructure is not restricted to roads. Another survey conducted by the CNT among soy and corn exporters (responsible for about 43% of the country's exports) concluded that 83.3% of them consider the lack of railway coverage and the poor quality of existing railroads 'serious' or 'very serious' obstacles to their business and a remarkable 100% of the respondents have the same opinion about the low productivity of port terminals and the lack of adequate equipment for port operation.²⁰

The low coverage and poor quality of existing infrastructure on the one hand and insufficient investment to improve infrastructure on the other, have obvious ramifications for the country's external competitiveness and are a serious hindrance to its ability effectively to contribute to the development of production-sharing and RVCs in South America. As Figure 4 shows, the quality of Brazilian trade- and transport-related infrastructure (a component of the World Bank's Logistics Performance Index) is not only far below the standards in other regions used as benchmarks but has been in decline since 2010. Moreover, this poor situation is not limited to Brazil: average indices for Mercosur and South America are even worse and also fell in 2014, the latest year for which figures are available.

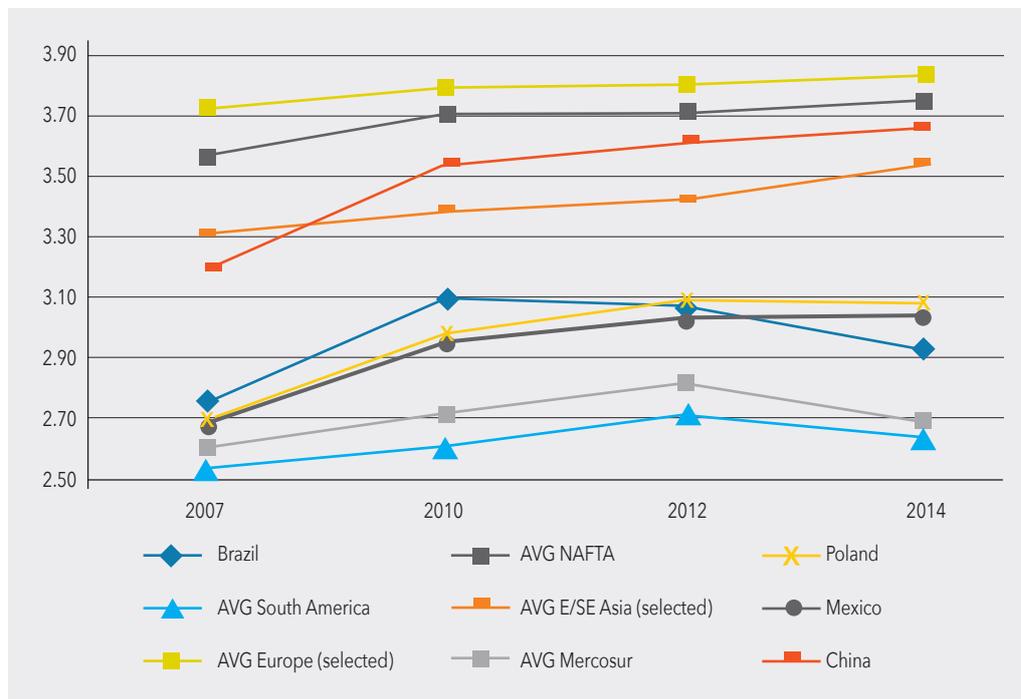
As other components of the Logistics Performance Index show, the obstacles to international trade in these countries go beyond physical infrastructure per se. One example is customs efficiency: Figure 5 indicates that Brazil, Mercosur – and South America as a whole – fare poorly in this respect. As Figure 6 shows, the overall result clearly is much the same, a situation that has serious consequences for regional integration. The example of Mexico is noteworthy: with index levels similar to those of the South American countries at the beginning of the series, that country's performance has been steadily improving and constitutes a mode for its southern neighbours, albeit one that is unheeded.

18 CNT (Confederação Nacional do Transporte), 'Pesquisa de Rodovias', 2012, <http://pesquisarodovias.cnt.org.br/Paginas/Inicio.aspx>.

19 Moreira M *et al.*, *op cit.*

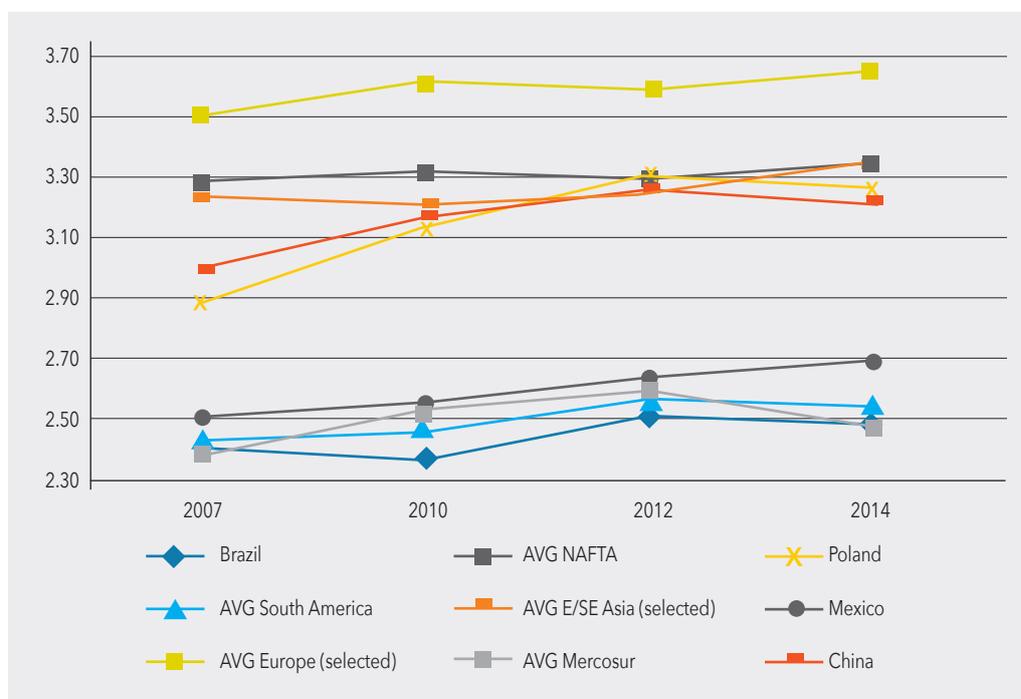
20 CNT, 'Transporte & Desenvolvimento: Entraves Logísticos ao escoamento de Soja e Milho', 2015, <http://www.cnt.org.br/Imagens%20CNT/PDFs%20CNT/Pesquisa%202015/entravesatualizado.pdf>.

Figure 4: Logistics Performance Index: Quality of trade & transport-related infrastructure (1 = low to 5 = high)



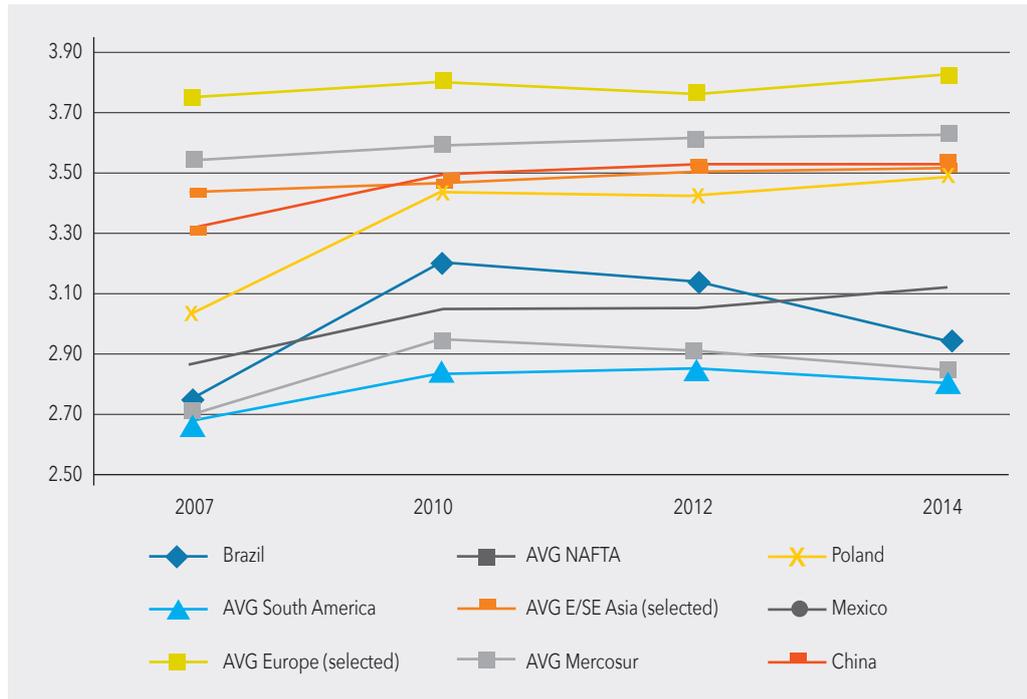
Source: World Bank, Logistics Performance Index, <http://lpi.worldbank.org/>

Figure 5: Logistics Performance Index: Customs efficiency



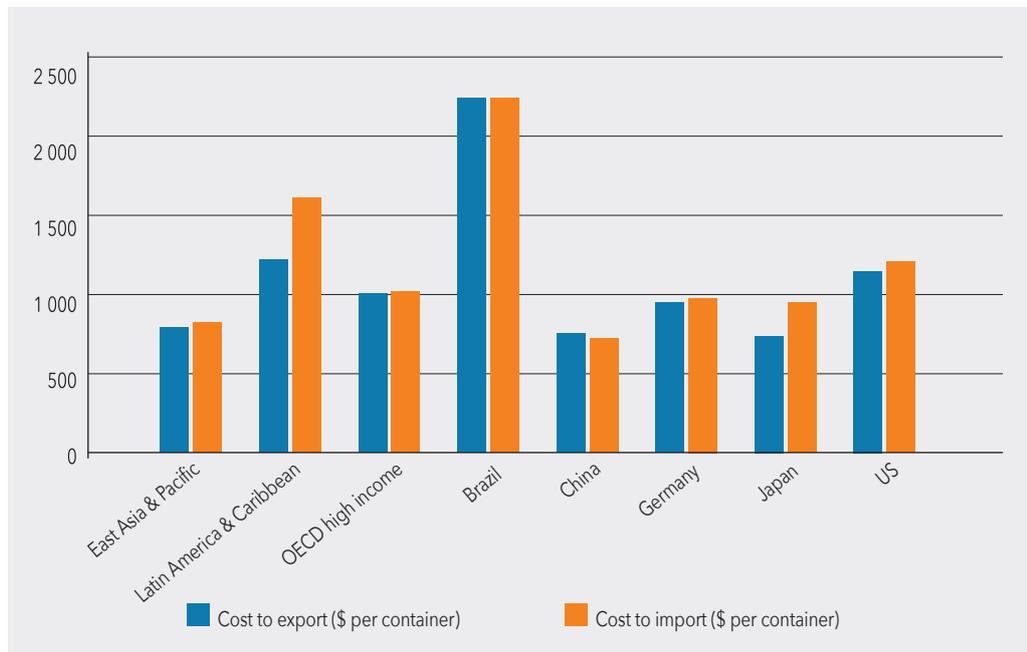
Source: World Bank, Logistics Performance Index, <http://lpi.worldbank.org/>

Figure 6: Logistics Performance Index: Overall



Source: World Bank, Logistics Performance Index, <http://lpi.worldbank.org/>

Figure 7: Doing business, cost to import & export



Source: World Bank, Ease of Doing Business Report, <http://www.doingbusiness.org/>

One striking example of the consequences of this situation for the region's trade and integration capabilities can be seen in trade costs. Figure 7 shows the estimated costs to import and export, as calculated by the World Bank's Ease of Doing Business Report. Brazilian costs are much higher than those of the other countries and regions used as benchmark. Data for South America as a single region is not available but the results for Latin America and Caribbean (of which South America is a large subset) suggest that the situation is not good.

Given this framework and its consequences, the prospects for improvement are not encouraging, at least in the short term and in Brazil, which has somehow to manage to hive off infrastructure investment amid a complicated economic environment in which the government is struggling to implement a series of fiscal adjustment measures. At the same time major infrastructure companies are involved in corruption scandals that may threaten their operations in the foreseeable future.²¹ The situation is even worse in neighbouring states such as Argentina and Venezuela, both of which are undergoing serious fiscal and political hardship.

In this context the Initiative for the Integration of the Regional Infrastructure of South America demands attention. Launched in 2000 with the objective of helping bridge the infrastructure gap in the region, which was regarded as a serious threat to internal and external trade, it was absorbed 11 years later into the South American Council for Infrastructure and Planning, itself subordinate to the Quito-based Union of South American Nations (Unión de Naciones Suramericanas, or Unasur). Some analysts suggest that the essentially political nature of Unasur may hinder (or has been hindering) its potential as an effective technical support body through a loss of focus on infrastructure development.²²

CONCLUSION

This article has looked at two related questions. The first is whether or not there is a process of regional production-sharing taking place in South America similar to those in East Asia, North America or Europe, along with the establishment of RVCs connecting South American countries and the construction of a system of regional fragmented production. Although no unqualified answer to this question can be arrived at there is evidence that any response would be negative: the data analysed here suggest that production-sharing in South America, although it may exist in particular sectors (as some case studies show), is not as widespread as in the other regions considered, where the growth of RVCs connecting many

21 See, for example, *BBC News*, 'Petrobras scandal: Top construction bosses arrested in Brazil', 19 June 2015, <http://www.bbc.com/news/world-latin-america-33203790>.

22 Costa C & M Gonzales, 'Infraestruturafísica e integração regional na América do Sul: uma avaliação da iniciativa para a integração da infraestrutura regional da América do Sul', Institute of Applied Economic Research Discussion Paper, 2060, 2015.

companies in several countries is much more dynamic. Furthermore, South America differs from those other regions in that there seems to be no clear hub country capable of leading this process, such as there is in Europe or the NAFTA region.

The second, related question that underlies this study is whether or not Brazil, the largest economy and the most powerful nation in South America, can become the hub country that leads the region towards productive integration. The answer to this may be even more challenging. A number of obstacles can be identified that may hamper Brazil's ability to perform this role, ranging from the historically closed nature and vertical integration bias of its economy to the inadequacy of its physical and institutional infrastructure.

The improvement of this infrastructure is a necessary, though not sufficient, condition for the development of competitive RVCs in South America. In a framework of internationally fragmented production, trade becomes an essential and intrinsic part of the production process; moreover, the nature of trade itself is changing: as Baldwin²³ stresses, the global trading system is becoming more than merely 'selling things', as 'business has come to rely on the trading system when making things'. This '[21st] century trade', which involves continuous flows not only of goods but also of services, capital, information, knowledge and even people, has become fundamental for global production in an internationally fragmented framework. Hindering trade flows therefore means harming production itself – and consequently reducing competitiveness and the prospects for successful integration.

Against this background, as Baldwin points out, the scope of policies and barriers that may limit these flows is so broad as to include a range of subjects that are not traditionally considered 'trade issues' because usually they are not obstacles to 'selling things' internationally. More than merely reducing tariffs and raising non-tariff barriers, fragmented production demands harmonisation and congruence in a broad set of compatible rules, standards and policies on areas as diverse as capital restrictions, short-term visas, anti-competitive practices and environmental requirements; not to mention the crucial subject of assuring and protecting proprietary rights over information flows between all the agents and firms involved in the process. In sum, production-sharing in RVCs tends to create demand for an integrated economic space so that cross-border production processes can function unhindered, without friction or interruption. At present South America is still far from such a situation with a number of obstacles in place that could (and do) cause those frictions and interruptions. The examples dealt with in this paper – such as physical and institutional infrastructure – are only some among many.

23 Baldwin R, 'Global manufacturing value chains and trade rules' in *The Shifting Geography of Global Value Chains: Implications for Developing Countries and Trade Policy*. Geneva: World Economic Forum, 2012.

If it is to prove capable of leading a process of integration, therefore, one essential condition would be for Brazil effectively to tackle these obstacles. Developing more and better-quality transport and trade-related infrastructure; improving customs efficiency and reducing bureaucracy and red tape at border procedures; and deepening trade and economic integration arrangements, especially with its South American neighbours; these together form some of the non-traditional issues involved in moving towards regulatory coherence and harmonisation of trade- and production-related rules and standards. They are necessary conditions for developing successful cross-border value chains in South America.

Clearly, political will and effective participation (and interest) from the private sector are also essential. A communications initiative stressing the potential benefits of the process would be a way to start turning heads in the right direction, although increasing productivity and innovation capacities would be essential for actually reaping the benefits of value-chain integration.

[The opinions expressed in this paper are the authors' own and do not necessarily express the views of their organisations]



Electricity Generation: A Driver of SADC Regional Integration?

EXECUTIVE SUMMARY

The 2014 SADC heads of state summit in Harare adopted industrialisation policy as a means of strengthening regional integration. Greater regional co-operation is also emerging as a means towards diversifying SADC economies and boosting international partnerships. Access to energy, however, remains a challenge for most SADC countries. Although industrialisation demands an adequate energy supply, heavy reliance on fossil fuels has encountered widespread opposition – prompted by climate change concerns – driving the need for sustainable energy solutions. This paper advocates strengthening regional power pools to enhance effectiveness and efficiency in resource utilisation. A power pool can promote energy security and increase service reliability through shared, interconnected electricity systems. It may also help promote larger regional markets as a basis for future economic growth. The paper maps SADC's electricity access, role players, energy technologies and technological investment within the bounds of its industrial policy; and suggests ways in which the electricity generation industry might support efforts toward regional integration.

INTRODUCTION

The 34th Annual Summit of Heads of State and Government of SADC was held in Harare,

Zimbabwe in August 2014. The communiqué issued after the meeting endorsed the importance of industrialisation for regional integration.¹ Member states agreed that the manufacturing industry is one of the central pillars of economic development through creating enough jobs to reduce poverty and setting regional economies on a growth path;² at the same time it is critical to economic diversification and the development of productive capacity.³ The statement was issued at a time when sub-Saharan Africa was moving sufficiently away from resource dependency to entertain aspirations of becoming a hub of global economic growth, with some countries' annual growth rates thought to be as high as 5%.⁴ The World Bank estimates that five sub-Saharan African countries have already attained middle-income status.⁵ A major challenge, however – notably in the SADC region – is providing the reliable supplies of electrical energy that are needed to drive industrialisation. Unfortunately, not all countries in SADC are equally capable of meeting this need. Even South Africa, the most advanced of them, is grappling with energy shortages.

Mainstream economists consider land, labour and capital as primary factors of production, with goods such as fuel and materials as intermediate inputs.⁶ They seldom stress the part played by energy in economic growth. The present study, however, recognises that energy constituents such as fuels are reproducible factors,⁷ while laying emphasis on the part played by energy availability in economic growth and industrialisation.

To realise their industrialisation objectives SADC countries could and should use energy production as a key platform for regional integration. An industrialisation framework can be developed based on present opportunities,⁸ the first of these being the exploitation of existing renewable sources as part of a transition to the wider use of renewable energy. The second is a strengthening of the science, technology and engineering capabilities of SADC members, most likely through collaborative research and development. The third is to promote harmonisation of the energy sector through regional power pools.

1 Mureverwi B, 'SADC Summit's Emphasis on Industrial Development: Implications on Practical Policy Formulation', Tralac (Trade Law Centre), Trade Brief. Stellenbosch: Tralac, September 2014.

2 SADC (Southern African Development Community), *Industrial Development Policy Framework*. Gabarone: SADC, 2014.

3 *Ibid.*

4 WEF (World Economic Forum), *Delivering on Africa's Promise*, Report. Geneva: WEF, 2013, <http://www.weforum.org/events/world-economic-forum-africa>.

5 *Ibid.*

6 Stern DI, 'Energy use and economic growth in the USA: A multivariate approach'. *Energy Economics*, 15, 1993, pp. 137–150.

7 Stern DI, 'A multivariate co-integration analysis of the role of energy in the US macro-economy', *Energy Economics*, 22, 2000, pp. 267–283.

8 Juma C, 'The new harvest', in *Agricultural Innovation in Africa*. London: Oxford University Press, 2011.

BACKGROUND AND POLICY CONTEXT

SADC industrialisation policy reflects the fact that since 2000 industrialisation has been understood as a primary element in establishing sustainable growth and development. The SADC Protocol on Trade, which came into effect in that year, called for an industrialisation strategy alongside the implementation of the SADC Free Trade Area. In addition, the SADC Regional Indicative Strategic Development Plan (RISDP), adopted in 2003, reflected member states' commitment to a number of priority areas, including industrialisation policies, with a focus on promoting industrial linkages and the efficient utilisation of regional resources. The RISDP called on member states to pursue national industrial policies and strategies informed by the need to foster regional coherence and reduce regional development imbalances.

Sector-specific analysis – including value chain analysis – was conducted with a view to promoting sector-specific strategies. This in turn led to the adoption in 2009 of a programme to upgrade and modernise existing industries, as well as to reinforce institutional support for infrastructure in order to improve productivity and competitiveness; in itself an admission that SADC needed to strengthen its industrial infrastructure. For this objective to be realised, however, SADC must intensify its regional integration efforts. The energy sector is one of the means through which this can be achieved.

SADC'S ENERGY LANDSCAPE

Energy security is inextricably linked to industrialisation, but along with other regions of sub-Saharan Africa, SADC members have the world's lowest access to energy.⁹ Rolling blackouts are already common and energy demand is rising: the World Bank anticipates a 40% increase over the next 10 years,¹⁰ which if realised will probably widen the existing supply gap between household and industrial consumption. Figure 1 illustrates how energy demand in Africa at present is skewed towards the industrial sector and urban areas.

Projections from the International Renewable Energy Agency (Irena) indicate that by 2030 electricity demand in the SADC region is expected almost to double, from 300TWh¹¹ to 580TWh; and to reach 920TWh by 2050.¹² As of 2010 installed capacity fell well short of this at about 52GW;¹³ 72% is based on coal-fuelled power generation, 18% on hydropower and the remainder on oil and nuclear fission.

9 Eberhard A *et al.*, 'Underpowered: The State of the Power Sector in sub-Saharan Africa', World Bank Background Paper, 6, Africa Infrastructure Country Diagnostic. Washington, DC: World Bank, 2008.

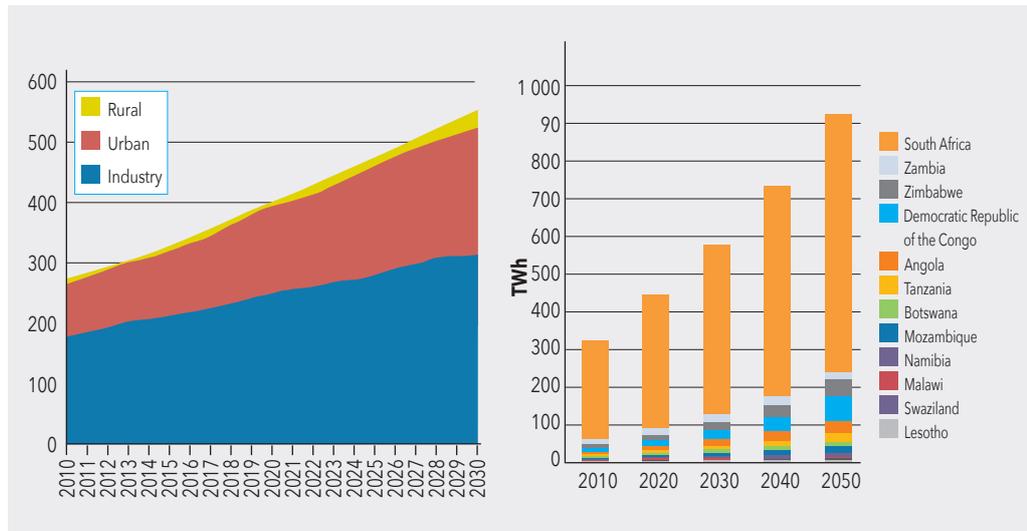
10 World Bank, *The World Bank and energy in Africa*, fact sheet, 2013, <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/AFRICAEXT/0,contentMDK:21935594~pagePK:146736~piPK:146830~theSitePK:258644,00.html>.

11 Irena (International Renewable Energy Agency), *Southern African Power Pool: Planning and Prospects for Renewable Energy*. Abu Dhabi: Irena, 2013, <https://www.irena.org/DocumentDownloads/Publications/SAPP.pdf>.

12 *Ibid.*

13 *Ibid.*

Figure 1: Energy demand projections by country and category



Source: Irena (International Renewable Energy Agency): Southern African Power Pool. Planning and prospects for renewable energy, Irena, 2013

The South African system dominates the Southern Africa Power Pool (SAPP) and accounts for 80% of regional capacity.¹⁴ For all SADC countries to reach the level of industrialisation already attained by South Africa, member states will have to provide consistent energy output far beyond their present production capacity. At today's production and supply levels, SADC faces a series of problems. These include the limited scope and coverage of energy infrastructure in terms of both geographic area and users; a large shortfall in generating capacity; technical obsolescence and poor state of the energy infrastructure; low levels of resource efficiency, leading to high unit costs; and widespread politically motivated manipulation of electricity prices.

This array of obstacles reflects overall inefficiency in planning and policy, as well as the unsustainable finances of government-owned utilities and a resultant lack of essential investment in the energy sector. A critical feature is the domination of state-owned national power utilities, which has hampered – or altogether excluded – the participation of privately owned energy producers. The existing system of energy production and supply lacks the incentives and flexibility to provide easy and equitable grid and market access to privately owned power producers. A further implication is that the dominance of parastatals renders energy provision susceptible to political manipulation; hence the achievement of greater industrialisation within SADC implies more participation from independent energy producers.

¹⁴ *Ibid.*

Coupled with the question of production and supply of sufficient energy is the promotion of its efficient use. Governments should long ago have developed sound policies to promote the efficient use of available energy, together with the means to implement them properly. Efficiency improvements can yield performance rewards at a fraction of the cost of increasing energy production per se. While it is true that policies can alter behaviour, laying down a framework for more efficient use of energy may not of itself bring about the desired result. Regional policymakers, political leaders and communities should emphasise 'using less to do more' as a common value.

CO-OPERATION IN THE SADC ENERGY SECTOR

Given the significance of energy production in SADC's industrialisation, the sector could well become a catalyst for regional integration.¹⁵ The formation of the SAPP in 1995 illustrates precisely this. In particular, energy experts in the region share the broad view that a co-operative approach offers opportunities for exploiting the very high hydropower potential in certain countries within the region – notably the Democratic Republic of the Congo (DRC) and Mozambique – which would lie dormant without the assurance of the substantial export market provided by a regional power pool.¹⁶

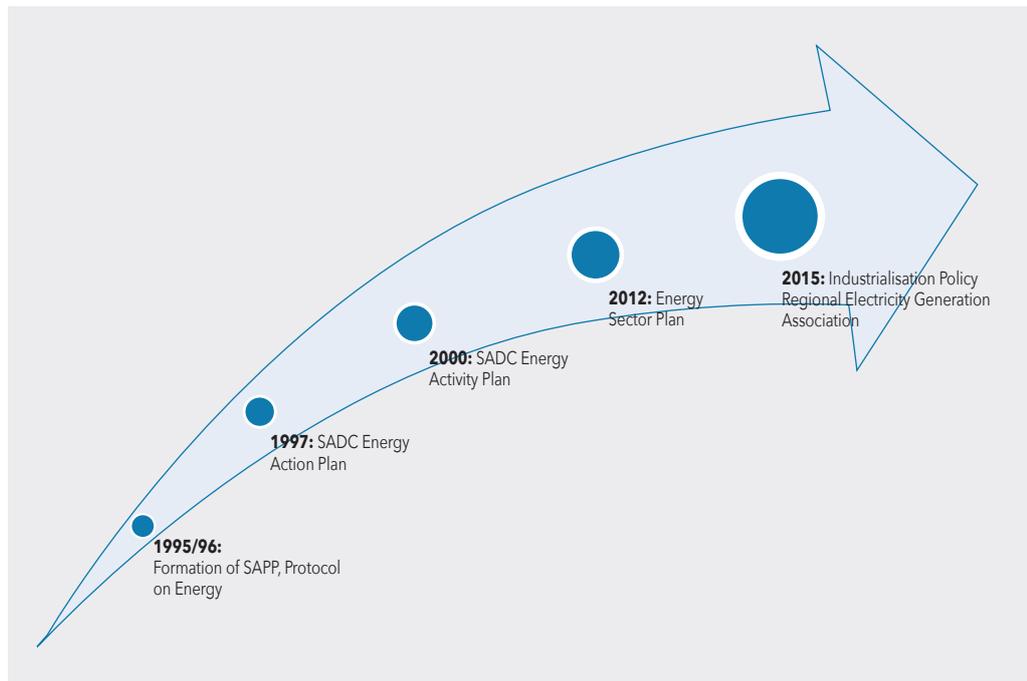
In 1996 SADC adopted a Protocol on Energy that provided a framework for co-operation on energy policy. This was followed in 1997 by an Energy Action Plan, in which the ministerial task team concerned recognised the need to reduce SADC's (then) power surplus capacity and put in place measures for regulating energy and exploring alternative energy sources. Subsequent developments centred on the need to enhance regional integration through the energy lens (see Figure 2). Each country derives mutual benefits from co-operation between member states. This is especially important insofar as a significant element in the success of newly industrialised nations is their ability rapidly to learn how to improve performance in a variety of sectors, including institutional development, technological adaptation, trade organisation and the use of natural resources.¹⁷

15 IEA (International Energy Agency), 'Extended World Energy Balances'. Paris: IEA/OECD Library, 2010.

16 Mbirimi I, *Electricity Mixes in the Context of Global Climate Change Mitigation Pressures*, IISD (International Institute for Sustainable Development), Series on Trade and Energy Security, Policy Report 5. Winnipeg: IISD, 2010.

17 Juma C, *op. cit.*

Figure 2: Evolution of SADC energy policy



Source: Authors

Despite SADC's promising policy frameworks and strategic direction, studies have highlighted the slow pace of developments in the energy sector. Member states fail to comply with regional energy guidelines partly because their national interest trumps the broader interests of the region. In addition, many of them prefer bilateral over multilateral agreements.¹⁸ Largely for these reasons, value chains within the energy sector have remained untapped.

REGIONAL STRENGTHS: RENEWABLE ENERGY

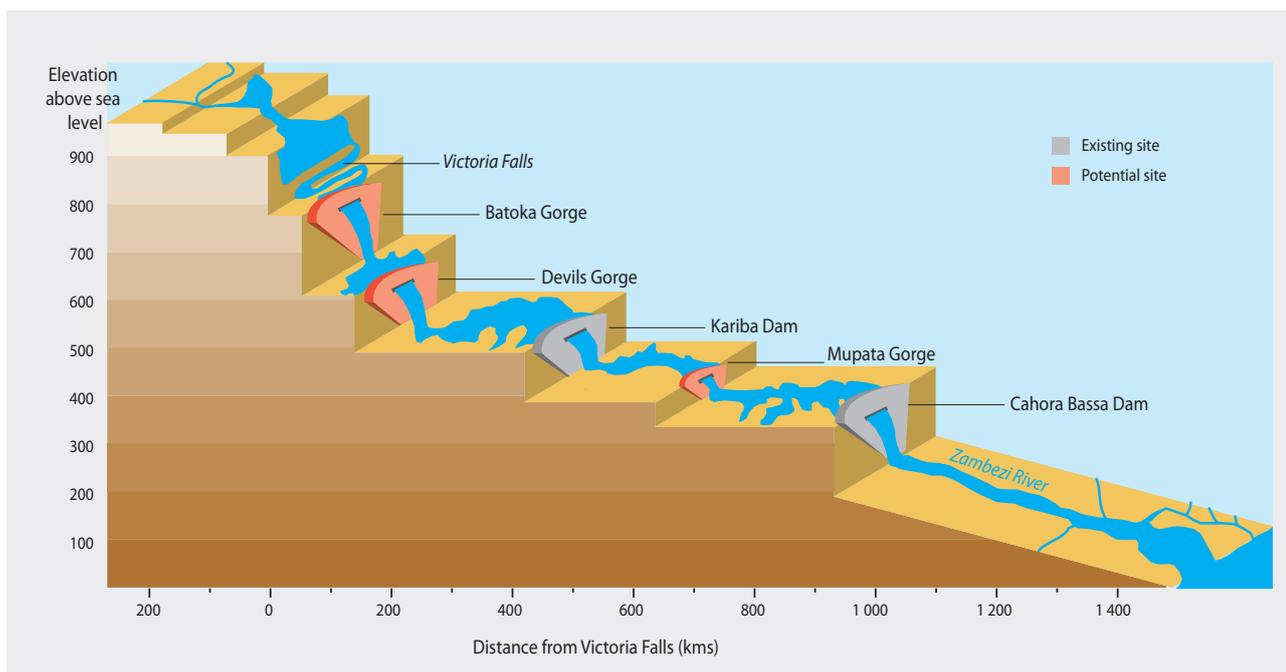
SADC is endowed with a heterogeneous mix of fossil and renewable energy sources (see Figure 3). Most countries in the region possess enough renewable energy potential to meet present demand through proven technologies. Many parts of sub-Saharan Africa enjoy daily solar radiation of between 4kWh/m² and 6kWh/m². The Great Rift Valley alone has largely untapped geothermal resources estimated at 9 000MW;¹⁹ elsewhere, mainly around coastal regions, there is much potential for wind power.

Hydropower, wind and biofuels together may make a significant contribution to the SADC energy landscape.

¹⁸ Mhaka G, 'Energy power development SADC's top list of priorities', *The Chronicle* (Harare), 21 January 2015.

¹⁹ UNEP (UN Environmental Programme), *Financing Renewable Energy in Developing Countries: Drivers and Barriers for Private Finance in sub-Saharan Africa*, UNEP Financing Initiative. Nairobi: UNEP, 2012.

Figure 4: Existing and potential hydropower projects: Zambezi River



Source: SADC and Zambezi River Authority, 'Rapid Assessment Report: Integrated Water Resources Management Strategy for the Zambezi River Basin'. Gaborone: SADC Water Division, 2007

The Zambezi River basin alone probably has enough capacity to power the entire region, if harnessed as shown in Figure 4. The SAPP estimates that although the Zambezi could produce more than 20 000MW,²¹ at present only 23% of this is being harnessed, most of it from the Kariba Dam between Zambia and Zimbabwe and the Cahora Bassa Dam in Mozambique.²² The Grand Inga hydropower project on the Congo River in the DRC offers a further opportunity for regional integration. It is a multi-phase hydropower station that might generate as much as 40 000MW, enough to power half of Africa.

Development to this level of output will require a phased approach. South Africa has signed a treaty with the DRC providing a framework for facilitation of power generation and delivery to South Africa; the third phase of Grand Inga (Inga 3) will provide 2 500MW to South Africa while contributing to regional integration, energy security and economic growth in an environmentally sustainable manner.²³ Energy experts envisage a new transmission line from the DRC to South Africa to be constructed after the completion of Inga 3, most likely cutting across Zambia, Zimbabwe and Botswana.

21 SADC & Zambezi River Authority, *Rapid Assessment Report: Integrated Water Resources Management Strategy for the Zambezi River Basin*. Gaborone: SADC, 2007.

22 GRID-Arendal, *Existing and potential hydropower projects on the Zambezi River*. Arendal: GRID-Arendal, 2013, http://www.grida.no/graphicslib/detail/existing-and-potential-hydropower-projects-on-the-zambezi-river_2995.

23 South Africa.info, 'South Africa pushes for Grand Inga hydropower project go-ahead', <http://www.southafrica.info/news/grand-inga-hydropower-project%20.htm#.VcCZVPmWaAU>.

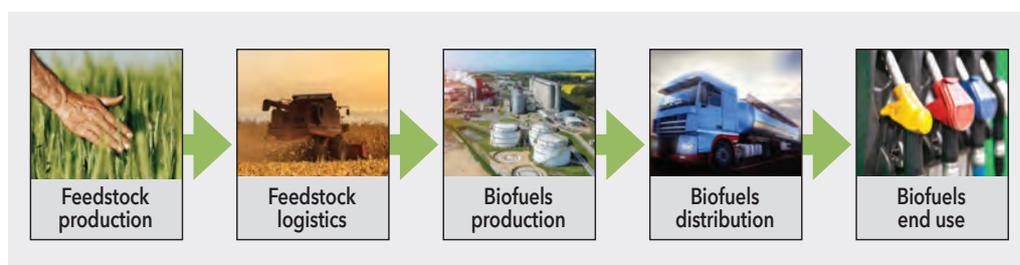
Biofuels and wind

SADC has been relatively successful in scaling up biofuels as part of the renewable energy mix. The Southern African Development Commission developed a strategy for biofuels initiatives within SADC, to be implemented through a biofuels task force, which in turn developed a policy support tool (the Crop Decision Making Tool) that culminated in a 'State of Play Study' under the Basic Energy Co-operation programme. This triggered a series of innovations with the potential to promote industries that can help realise SADC's industrialisation aims (see Table 1).

Among SADC countries, South Africa has displayed exceptional technological innovation. Some of the most notable examples include:

- discovery and characterisation of new yeasts, such as *Candida shehatae*, which can convert pentose sugars derived from the hemicellulose fraction of bagasse into ethanol;
- development of a consolidated bioprocessing process that offers the largest potential cost reduction so far of any research-driven improvement in biomass-to-bioethanol conversion;
- sunflower-based technology under which the chemical process of transesterification with methanol and alkali has proved successful in producing biodiesel fuel;
- Sasol's model for initiating a commercial biomass conversion industry; and
- Sasol's technology for gasification, synthesis and separation, originally developed for coal conversion and later adapted for biomass feedstock, either stand-alone or in combination with biological processing.

Figure 5: Value chains on bio-derived energy production and distribution



Source: Authors

Figure 5 illustrates the potential for industrial development across energy production and distribution. In Mauritius, for example, biomass-based electricity co-generation (ie, combined heat and power production) from sugar estates now accounts for 40% of total annual electricity production.²⁴ A further success in this field is the \$437 million investment by South Africa's Industrial Development Corporation and the South African National Development Institute in two biofuels projects that by 2009 were together producing 190Ml of bio-ethanol from sugar cane and sugar beet.²⁵ In employment terms a 10% supply of such fuel relative to total consumption has been estimated to be the equivalent of a new sugar industry, creating some 110 000 jobs.²⁶

EMERGING OPPORTUNITIES FOR THE ENERGY SECTOR

Declining cost of renewables

Generation costs for some renewable energy technologies are falling steadily and some are now comparable with those of conventional generation. Solar photovoltaic generation, for example, has become almost competitive with power from coal over the past few years²⁷ and wind power in good locations can deliver electricity at a cost below \$69/MWh, against \$67/MWh for coal-based generation.²⁸ Recent analyses of hydropower show that average investment costs for large hydropower plants (with storage) typically range from \$1,050/kW to \$7,650/kW, with small hydropower projects at \$1,300/kW–\$8,000/kW. Small or 'mini' hydropower projects therefore offer proven viability, particularly in off-grid, remote and rural areas. The cost of additional capacity at existing hydropower schemes, or installing generators at dams with no hydropower plant, can be as little as \$500/kW.²⁹

Some countries in SADC (South Africa among them) have an average annual rainfall of 500mm, which is low by world standards and which, combined with the seasonal flow of rivers and frequent droughts or floods, limits hydropower opportunities. Nevertheless, many of them possess enough hydrological potential to benefit substantially from small and mini hydropower plants.

24 Ramjeawon T, 'Life cycle assessment of electricity generation from bagasse in Mauritius', *Journal of Cleaner Production*, 16, 16, 2008, pp. 1727–1734.

25 Van Zyl WH & BA Prior, *South Africa Biofuels*, IEA Task Group, 39, Progress Report, 2009, <http://academic.sun.ac.za/biofuels/Media%20info/South%20Africa%20Biofuels%20May%202009%20Progress%20Report.pdf>.

26 Mosiah N *et al.*, 'Southern African Energy-Investment Flows and Challenges', paper presented to the South African Portfolio Committee on Energy, Cape Town, 24 August 2012.

27 Stuart B, 'South Africa: Grid parity within sight, but Refit needs to be implemented soon', *PV Magazine*, 24 August 2010, [http://www.pv-magazine.com/news._details/beitrag/south-Africa--grid-parity-within-sight--but-refit-needs-to-be-implemented-soon_100000754/](http://www.pv-magazine.com/news/_details/beitrag/south-Africa--grid-parity-within-sight--but-refit-needs-to-be-implemented-soon_100000754/), accessed 21 November 2011.

28 Morales A, 'Wind turbine prices below 1 million euros a megawatt', *Bloomberg Business*, 7 February 2011, <http://www.bloomberg.com/news/2011-02-07/wind-turbine-prices-fall-below-1-million-euros-per-megawatt-bnef-says.html>.

29 Irena, 'Hydropower', Working paper 1 3/5, Cost Analysis series. Bonn: Irena, 2012.

Table 1: Hydropower cost analysis

	Installed costs (\$/kW)	Operations and maintenance costs (%/year of installed costs)	Capacity factor (%)	Levelised cost of electricity (2010 \$/kWh)
Large hydro	1,050-7,650	2 - 2.5	25 to 90	0.02 - 0.19
Small hydro	1,300-8,000	1 - 4	20 to 95	0.02 - 0.27
Refurbishment/upgrade	500-1,000	1 - 6		0.01 - 0.05

Source: Irena, 'Hydropower', Working paper 1 3/5, Cost Analysis series. Bonn: Irena, 2012

Cross-border transmission

The SADC region has made significant infrastructural improvements in the electricity sub-sector, evidenced by the interconnection of nine SADC member states to the SAPP (see Figure 6). What clearly is now urgent is connecting the remaining three mainland member states (Angola, Malawi and Tanzania) to the SAPP, in line with the 1996 Protocol on Energy.

Power lines, existing and planned

Measures taken under the SAPP together with bilateral agreements have seen the construction of power lines between member states; the largest of them, between South Africa and Mozambique, transmits more than 3 000MW (see Table 1). Additional power lines in the planning stage include Zizabona (Zimbabwe, Botswana, Namibia and Zambia) with 600MW capacity; Westcor (DRC, Angola, Botswana, Namibia and South Africa) with 1 500MW capacity; and '765Kv' (DRC, Namibia, South Africa, Zambia and Zimbabwe) with 1 500MW capacity.

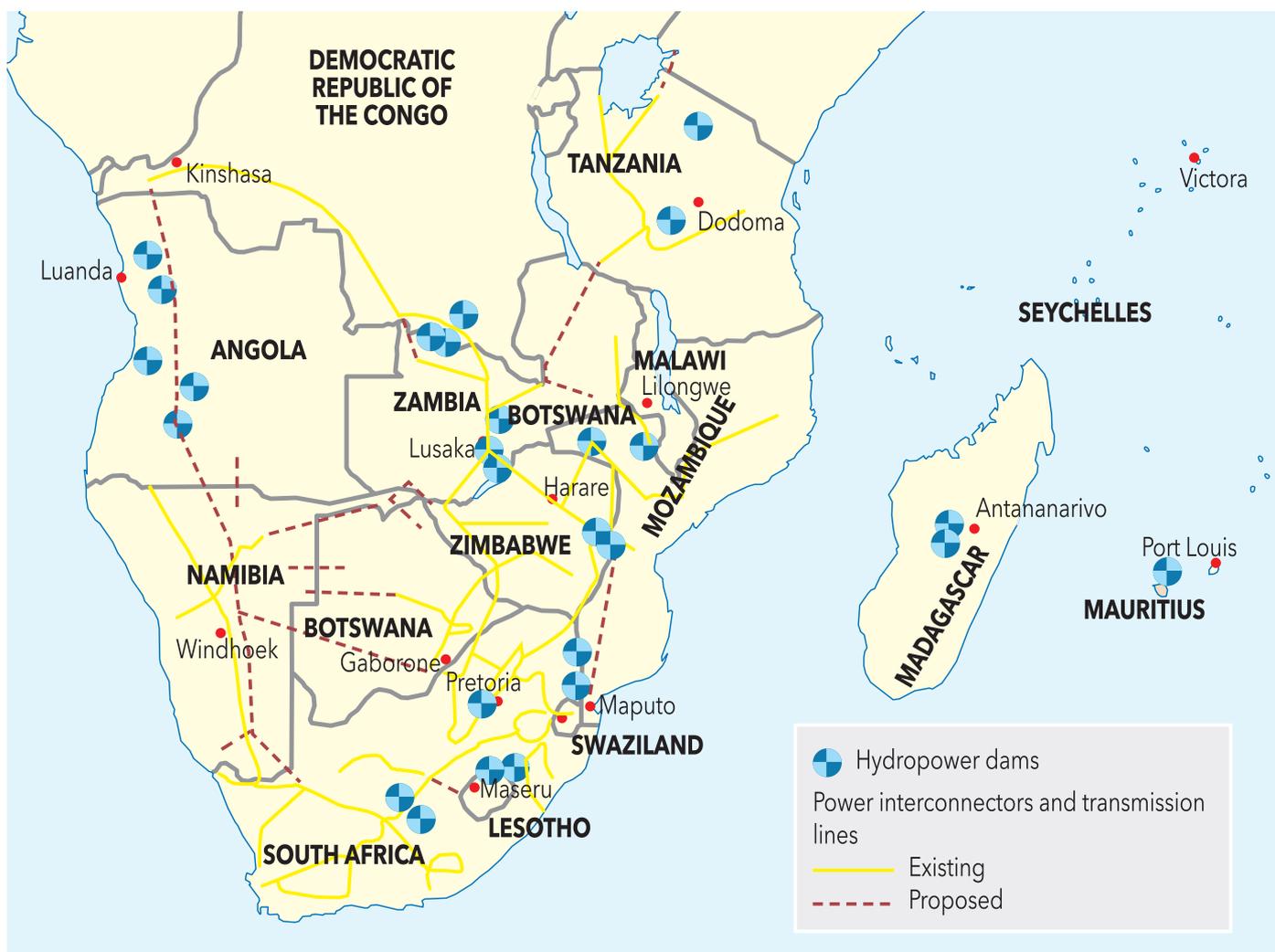
Foreign direct investment

Flows of investment into the SADC region's electricity sector have been rising. From 1998 to 2008 sub-Saharan Africa witnessed a 70% growth in electricity generation, from 73TWh to 123TWh, which translates into an average annual region-wide growth rate of 6% (although very unevenly spread).³⁰ Expansion in renewable energy has been equally strong, with total generation from renewable sources growing annually by 72%, from 45TWh to 78TWh, in the decade to 2008;³¹ hence 66% of all new electricity generated in sub-Saharan Africa since 1998 has come from renewable sources.

³⁰ *Ibid.*

³¹ *Ibid.*

Figure 6: Distribution of energy infrastructure



Source: Authors, redrawn from SADC data, <http://www.sadc.int/themes/infrastructure/en/electricity-generation/>, accessed 15 April 2015

Southern Africa is the leading region south of the Sahara judged on the number of projects funded through foreign direct investment (FDI) on the continent; South Africa remains the largest destination for FDI projects and its lead is widening.³² There are an increasing number of intra-African transnational companies with a growing share of intra-regional investment. Since 2007 FDI projects of that kind have shown a compound annual growth rate of 31.5%,³³ with South Africa emerging as a major investor in the region. The SAPP has played an important part in the process of heightened regional integration and development; it has helped increase market size, added to the attractions of the region for FDI and boosted the positive determinants for foreign investment. A key issue is the volume of FDI inflows into infrastructure development, given that low levels negatively affect the lagged value of revenues.

³² Ernst & Young, *Attractiveness Survey: Africa 2014: Executing Growth*, February 2015, www.ey.com/attractiveness.

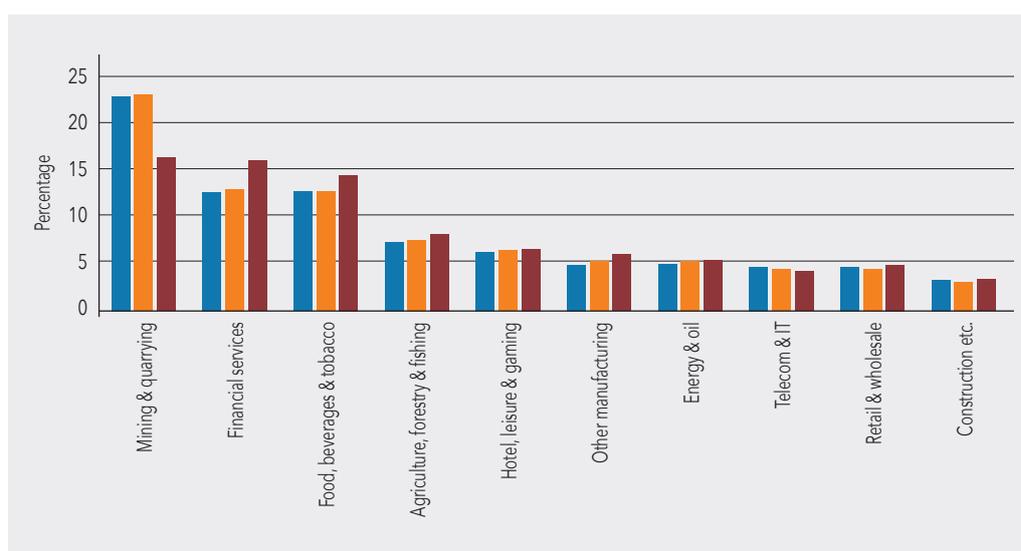
³³ *Ibid.*

Table 2: SADC: Existing power lines

Country 1	Country 2	Line capacity (MW)
Botswana	South Africa	800
Botswana	Zimbabwe	650
Lesotho	South Africa	230
DRC	Zambia	260
Mozambique	South Africa	3 850
Mozambique	Swaziland	1 450
Mozambique	Zimbabwe	500
Namibia	South Africa	750
South Africa	Swaziland	1 450
South Africa	Zimbabwe	600
Zambia	Zimbabwe	1 400

Source: Irena, 'Hydropower', Working paper 1 3/5, Cost Analysis series. Bonn: Irena, 2012

Figure 7: FDI within SADC, by sector

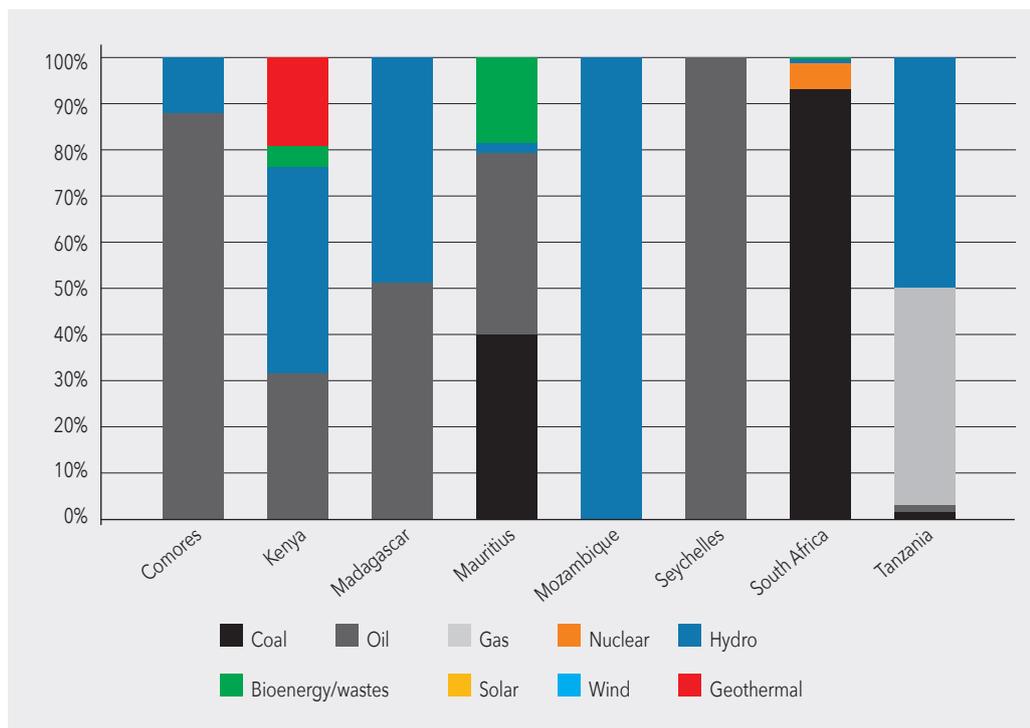


Source: Mupimpila C & FN Okurut, 'Determinants of Foreign Direct Investment in the Southern African Development Community (SADC)', *Botswana Journal of Economics*, 9, 13, 2012

Indian Ocean Rim Association

The Indian Ocean Rim Association (IORA)³⁴ offers prospects for improving regional integration and could be a binding force through co-operation in harnessing oceanic energy resources. This could in turn become a pillar of SADC regional development, with benefits extending beyond the SADC region to countries in the AU as a whole.

Figure 8: Energy sources, IORA member states



Source: Attri VN, Energy Transitions and Corporation in Indian Ocean Region, IORA (Indian Ocean Rim Association), <http://www.hsrc.ac.za/uploads/pageContent/5863/ENERGY%20TRANSITIONS%20AND%20CORPORATION.pdf>

CONCLUSION

Energy production can be a catalyst for regional integration. Such a function, however, demands the cross-pollination of capabilities, resources and technological skills. In addition, the scattered nature of renewable energy sources across the region necessitates regional co-operation and integration, through energy pooling and cross-border interconnection of electricity grids and gas pipeline networks. Successful initiatives in the region thus far demonstrate that regional infrastructure can be utilised to make best use of energy systems and improve reliability, as well optimise the exploitation of renewable resources.

³⁴ The IORA members are Comoros, Kenya, Madagascar, Mauritius, Mozambique, Seychelles, South Africa and Tanzania.

The reality, however, is that the SADC region still relies heavily on technologies developed elsewhere. These are often very costly; in addition they are not fully understood by local communities and are therefore often rejected, thereby failing in their aim of alleviating energy scarcity. In consequence the region continues to be energy deprived, a situation that has a direct negative effect on industrialisation. SADC member states nevertheless are endowed with abundant resources of renewable energy. To exploit this competitive advantage to the full member countries should commit themselves to existing frameworks and guidelines and in addition should consider developing:

- clear internal market policies and guidelines;
- cost-of-service policies and guidelines;
- financial planning policies and guidelines for energy utilities;
- cross-border energy trade guidelines;
- benchmarking programmes for transmission and distribution utilities;
- greater regularity agency capacities;
- policies to promote the participation of small and medium enterprises in the energy sector; and
- policies and guidelines to promote 'Green' economies.

If harmonised across the SADC region, such a process would serve to strengthen regional integration, using energy and energy industries as a basis and focal point for enhanced industrialisation.



Igor Makarov & Alexandra Morozkina

Regional Dimension of Foreign Direct Investment in Russia

EXECUTIVE SUMMARY

In the past decade Russia has become one of the key actors in the global foreign direct investment (FDI) market. Currently it is both one of the largest recipients and contributors of FDI in the world. This paper highlights the current state of inward and outward FDI in Russia, focusing on the regional dimension. Three main regional aspects of Russia-related investment flows are examined, namely inflows from and outflows to European countries; outflows to the countries of the Eurasian Economic Union (EEU); and inflows from the Asia-Pacific region (APR).

The EU countries have always been Russia's principal investment partners, but the crisis in Russia–West relations over the conflict in Ukraine has had a negative impact on this co-operation and actualised Russia's 'turn to the East' in terms of its investment strategy.

This repositioning of Russia's strategic investment focus – from Europe to Asia – was accompanied by other shifts: from the key role played by European Russia in attracting FDI to the rapid development of the country's Asian territories; from using fragmented and politically determined ad hoc instruments to attract FDI to implementing comprehensive mechanisms (ie, 'rapid development territories') in the Russian Far East; and from a fragmented and

passive policy on promoting outward FDI to the active policy that is especially necessary within the EEU. These shifts are likely to form the basis of Russian investment strategy in the near future. However, their success will be determined by more general factors: Russia's economic and institutional development and the growing crisis in its relations with Western countries.

INTRODUCTION

Russia is one of the largest recipients and contributors of foreign direct investment (FDI) in the world. This is partly the result of the widespread practice of 'carousel investment', where companies use tax havens or countries with favourable tax regimes to launder money and then reinvest it in Russia. However, Russia is also a huge market with a growing demand for consumer goods that remains attractive in spite of the considerable political risks and an unfavourable investment climate. At the same time, the largest Russian companies are highly capitalised and look for opportunities to diversify the locations of their activities.

This paper focuses on the regional structure of Russia's inward and outward FDI. Three groups of investment flows are highlighted:

- inflows from and outflows to European countries, historically Russia's major investment partners;
- outflows to the countries of the EEU (inflows from the EEU to Russia are not particularly large); and
- inflows from the APR (outflows from Russia to most APR countries are negligibly small), which is one of the newly established priorities of Russian policy.

For a long time the regional structure of Russia's inward and outward investments was stable, with Europe playing a dominant role. This is starting to change, reflecting the changing priorities in Russia's external policy. However, Russia's reorientation towards greater investment collaboration with Eurasian and APR countries is a very slow process that is far from completed.

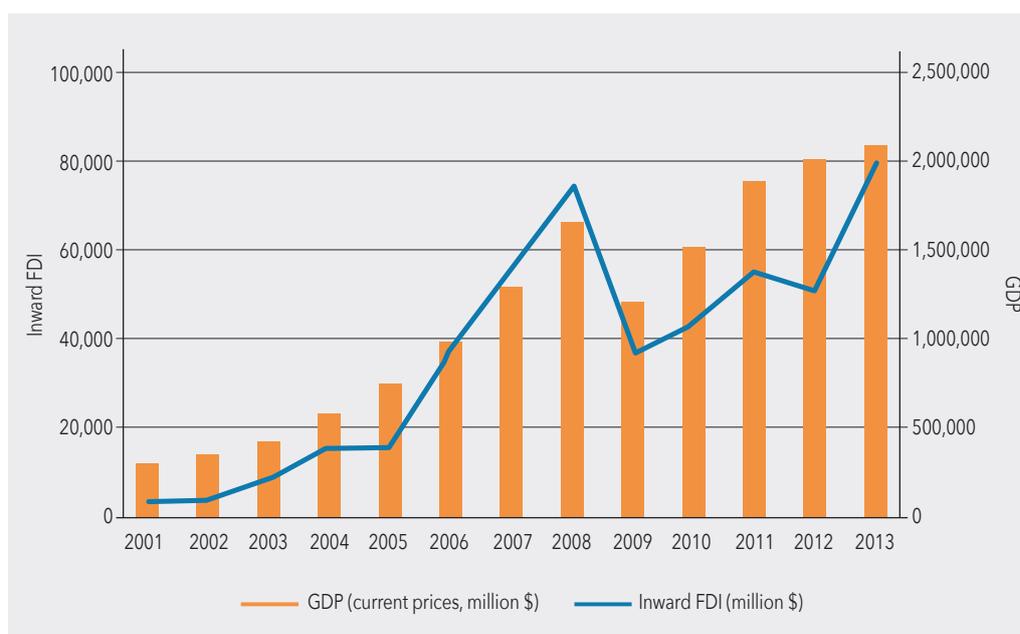
The paper then examines Russia's inward and outward FDI. Its third section examines the inward and outward investment flows into the three regional groups, while the final section reviews the evolution of Russia's policy to attract FDI and its reaction to global economic and political shifts in the past decade.

OVERVIEW OF FOREIGN DIRECT INVESTMENT IN RUSSIA

Volumes of Russia's inward and outward FDI

Since the upswing in its economic growth after the crisis of 1998, Russia has been increasingly attractive to inward FDI. From 2001 to the financial crisis of 2008, FDI in Russia grew from \$2.7 billion to \$74.8 billion annually (Figure 1). This dramatic growth was caused by a number of factors. First, the base level was very low. Second, the country had good prospects for economic growth fostered by high oil prices. Third, the country's internal financial system was underdeveloped and failed to provide firms with sufficient financial resources. Fourth, consumption grew rapidly and Russia became an attractive market for producers of consumer goods, especially because its domestic industry still retained a lot of Soviet-era features and failed to produce commodities of high quality.

Figure 1: Gross domestic product (GDP) and inward FDI to Russia, 2001–2013



Source: UNCTADStat, 'Foreign direct investment', Database, http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx?sRF_ActivePath=p,5&sRF_Expanded=p,5; World Bank, 'World development indicators', Database, <http://data.worldbank.org/data-catalog/world-development-indicators>

The rapid increase in FDI in Russia created a situation where (for the first time) Russia's position in the world in terms of attracting FDI started to correspond to its position in terms of GDP.¹ For example, in 2007 Russia ranked 11th in the world in terms of both inward FDI and GDP, while in 2008 it ranked 8th in terms of GDP and 6th in terms of FDI (Table 1).

1 Vercueil J, 'Foreign direct investments in Russia', in *Russia 2013 Yearbook*, French-Russian Center Observo, 2013.

Table 1: Russia's ranking by GDP and FDI inflows, 2001–2013

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Russia's ranking: FDI inflows	39	29	17	14	14	11	11	6	8	10	9	8	4
Russia's ranking: GDP	17	16	16	16	14	12	11	8	12	11	9	8	8

Source: UNCTADStat, 'Foreign direct investment', Database, http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx?sRF_ActivePath=p,5&sRF_Expanded=p,5; World Bank, 'World development indicators', Database, <http://data.worldbank.org/data-catalog/world-development-indicators>

The 2008 financial crisis resulted in decreasing investment in Russia, and by 2012 FDI still did not exceed 2008 levels. However, 2013 saw a dramatic jump – 57% – in FDI inflows to Russia, to \$79 billion.² It made Russia the world's fourth largest recipient of FDI for the first time. Not taking into account the British Virgin Islands, in terms of inward FDI flows Russia was only behind the US and China. The main cause of this jump was a single transaction by British Petroleum (BP), which acquired 18.5% of Russia's state oil company Rosneft as part of Rosneft's \$57 billion acquisition of TNK-BP.³

According to preliminary UN Conference on Trade and Development data, in 2014 FDI to Russia decreased by 70%, to \$19 billion,⁴ mainly as a result of the high political risk associated with the Ukrainian political crisis. Sanctions imposed on Russia by Western countries, along with an expected recession in Russia in 2015, contributed to the pessimistic outlook. The mitigation of political risks, institutional improvements and renewed economic growth are necessary to restore the trust of foreign investors.

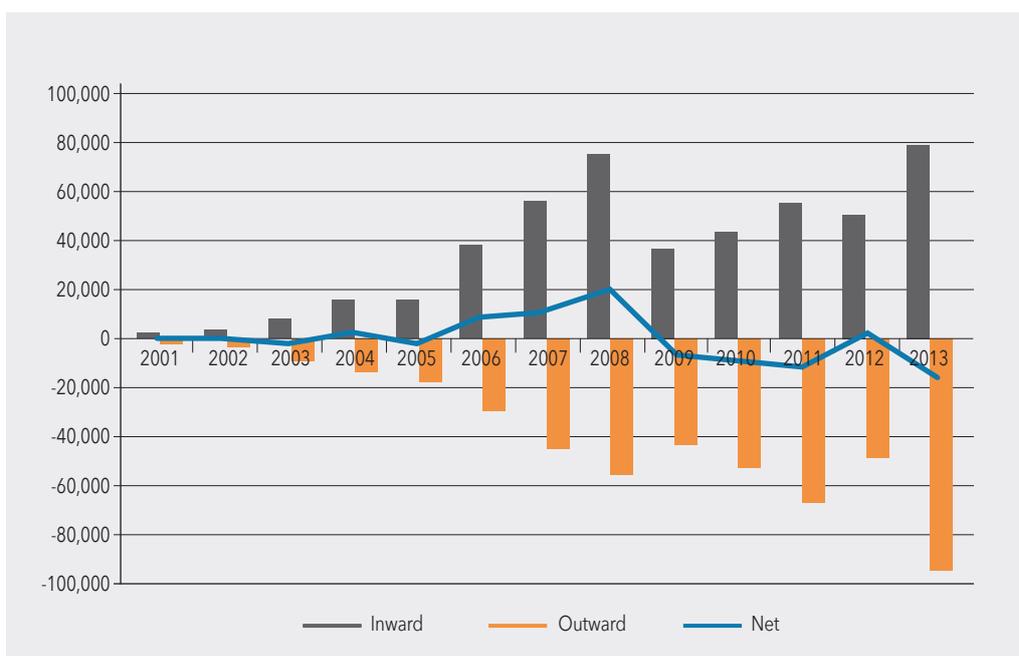
The large volumes of inward FDI flows to Russia are accompanied by even greater outward flows. In 2001–2013 Russia was a net exporter of FDI (Figure 2). The big investments in Russia are underpinned by capital that had previously been taken out of the country. This 'carousel' mechanism is primarily realised through tax havens. Some of these tax havens (the British Virgin Islands, Cyprus, Bermuda) top lists of both recipients and contributors of Russian FDI.

2 UNCTADStat (UN Conference on Trade and Development World Statistical Database), 'Foreign direct investment', database, http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx?sRF_ActivePath=p,5&sRF_Expanded=p,5.

3 UNCTAD, 'Global Investment Trend Monitor', 15, 28 January 2014, http://unctad.org/en/PublicationsLibrary/webdiaeia2014d1_en.pdf.

4 UNCTAD, 'Global Investment Trade Monitor', 18, 29 January 2015, http://unctad.org/en/PublicationsLibrary/webdiaeia2015d1_en.pdf; Vercueil J, op. cit.

Figure 2: Russia's annual inward and outward FDI, 2001–2013, million \$



Source: UNCTADStat, 'Foreign direct investment', Database, http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx?sRF_ActivePath=p,5&sRF_Expanded=p,5

Other outward FDI flows from Russia are associated with the activities of large Russian energy companies that are attempting to invest in strategic assets abroad.

Russia's FDI experienced significant changes over the past decade. In the 1990s and the early 2000s the increasing amount of outward FDI was primarily the result of companies' owners moving capital out of Russia to avoid political risks. Since 2005–2006 the motivation has become more rational and associated with commercial interests, such as gaining access to strategic assets or new technologies, and promoting and diversifying production, etc.⁵ As a consequence, while Russia's FDI abroad was initially viewed by the Russian government only as a loss of resources and an obstacle to economic growth,⁶ certain strategic investment projects have started to garner significant political support.⁷ Many researchers regard Russia's outward FDI as a foreign policy tool. Most of Russia's outward FDI is aimed at resource-related sectors, particularly energy and metals.⁸

According to preliminary estimates, in 2014 Russia's outward FDI was half the 2013 level, although overall capital outflows reached record-high levels. Large Russian companies

5 Pakhomov A, 'Eksport pryamikh investitsiy iz Rossii. Ocherki teorii i praktiki'. Moscow: Izdatyel'stvo Instituta Gaidara, 2012.

6 Kalotay K, 'The Crimean crisis and the future of Russian outward foreign direct investment', *Baltic Rim Economies*, 4, 31 October 2014.

7 Pakhomov A, op. cit.; Kalotay K & A Sulstarova, 'Modeling Russian outward FDI', *Journal of International Management*, 16, 2, 2010.

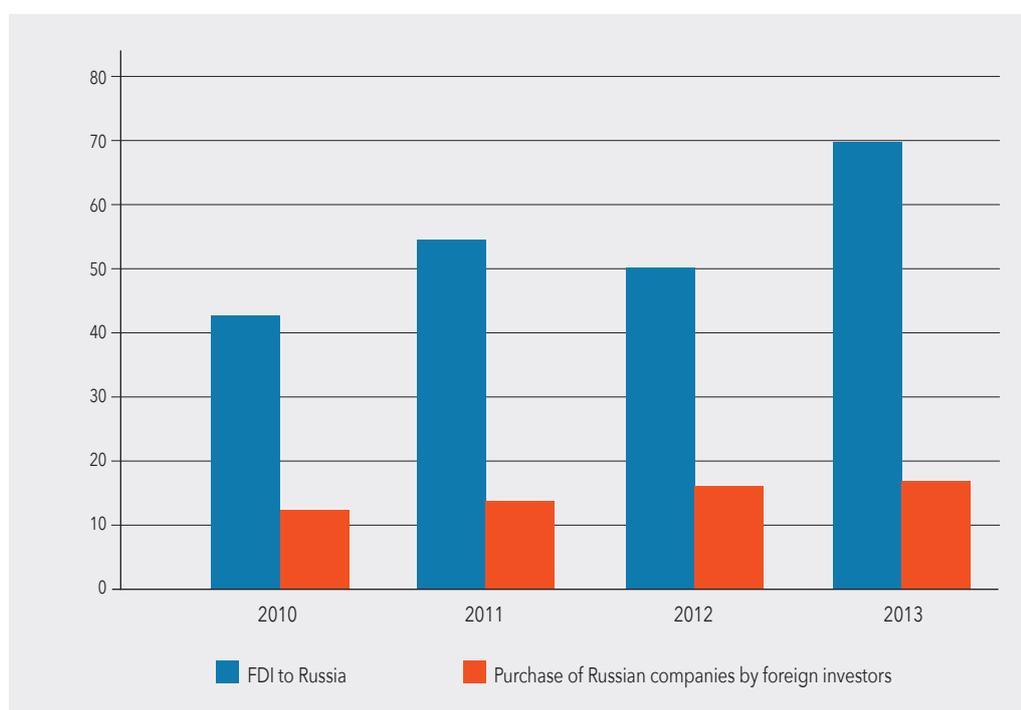
8 Liuhto KT & SS Majuri, 'Outward foreign direct investment from Russia: A literature review', *Journal of East-West Business*, 20, 4, 2014.

(including state-controlled enterprises) curtailed their activities abroad because of a scarcity of financial resources and fears of potential restrictions in countries condemning Russia's actions in Ukraine.⁹ Significant growth in Russia's outward FDI is unlikely until relations between it and the West stabilise. However, some increase in FDI to the BRICS countries, Central Asia and tax havens is possible and could mitigate the overall FDI decline.

Structure of Russia's inward FDI

None of the official data on FDI to Russia is categorised according to the choice of market entry mode: ie, mergers and acquisitions, greenfield investments or joint ventures. However, KPMG¹⁰ estimates that in 2013 the value of Russian assets purchased by foreign investors amounted to \$16.9 billion (Figure 3) – about 24% of total FDI to Russia. One could thus conclude that FDI to Russia is mostly in the form of greenfield investments and joint ventures, eg, building factories and infrastructure.

Figure 3: FDI to Russia, value of Russian assets purchased by foreign investors, 2010–2013, billion \$



Source: Central Bank of Russia, 'Foreign direct investment database', http://www.cbr.ru/statistics/?Prtid=svs&ch=PAR_30241#CheckedItem

⁹ Kalotay K, *op. cit.*

¹⁰ KPMG, 'Ryynok sliyanii i pogloschenii v Rossii v 2013 godu', Moscow, March 2014, http://www.kpmg.com/RU/ru/IssuesAndInsights/ArticlesPublications/Documents/S_MA_3r_2014.pdf.

As the Russian economy's main competitive advantage is the country's abundance of natural resources, there is a widespread belief that resource-related activities attract the most FDI to Russia. This is a myth. In 2010 more than a half of all investment was directed at finance and insurance, as well as to wholesale and retail trade. In 2013 this share decreased to 39%, but it still remains dominant (Table 2). The large volumes of FDI directed at finance and commerce are explained by the fact that the economic growth seen in the 2000s created a strong urban middle class with Western-style consumer behaviour. This led to the boom in sectors such as retail, banking and construction. The share of high-tech industries in the total amount of FDI to the country is low and does not exceed 4–5%.

Table 2: Annual inward FDI flows to Russia by industry in 2010 and 2013, million \$

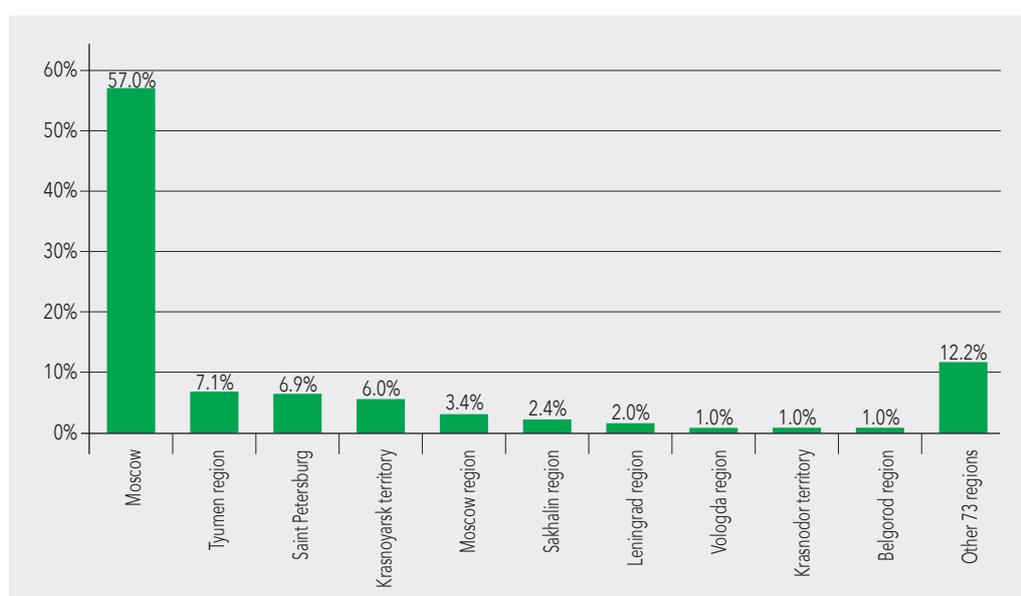
Industry	2010		Industry	2013	
	million \$	%		million \$	%
Total allocated	139,561	100%	Total allocated	189,097	100%
Financial and insurance activities	51,268	37%	Wholesale and retail trade; repair of motor vehicles and motorcycles	43,903	23%
Wholesale and retail trade; repair of motor vehicles and motorcycles	21,809	16%	Financial and insurance activities	31,102	16%
Mining and quarrying	10,683	8%	Mining and quarrying	26,219	14%
Real estate activities	7,523	5%	Coke and refined petroleum products	21,618	11%
Basic metal and fabricated metal products	6,644	5%	Basic metal and fabricated metal products	13,481	7%
Construction	5,859	4%	Other service activities	8,685	5%
Information and communication	5,555	4%	Real estate activities	7,732	4%
Food products, beverage and tobacco products	5,115	4%	Construction	5,771	3%
Professional, scientific and technical activities	4,771	3%	Information and communication	5,305	3%
Other service activities	4,190	3%	Food products, beverage and tobacco products	4,776	3%
Manufacture of motor vehicles, trailers and semi-trailers and other transport equipment	2,425	2%	Mining and quarrying, except of fuel and energy materials	3,453	2%
Electricity, gas, steam and air conditioning supply	2,144	2%	Chemicals and chemical products	3,121	2%
Chemicals and chemical products	2,065	1%	Transportation and storage	2,899	2%
Other	9,510	7%	Other	11,032	6%

Source: Central Bank of Russia, 'Foreign direct investment database', http://www.cbr.ru/statistics/?Prtid=svs&ch=PAR_30241#CheckedItem

As for extractive industries, foreign investors have shown interest but face a number of obstacles. Federal law N57-FZ 'On the procedures for foreign investments in businesses of strategic importance to Russian national defence and state security' of 2008 limits the participation of foreigners in businesses that are associated with the military, space and aviation, nuclear energy and cryptography, as well as in activities related to natural monopolies, fisheries, and the exploration for and extraction of natural resources in subsurface areas that have federal status.¹¹ According to the act, transactions as a result of which 'foreign states, international organisations or organisations under their control gain direct or indirect control over more than 25% of the total voting shares (stock) of the business entities of strategic importance to national defence and state security, or any other possibility to block decisions made by the management of such business entities, or acquire the right to directly or indirectly control more than 5% of the total voting shares' must be approved beforehand by a special committee headed by the prime minister.¹²

Inward FDI is unevenly distributed across Russia. For example, in 2013 nearly 70% of all the FDI inflows to Russia were directed at two main conglomerations (Moscow and the Moscow region, and St Petersburg and the Leningrad region), with 57% going to Moscow alone (Figure 4). Other top recipients – the Tyumen region, Krasnoyarsk territory and Sakhalin region – are resource-abundant regions where a number of large projects are operating with the participation of foreign partners.

Figure 4: Allocation of inward FDI flows to Russia by region, 2013



Source: Central Bank of Russia, 'Foreign direct investment database', http://www.cbr.ru/statistics/?Prtid=svs&ch=PAR_30241#CheckedItem

¹¹ Russia, Federal Law N57-FZ, 'Procedures for Foreign Investments in Business Entities of Strategic Importance for Russian National Defense and State Security', 2008, http://en.fas.gov.ru/legislation/legislation_50727.html.

¹² *Ibid.*

The National Rating Agency tried to exclude the FDI coming from tax havens from this data. In some regions tax havens' share reached 100%, and tax havens provided 65.4% of FDI flows to Moscow in 2013. This data revision led to less regional inequality in terms of FDI. Three oil- and gas-rich regions (the Nenets and Yamal Nenets autonomous okrugs and Sakhalin region) remain the leaders, but were joined by Primorye territory in the Russian Far East and two industrialised regions in Central Russia (the Kaluga and Tula regions). Moscow came seventh.¹³

RUSSIA'S INWARD AND OUTWARD INVESTMENT BY REGION

Europe

Europe is the largest contributor and recipient of Russian FDI. A considerable amount of Russian investment flows to Europe pass through tax havens, thus the official figures do not always reflect the real geographical distribution of outward FDI. The Institute of World Economy and International Relations of the Russian Academy of Science (IMEMO)¹⁴ estimates the foreign assets of the 20 largest Russian transnational companies as a proxy for the real distribution of investment by country (Figure 5). According to this data, accumulated investment in Europe amounted to almost half of all investments in 2009 (official statistics show a much lower level – 25% – for the same period).¹⁵

Europe's prominent role in FDI flows is the result of the structure of Russia's external trade, which is largely concentrated in Europe. Russian companies are interested in additional outward investment in the production chains, technological cycles, guaranteed product markets and supplies in Europe. However, taking into account Russia's current focus on Eastern markets, investment in European countries is likely to decrease in the coming years.

The main destinations of Russian FDI outflows to Europe are tax havens (eg, Cyprus and Luxembourg) or rich European countries that guarantee strict confidentiality and have favourable tax regimes (eg, the Netherlands, Switzerland and Austria). Usually such investments are aimed at securing tax benefits or laundering money, and suggest eventual reinvestment in Russia. From the data it is also clear that the share of investment outflows from Russia to European countries decreases as the share of non-European tax havens expands. For example, at the moment the largest recipient of Russian FDI outflows is the British Virgin Islands (increasing from 1.6% of total FDI from Russia in 2007 to 71.8% in 2013).¹⁶

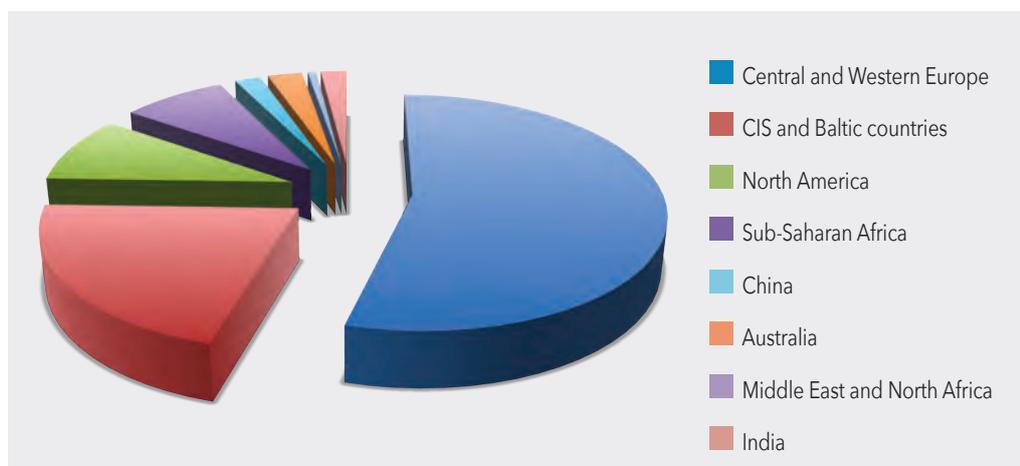
13 Natsional'noye reitingovoye agentstvo, 'Pryamyye inostrannyye investitsii v Rossii: regional'niy aspekt. Itogi 2013 goda'. Moscow, April 2014, http://www.ra-national.ru/uploads/rus/files/analytic/file_review/20.pdf.

14 IMEMO RAN (Institute of World Economy and International Relations of the Russian Academy of Science), Export rossiyskikh pryamih investitsiy stabilizirovalsya po mere okonchaniya mirovogo krizisa. Moscow: IMEMO, 23 June 2011, http://www.imemo.ru/files/File/ru/publ/2011/23062011_pr.pdf.

15 Central Bank of Russia, 'Foreign direct investment database', http://www.cbr.ru/statistics/?Prtdid=svs&ch=PAR_30241#CheckedItem

16 *Ibid.*

Figure 5: Location of foreign assets of 20 largest Russian companies, 2009



Source: IMEMO RAN, 'Export rossiyskih pryamih investitsiy stabilizirovalsya po mere okonchaniya mirovogo krizisa'. Moscow: IMEMO, 23 June 2011, http://www.imemo.ru/files/File/ru/publ/2011/23062011_pr.pdf

Table 3: Outward FDI to Europe by country, 2007 and 2013

2007				2013			
		\$ million	% of total FDI			\$ million	% of total FDI
1	Cyprus	14,700	32.8	1	Cyprus	7,689	8.87
2	Netherlands	11,991	26.8	2	Austria	5,265	6.07
3	UK	2,454	5.48	3	Switzerland	1,358	1.57
4	Switzerland	1,404	3.13	4	Spain	1,356	1.56
5	Germany	673	1.50	5	Germany	1,334	1.54
6	Luxembourg	497	1.11	6	Luxembourg	1,314	1.52
7	Spain	258	0.58	7	UK	1,294	1.49
8	France	257	0.57	8	Denmark	752	0.87
9	Czech Republic	248	0.55	9	Latvia	568	0.66
10	Austria	230	0.51	10	Bulgaria	554	0.64

Source: Central Bank of Russia, 'Foreign direct investment database', http://www.cbr.ru/statistics/?Prtid=svs&ch=PAR_30241#CheckedItem

The group of countries investing in Russia remains largely unchanged (six out of the top 10 countries appear on both the 2007 and 2013 lists), although the amounts vary. In some years more than half of Russia's inward FDI comes from tax havens (Table 4). Taking into account that most of this FDI and a significant percentage of that from tax-friendly European countries are Russian in origin, the total volume of FDI to Russia should not be overestimated.

Table 4: Inward FDI from Europe by investor country, 2007 and 2013

2007				2013			
		\$ million	% of total FDI			\$ million	% of total FDI
1	Cyprus	11,917	21.3	1	UK	18,927	26.8
2	Netherlands	10,268	18.4	2	Luxembourg	11,639	16.5
3	Germany	7,626	13.6	3	Ireland	10,399	14.7
4	Norway	1,300	2.33	4	Cyprus	8,285	11.7
5	Finland	677	1.21	5	Netherlands	5,751	8.14
6	UK	656	1.17	6	France	2,100	2.97
7	Sweden	529	0.95	7	Switzerland	1,086	1.54
8	France	415	0.74	8	Belgium	755	1.07
9	Switzerland	386	0.69	9	Hungary	736	1.04
10	Spain	366	0.66	10	Germany	319	0.45

Source: Central Bank of Russia, 'Foreign direct investment database', http://www.cbr.ru/statistics/?Prtid=svs&ch=PAR_30241#CheckedItem

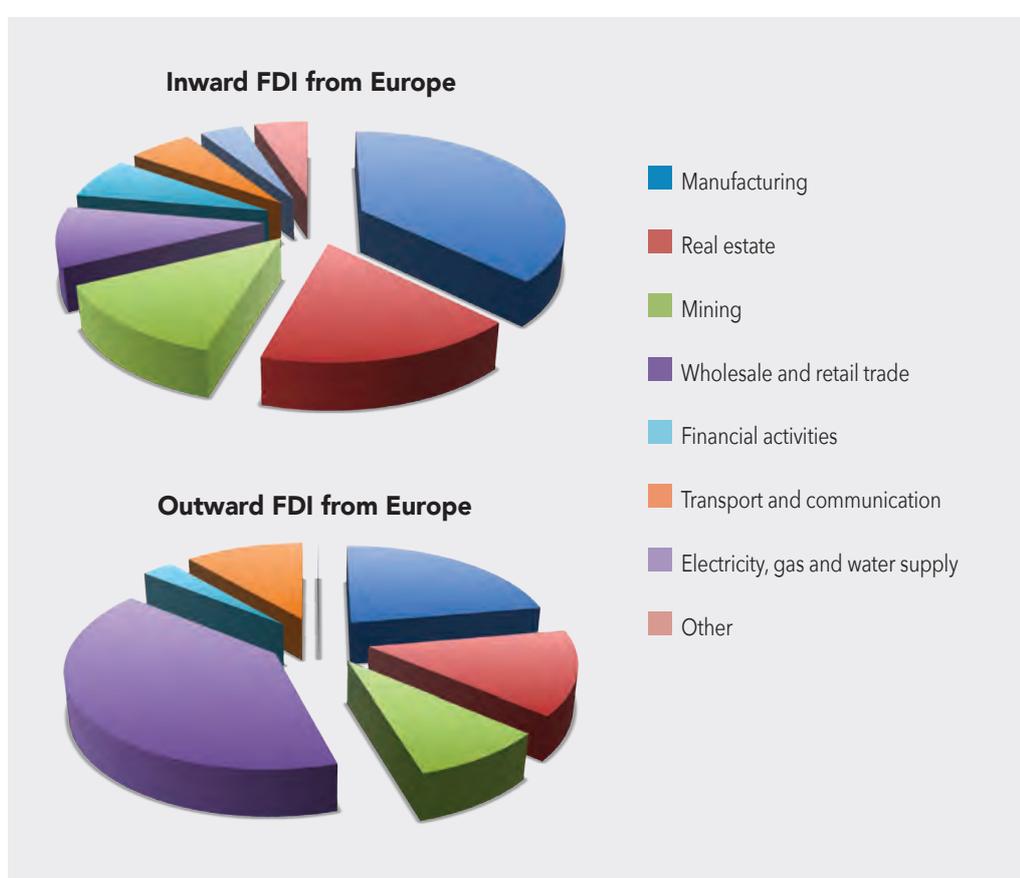
There are a few estimates of the share of pseudo-FDI, ie, reinvestments by Russian companies via tax havens. Kuznetsov estimates this share at 20%, IMEMO at 60–70%, and Solntsev at 50%.¹⁷ As a result, official estimates of the geographical distribution of FDI may not be precise. For example, according to official statistics Russia's main investment partners in Europe are based in the British Isles (UK and Ireland) and Western (Luxembourg, France) and

17 Kuznetsov A, 'Evolutsiya rossiyskikh TNK: Ot regionalnih kompaniy k globalnim', *Vestnik Federalnogo Gosudarstvennogo Uchrezhdeniya 'Gosudarstvennaya registratsionnaya palata pri Minyuste RF'*, 4, 2011.

Southern Europe (Cyprus), whereas the more geographically and historically close Central and Eastern European countries account for only 2.2% of FDI inflows and 4.1% of outflows.¹⁸

The main recipients of total FDI, including pseudo-FDI, from the EU to Russia are the manufacturing and real estate sectors. Together they account for more than 50% of all inward FDI stocks from Europe. Outward FDI is also not diverse. Two sectors – manufacturing and wholesale and retail trade – account for 62% of the FDI stocks from Russia to European countries.

Figure 6: Inward FDI stocks from Europe to Russia and outward FDI stocks from Russia to Europe, 2013



Source: Russian Federal State Statistics Service, <http://www.gks.ru/>

¹⁸ Central Bank of Russia, 'Foreign direct investment database', http://www.cbr.ru/statistics/?Prtd=svs&ch=PAR_30241#CheckedItem

Eurasia

Russia is making a concerted effort at greater integration with the Eurasian region in which the post-Soviet space is usually understood. The Eurasian Economic Community (EAEC) was founded in 2000 and consists of Belarus, Kazakhstan, Kyrgyzstan, Russia, Tajikistan and Uzbekistan (whose membership is currently suspended). It was established to promote a customs union and a single economic space, co-ordinate member states' policies and integrate them into the world economy. The Eurasian Customs Union (or the Customs Union of Belarus, Kazakhstan and Russia) was established in 2010, and the EEU, which features greater economic integration, was established on 1 January 2015. The EEU consists of Russia, Belarus, Kazakhstan, Armenia and Kyrgyzstan (which joined in May 2015). In contrast to the EAEC and Eurasian Customs Union, the EEU envisages the formulation of common trade, monetary and fiscal policies and the establishment of supranational agencies, including an economic commission, commodities commission and international investment bank.

Currently, FDI inflows from EEU members to Russia amount to 0.7% of its total FDI inflows, and FDI outflows from Russia to member countries account for 1.9% of its total outflows, according to official data of the Central Bank of Russia.¹⁹ However, this data is not entirely relevant due to the large amount of FDI flows to and from Russia via tax havens. The Eurasian Development Bank gives estimates of FDI flows between the Eurasian countries from the official Central Bank of Russia's data. The biggest gap is between the official and estimated outflows from Russia to Kazakhstan (Table 5).

Table 5: FDI stocks by country, EEU members, 2009–2013, billion \$

	2009		2010		2011		2012		2013	
	^a MMI	^b CBR	MMI	CBR	MMI	CBR	MMI	CBR	MMI	CBR
Kazakhstan	10.3	1.7	10.0	2.0	10.7	2.6	10.9	2.5	9.3	2.8
Belarus	4.0	5.7	5.2	5.7	7.4	4.7	7.7	3.8	7.9	4.1
Armenia	1.9	1.5	2.0	1.8	2.1	1.4	2.2	1.6	2.2	1.4
Kyrgyzstan	0.4	0.1	0.6	0.1	0.6	0.1	0.7	0.2	0.6	0.2
Total	16.6	9.0	17.8	9.6	20.8	8.8	21.5	8.1	20.0	8.5

Note: ^aMMI = Monitoring of Mutual Direct Investments in the Commonwealth of Independent States;

^bCBR = Central Bank of Russia

Source: EABR (Eurasian Development Bank), 'Monitoring of Mutual Direct Investments in the Commonwealth of Independent States countries', Report No. 26, St Petersburg, 2014; Central Bank of Russia, 'foreign direct investment database', http://www.cbr.ru/statistics/?Prtid=svs&ch=PAR_30241#CheckedItem

¹⁹ *Ibid.*

Table 6: Accumulated FDI by country, EEU members, 2013, billion \$

Recipient country	Investing country			Total
	Belarus	Kazakhstan	Russia	
Armenia	-	0.01	2.2	2.21
Belarus	-	0.02	7.9	7.92
Kazakhstan	0.05	-	9.27	9.32
Kyrgyzstan	-	0.5	0.64	1.14
Russia	0.39	2.96	-	3.35
Total	0.44	3.49	20.01	23.94

Source: EABR, 'Monitoring of Mutual Direct Investments in the Commonwealth of Independent States countries', Report No. 26, St Petersburg, 2014

Russia is the principal investor in all regional states (Table 6), with the largest flows directed to Kazakhstan and Belarus. FDI flows in the opposite direction are much lower. Investments to Russia come mostly from Kazakhstan, as it is a second-largest investor in the region.

Further deepening and expansion of integration is expected to increase interregional investment flows. At the same time, the potential for investment expansion is limited. First, most transnational Russian companies are already active in this market. Second, most of the available attractive assets have already been acquired. Third, competition for this market has increased in recent years as Western Europe and especially China are showing growing interest in it.

From the Russian perspective the members of the EEU – Belarus, Kazakhstan, Kyrgyzstan and Armenia – are of the greatest interest.

Belarus

Investment flows in Belarus are strictly regulated by the authorities, thus the public sector is the source of most investments, both foreign and domestic. As Belarus and Russia have strong economic ties, almost half of FDI in Belarus is Russian. The largest investment project financed by a Russian company has been the purchase of natural gas company Beltransgaz by Gazprom for \$5 billion. Experts do not envisage any comparable projects in the foreseeable future.²⁰ The second-largest project is valued at a sixth of the Beltransgaz

²⁰ EABR (Eurasian Development Bank), 'Monitoring of Mutual Direct Investments in the Commonwealth of Independent States countries', Report, No. 26, St Petersburg, 2014.

acquisition (MTS Belarus, which is a joint venture by MTS Russia [49%] and Beltelecom [51%]). As for investment opportunities, the government of Belarus is considering selling its 51% share in MTS Belarus, but the Eurasian Development Bank²¹ estimates that the deal will not net it more than \$1 billion. This means that closing the deal would increase Russian FDI in Belarus by only 10%. Another possible forthcoming deal is the purchase of the Mozyr oil refinery by Rosneft as part of Belarus's privatisation programme. However, it is unlikely that Rosneft will be prepared to pay the announced \$4 billion. The Russian banking sector is also interested in expanding into Belarus, which could increase FDI flows. In 2012 the total authorised capital of Russian banks' Belarus subsidiaries increased by \$237 million; in 2013, by \$85 million.²² Russian companies in other service sectors could be interested in additional investments to increase their sales in Belarus. However, it is unlikely that investments in the oil refinery, service and financial sectors will significantly increase FDI in Belarus in the near future.

Kazakhstan

Kazakhstan is a country of increasing investment opportunities coupled with rising competition. Key competitors are Chinese companies (which are mostly interested in getting access to natural resources) and Western European companies (which are interested in meeting local companies' demand for Western technology). Infrastructure projects are attractive to both Russia and China, and not only in Kazakhstan but also in other Central Asian countries. However, currently most Chinese and Russian investors' projects are concentrated in the energy sector. China and Russia are often competitors in the field of oil and natural gas extraction. At the moment, Russian investments are much smaller than those of the Chinese. Thus, Lukoil invested about \$3 billion in Kazakhstan. Gazprom's investments are steadily increasing and amount to \$0.3 billion, while Russia invested an additional \$0.2 billion in the Kazakh section of the Caspian pipeline syndicate. In comparison, China's CNPC invested more than \$12 billion in oil and gas production in Kazakhstan and an additional \$6.2 billion was directed at the construction of pipelines. Sinopec invested \$1.4 billion in fossil fuel production, CITIC and China Investment Corp. invested \$0.95 billion and a few relatively minor companies invested \$0.7 billion.²³

Excluding oil and gas projects, Russian FDI in Kazakhstan is fairly small, albeit increasing. In 2013 Atomredmetzoloto bought uranium mines, and in 2014 Evraz established a joint venture – Evraz Caspian Steel (light-section rolling mill) – in the steel industry (its share

²¹ *Ibid.*

²² *Ibid.*

²³ *Ibid.*

amounted to 65%), according to the Evraz Group.²⁴ Examples of other projects in the manufacturing sector are the development of the Kok-Jon phosphate rock deposit and the planned construction of a fertiliser complex by EuroChem, and the acquisition of 50% of Kazakhstan's locomotive factory (Locomotive Kurastyru zauyty) by Transmashholding.

China is planning to develop its Silk Road Economic Belt in Central Asia, which promises \$40 billion in Chinese investment in the near future. Russia's President Vladimir Putin and China's President Xi Jinping signed a statement on co-operation on the development of the joint EEU and the Silk Road Economic Belt on 8 May 2015.²⁵ The document forms the basis for the co-ordination of the two projects and is aimed at building a common economic space in Eurasia.

Armenia and Kyrgyzstan

In Armenia there is limited potential for Russia to expand its investments as there is a dearth of attractive projects and Russian companies already have a large presence in the market. About 40% of the country's FDI is Russian.

Kyrgyzstan is likely to be politically unstable in the foreseeable future. Frequent government-sanctioned property redistribution in this country impedes FDI inflows. Russia is among three key investors in Kyrgyzstan, along with China and Canada. Russian investment in Kyrgyzstan is mostly directed at the energy sector – in 2014 Gazprom bought Kyrgyzgazprom for the symbolic amount of \$1 but undertook to invest about RUB²⁶ 20 billion (\$0.5 billion) in fixed assets over a five-year period. The Kyrgyz government also signed a sale agreement with Rosneft for 51% of Manas airport. Co-operation is expected to increase since Kyrgyzstan has joined the EEU.

Asia-Pacific region

The countries of the APR have never been major partners of Russia in terms of investment co-operation. Japan had a negative experience in the Sakhalin-2 energy project, which was initially driven by Anglo-Dutch Shell (55%), Japanese Mitsui (25%) and Mitsubishi (20%). In 2007 the controlling stake was transferred to Gazprom. South Korea proposed a number of joint logistic projects in the Primorye region for the Asia–Pacific Economic Co-operation Summit in Vladivostok in 2012, but the Russian party seemed unmotivated.²⁷ China has always been interested in investing in Russia, but until recently Russia has not been very

24 EVRAZ, 'Structure', <http://www.evraz.com/about/structure/>.

25 'Joint statement of the People's Republic of China and the Russian Federation on cooperation on the development of the joint EEU and the Silk Road Economic Belt', 8 May 2015, <http://kremlin.ru/supplement/4971>.

26 Currency code for the Russian rouble.

27 Makarov IA *et al.*, *Toward the Great Ocean – 2, or Russia's Breakthrough to Asia*. Moscow: Valdai Discussion Club, 2014

enthusiastic about the prospect. Many businesspeople confirm that there have been informal limitations to Chinese participation in strategic projects in Russia. The Russian government has always viewed Chinese economic expansion in Russia as a threat, and feared that it would be followed by demographic expansion. While the population of the Russian Far East (6.2 million km², or 36% of Russia's territory) is 6.2 million, China's three north-eastern provinces (total area of 810 000 km²) are populated by 110 million people. This is the main reason why Russia's resource sector has been closed to Chinese investors, as have been all projects that required a Chinese labour force. As for the more advanced industries in European Russia, such as logistics or automobiles, Chinese investment was blocked because of fears that this would lead to the import of Chinese technologies (which have different standards relative to Russian ones and thus could undermine complementary economic activities based on Russian standards) and that China would monopolise the market.²⁸ As a result, in 2012 the APR countries provided only about 1% of inward FDI in Russia.

However, Russia's investment in the APR used to be even smaller (Table 7). The Asian market environment is very different from the European or post-Soviet one and Russian companies still lack the necessary skills and experience. There are only two significant exceptions among the APR countries. The first is Singapore, which is a global financial centre, and the second is Vietnam, which has been one of Russia's major partners since the Soviet era. A joint energy company, Vietsovetpetro, was established in 1981 and still operates today. In 2000 another joint enterprise – Vietgazprom – was created. Both successfully developed oil and gas projects in Vietnam a decade ago, but since then their activities have contracted.

Russia's investment co-operation with the APR countries started to change in 2012. The transformation of the global economic and political landscape led to changes in the regional priorities of Russia's foreign policy – Russia began to 'turn to the East'. This necessitated intensifying both political ties and trade and investment co-operation with Asian countries, which should result in Russia's full-scale integration into the Asia–Pacific region.²⁹

These changes in Russia's external economic policy were initiated in parallel with the rapid development of Russia's Eastern territories. Russia's Far East became a platform for intense collaboration with other APR countries (see below). Russian state agencies and companies signed memorandums of understanding (MoUs) on participation in investment projects in the Far East with a dozen large foreign companies, including Marubeni, Mitsubishi, Toyota Tsusho, Sumitomo, Mitsui & Co, and Itochu.³⁰

28 Gabuev A, 'A troublesome partnership', *Russia in Global Affairs*, 13, 5, 2014.

29 Makarov IA *et al.*, *op. cit.*

30 Ministry for the Development of the Russian Far East, 2014, <http://minvostokrazvitia.ru/>.

Table 7: Inward FDI from the APR to Russia and outward FDI from Russia to the APR in 2012, \$ million

	Inward investment		Outward investment	
	2012 (flow)	2012 (stock)	2012 (flow)	2012 (stock)
China	450	2152	63	234
Hong Kong	65	373	9	133
Japan	596	2571	-	21
South Korea	119	1340	19	32
Singapore	577	749	1,262	1,252
Vietnam	-26	386	99	412
Thailand	10	108	79	163

Source: UNCTADStat, 'Foreign direct investment', database, http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx?sRF_ActivePath=p,5&sRF_Expanded=p,5

This co-operation is now being decelerated because of the conflict in Ukraine. Japan joined the sanctions against Russia, which made some joint projects impossible. South Korea has preferred to take a wait-and-see attitude. However, Russia–China investment co-operation has been developing rapidly. In 2012 the Russian Direct Investment Fund and China Investment Corporation established the Russia–China Investment Fund (RCIF). According to the official press release, 'RCIF focuses on projects that foster economic cooperation between the two nations and will invest at least 70% of its capital in Russia and Commonwealth of Independent States countries and up to 30% in China.'³¹ A number of joint projects have already been launched. Since 2013 all the informal limits on Chinese participation in Russia's strategic projects have been removed.³² In 2013 China's CNPC acquired 20% of the ambitious Yamal liquefied natural gas project in the Russian Arctic operated by Russian gas company NOVATEK. Russia's largest oil company, Rosneft, started to attract finance from China's energy companies in exchange for future oil supplies and shares in Russia's oilfields. In 2014, 78 agreements were signed during meetings between Putin and Jinping in May and September, most of which were commercial. Another 32 agreements were signed in May 2015. Chinese firms have gained access to many Russian

³¹ RDIF (Russian Direct Investment Fund), website, http://rdif.ru/Eng_Index/.

³² Gabuev A, *op. cit.*

industries, including energy, logistics, automobile and food. However, Russia's FDI in China is much more limited. The largest confirmed project is an oil refinery in Tianjin, in which Rosneft holds a 49% share.

Russia–China investment co-operation is likely to accelerate in the near future. Russian companies need project finance, which now cannot be provided by either internal sources or Western firms. In order to attract finance from China, Russian firms will have to agree to favourable conditions for China's participation in investment projects in Russia. Co-operation is expected to be especially strong in the energy sector, where Russia's assets are the most attractive, while the relevant Russian companies also suffer the most under Western sanctions.

RUSSIA'S POLICY ON FDI

In terms of FDI, the Russian government has thus far focused on attracting inward investment rather than promoting outflows. The lack of policies supporting outward FDI can be explained by the continuous capital flight from Russia. For a long time any capital outflows were considered to be a negative phenomenon. The Russian government has only recently begun to provide political support to outflow investments, and then mainly to large energy companies whose investments in developing or transitioning economies have both commercial and geostrategic significance.³³

Other companies (including small and medium enterprises) still receive little support. One of the functions of the state-controlled Export Insurance Agency of Russia, established in 2011, is to provide financial support to outward FDI, but due to its limited authorised capital it is unable to provide sufficient support to both exporters and investors. Russia's diplomatic corps, trained in the Soviet era, work primarily on political issues and have insufficient experience in promoting Russian companies abroad. As a result, governmental support of Russian FDI abroad is fragmented and inconsistent.

Russian policies aimed at attracting FDI to the country are much more developed and comprehensive. According to an Ernst & Young survey, FDI in Russia created more than 13 000 jobs in 2012. In terms of jobs created by FDI, Russia ranked second in Europe.³⁴ Yet despite these encouraging numbers, job creation has never been considered to be Russia's main objective in attracting FDI. Russia has a low unemployment rate (5.5% in 2013),³⁵ and in large cities, which are the most attractive for FDI, it is close to zero. Nevertheless, attracting FDI has for a long time been one of the top priorities of Russian economic policy.

33 Pakhomov A, *op. cit.*

34 Ernst & Young, 'Ernst & Young's attractiveness survey: Russia 2013 – Shaping Russia's future', 2013, [http://www.ey.com/Publication/vwLUAssets/2013-Russia-attractiveness-survey-Eng/\\$FILE/2013-Russia-attractiveness-survey-Eng.pdf](http://www.ey.com/Publication/vwLUAssets/2013-Russia-attractiveness-survey-Eng/$FILE/2013-Russia-attractiveness-survey-Eng.pdf).

35 Russia's Federal State Statistics Service, website, <http://www.gks.ru/>.

Russia's main objectives in attracting FDI are diversifying and modernising the economy, introducing new technologies and encouraging innovation. FDI from Western countries is necessary as a source of new technologies and modern management practices – both of which are scarce in Russia.

Thus the most valuable investments for Russia are those aimed at high value-added industries, especially high-tech. The biggest success story of the past decade has probably been the development of the automotive cluster in the Kaluga region. A combination of geographical proximity to Moscow's fast-growing car market, flexible regional management and a favourable tax and administrative regime provided by the federal and regional governments made it possible to attract such companies as Volkswagen, Volvo, Peugeot, Citroen and Mitsubishi Motors in 2007–2008. In 2012 the 500 000th VW was produced in Kaluga. Three plants together with 22 suppliers comprise one of the most successful business projects in Russia and created 12 000 jobs in a region that had not seen any industrial development previously.³⁶

After Dmitri Medvedev had succeeded Putin as president in 2008, support for high-tech industries was declared one of the main state priorities. Skolkovo Innovation City was built near Moscow in order to support researchers, entrepreneurs and investors focusing on information technology, energy efficiency, biomedicine, space, nuclear technology, etc. Another technopark was built near Kazan and has become one of the largest in Eastern Europe. This technopark was organised in the form of a special economic zone. Another high-tech-oriented special economic zone was created in Tomsk city in western Siberia. It has already managed to attract some large companies, such as Nokia Siemens Networks, Darim International and Rovi Corporation.³⁷ The initial results of these initiatives have been mixed: some start-ups were launched successfully and technoparks see positive investment dynamics, but none of the expected breakthroughs has materialised yet.

Another important objective of attracting FDI is creating poles of economic growth outside Moscow and resource-rich regions. In 2005 Federal Law N116-FZ 'On Special Economic Zones in the Russian Federation' was passed. The aim of the law was to install special tax and administrative regimes in those territories with competitive advantages in order to attract investors. This economic activity should help to advance the complex development of regions, furthering economic growth without direct state support. Thus far 30 special economic zones have been created (the last one – a special economic zone for the automotive industry – in August 2014 in Vladivostok). They are divided into four groups: industrial; innovation; tourism; and ports and logistics. Industrial and innovation zones are

³⁶ Crouch D, 'Russian automotive: Kaluga creates cluster template', *Financial Times*, 26 June 2013.

³⁷ Ernst & Young, *op. cit.*

the most developed. Investors have access to the necessary infrastructure at preferential terms, with a favourable administrative and special tax regime (Table 8).

Table 8: Financial incentives in industrial and innovation special economic zones

	Russia	Special economic zones	
Profit tax, %	20	2–15.5	
Wealth tax, %	2.2	0	
Land tax, %	1.5	0	
Transport tax, euro per horsepower	0.1-3.5	0	
Payroll tax, %	30	Operating personnel	Research and development personnel
		30	14
Price of land	100% market price	4–50% of cadastral price	

Source: JSC ‘Special economic zones’, <http://eng.russez.ru/>

According to a report published by Russia’s Audit Chamber in 2013,³⁸ the state has spent RUB 122 billion (about \$3.7 billion) on special economic zones since 2006. Despite significant administrative and tax incentives, these zones have failed to attract investors. Only one zone – Alabuga in Tatarstan – is viewed as a success. All the tourism and logistic zones have failed; some have not attracted one new investor since their launch. In 2010 one of the tourism zones in Krasnodar territory was closed. In 2014 two more zones became moribund: the logistic zone in the Murmansk region and the tourism zone on Russkiy Island in Vladivostok.³⁹

There are many possible explanations for the failure of these special economic zones. The industrial and innovation zones are too small and therefore unable to stimulate regional economic development. In some cases they have not been integrated into the transport,

38 Schyotnaya palata Rossiiskoi Federatsii (Accounting Chamber of the Russian Federation), ‘Otchyot o rezul’tatakh kontrol’nogo meropriyatiya “Audit effektivnosti ispol’zovaniya gosudarstvennykh sredstv, napravlennykh na sozdaniye I razvitiye osobykh ekonomicheskikh zon’, *Bulleten*’ Schyotnoy palaty, 3, 2014, <http://www.ach.gov.ru/upload/uf/fac/fac89025a3b0198bcdedfb9d1962bec.pdf>.

39 Zabavina J & P Netreba, ‘Mineconomrazvitiya predlagaet zakryt’ dve osobyie ekonomicheskie zony’, *RBC Daily*, 19 August 2014, <http://rbcdaily.ru/economy/562949992170761>.

economic and social networks of the region. Sometimes the locations of zones have been chosen on the basis of political rather than economic criteria (this affects primarily tourism special economic zones). In 2010 several zones were created in the North Caucasus, including in such unstable regions as the republics of Ingushetia and Dagestan. This was done for political reasons and as a result no new investors have been registered in these zones since their establishment.

Another example of political logic prevailing over economic realities is the establishment of two regional special economic zones: the Kaliningrad region (effective from 1996 to 2031) and the Magadan region (from 1999 to 2025). The former is an exclave separated from the main part of Russia by the Baltic states, while the latter is located in the east of Russia on the Pacific Ocean. In the 1990s both had strategic importance in terms of national defence and preventing separatism. Special economic zones were created there to mitigate political risk, and economically they are insignificant.

The most recent regional special economic zone was created in the Crimea in November 2014. It is considered a tool to revive economic activity in the republic and has a notable political dimension. However, it is unlikely to attract FDI, as political risks tend to outweigh potential benefits, however sizeable the latter may be.

On the whole, the measures undertaken by the Russian government to attract foreign investors have had limited success as a result of the negative investment climate in the country. Russia's accession to the WTO has not improved this significantly. In the World Bank's annual 'Doing Business' rankings, before 2013 Russia was consistently ranked outside the top 100 countries – in 2012 it ranked 112th out of 189 countries.⁴⁰

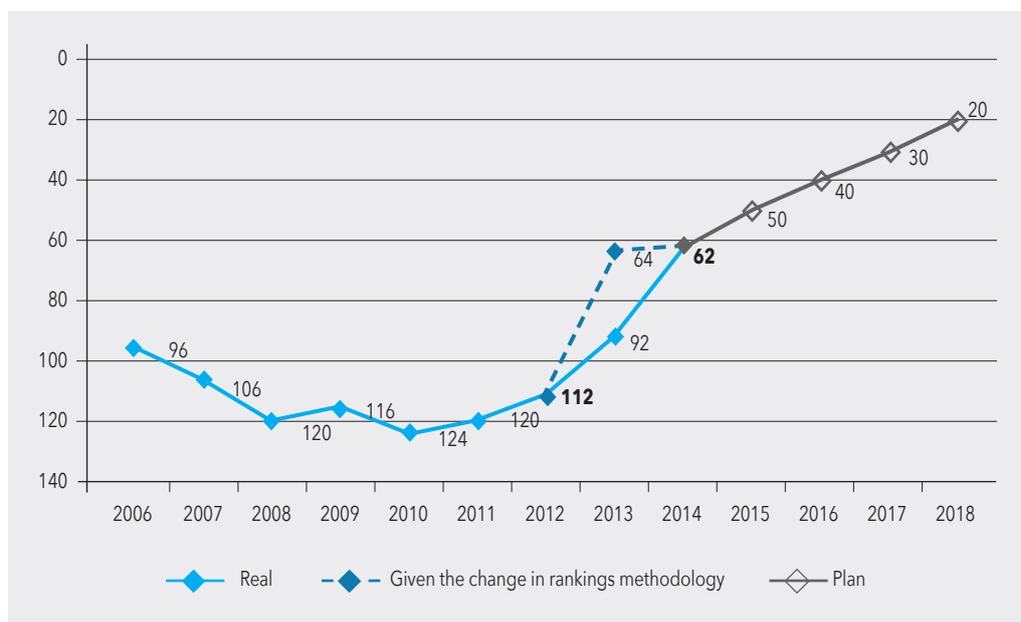
The problems inherent in a negative investment climate are well understood by the government. Putin has set an objective of Russia's being ranked 20th by 2018. This does not seem impossible: in 2013 Russia was ranked 92nd, and in 2014 62nd (the latter breakthrough is mostly the result of a change in calculating the rankings – according to the new algorithm Russia was already 64th in 2013; see Figure 7).⁴¹ However, future progress will be more complicated: in the last few years the government has addressed the most evident official barriers to foreign investment, such as bureaucratic interference. Further progress will require structural measures. It should also be mentioned that the rankings only consider data for Moscow and St Petersburg, while the investment climate in other Russian cities is usually worse.⁴²

40 World Bank, 'Doing Business Rating', 2014, <http://www.doingbusiness.org/>

41 *Ibid.*

42 Kuvshinova O & M Lutova, 'Rossiya voshla v pervuju sotn'u Doing Business – 2014', *Vedomosti*, 29 October 2013, <http://www.vedomosti.ru/finance/news/18071661/galvanizaciya-rossii>.

Figure 7: Russia's position in the World Bank's 'Doing Business' rankings



Source: World Bank, 'Doing Business Rating', <http://www.doingbusiness.org/>

As one of the measures to attract FDI to Russia, the Russian Direct Investment Fund (RDIF) was established in 2011. It is a \$10 billion fund aimed at making equity investments and securing co-investments in the Russian economy. The RDIF has already invested \$1.3 billion in joint projects. Another \$6 billion came from its international investment partners. The total sum of FDI attracted by the RDIF is estimated at \$15 billion.⁴³

In 2012 Russia initiated its 'turn to the East' policy and the Asian regions of Russia, ie, the Siberian and Far Eastern federal districts, became the focus of state investment policy. These territories are sparsely populated, some are characterised by severe climate conditions and they lack transport and social infrastructure. However, they also hold an abundance of natural resources: oil and gas, coal, gold and other metals, fresh water, forests, fish and arable land. Probably the most important competitive advantage of Siberia and the Russian Far East is that they are close to the rapidly developing Asian countries with their rising demand for natural resources and resource-intensive production. In order to develop Russia's Eastern territories, the Ministry for the Development of the Russian Far East was established in 2012. The rise of Siberia and the Russian Far East is increasingly considered a potential driver of the economic growth of the whole country. In December 2013 Putin identified it as a 'national priority for the whole 21st century'.⁴⁴

⁴³ RDIF, *op. cit.*

⁴⁴ President of Russia, 'Presidential Address to the Federal Assembly', 12 December 2013, website, <http://en.kremlin.ru/events/president/news/19825>.

In October 2013 the new model for the development of the Far East was approved. It is based on developing industries oriented at exports to Asia-Pacific and at attracting FDI. A presidential decree signed in September 2013 cut the tax rate on the profits made within investment projects realised in certain regions of Siberia and the Russian Far East from 1 January 2014. For the first five years the tax rate on company profits was reduced to 10% (and may be further reduced by regional governments to 0%); while for the following five years the maximum tax rate on profits is 18% (and may be further reduced by regional governments to 10%).⁴⁵

The main aims of the current state policy on the Russian Far East are:

- developing transport infrastructure (primarily railways);
- offering financial support to large investment projects initiated by Russian companies (primarily in the resource extraction and processing sectors); and
- organising the so-called advanced special economic zones, or rapid development territories.

These rapid development territories are the main instruments to attract FDI to the Russian Far East. They differ from special economic zones and are regulated by a separate law. Federal Law N 473-FZ 'On the Territories of Rapid Social and economic development in the Russian Federation' was passed in December 2014. Unlike special economic zones, rapid development territories take into consideration the competitive environment. They should be able to compete for FDI with similar territories in the other APR countries. Taking into account that, in terms of starting economic positions, the Russian Far East lags behind Singapore, Korea, China, Japan, etc., if it wants to be competitive it should provide investors with the best tax, administrative and investment regimes in the entire region. Thus the regulatory framework for rapid development territories was elaborated so that each individual element of the investment regime should be equal to the best the APR countries offer (Table 9): eg, the profit tax should be as low as in Korea, logistic costs as low as in Singapore, power costs as low as in the US, etc.

In order to reach such ambitious targets, two sets of incentives are provided to investors in rapid development territories. The first set involves a number of measures aimed at deregulating economic activity, while the second concerns tax breaks. Minister for the Development of the Far East Alexander Galushka presented the incentives in the following manner:⁴⁶

⁴⁵ PWC, 'Tax breaks in the Russian Far East are introduced', *Tax Flash Report*, 36, October 2013, http://www.pwc.ru/en_RU/ru/tax-consulting-services/assets/legislation/tax_flash_report_36_eng.pdf.

⁴⁶ President of Russia, 'Meeting with government members, 30 July 2014', website, <http://eng.kremlin.ru/news/22750>.

Table 9: Target characteristics of rapid development areas in the Russian Far East

Conditions in Asia-Pacific countries	Korea	China	Singapore	US	Canada	Japan	Russia – today	Russia – target
Profit tax, %	10	15	17	33	23.5	26.4	13.5	10
Inbound and outbound logistics cost, \$ per 20-foot container	700	550	440	1 320	1 660	970	1 800	440
Power cost, US cents per 1 kWh of electricity	7.3	7.4	13.6	6.9	7.4	17.9	11.7	6.9
Payroll taxes, %	8.8	26.7	16	7.7	8.7	25.6	14	7.7
Dealing with construction permits, days	29	67	26	27	163	193	244	26
Connection to the system power supply, days	28	41	36	68	142	105	254	28
Export support, score based on the volume of export support measures	5	4	4	4	5	3	2	5
Protection of intellectual property, rank score (rating IPRI)	2	3	4	5	4	5	3	5
Labour power	High	High	High	High	Middle	High	Low	High
Availability of suppliers	High	High	High	High	Middle	High	Low	High

Source: Ministry for Development of the Russian Far East, presentation for potential investors, 2014, <http://minvostokrazvitia.ru/upload/Ministry%20%20Russian%20Far%20East%201.pptx>

As far as deregulation goes, the key principle is to use the one window system for investors in the zones. This makes it possible to greatly simplify and reduce the amount of administrative formalities involved. It offers a free customs zone at the sites, reduces the time it takes to conduct the necessary checks, offers preferential rental rates and connection to engineering networks at the sites, allows investors to bring in the needed qualified workers outside of quotas, and offers a simplified procedure for land allocation.

As far as tax breaks go, we have approved the following provisions: investors who enter the advanced growth zones [rapid development territories] during the first three years following their establishment will benefit from an insurance deductions rate of 7.6 percent for the first ten years; tax holidays on profit, land and subsoil extraction taxes; and a simplified and fast-track procedure for reimbursing VAT.

The original list proposed by the Ministry for the Development of the Russian Far East consisted of 14 rapid development territories. Currently only nine such territories have been established.

The introduction of rapid development territories is a new instrument that has yet to prove its efficiency. According to the proposals of the Ministry of Economic Development, if successful this instrument should be rolled out to the other regions of Russia. However, the Ministry for the Development of the Far East argues that it should be unique to the Eastern territories, and that its advantage lies in its concentration of financial resources and ensuring the effect of scale.

Whatever the decision about the location of rapid development territories, it is evident that they will be at the heart of Russia's investment strategy for the near future. When the economic growth model based on extracting and exporting fossil fuels is no longer viable, the new model based on using Russia's other competitive advantages with the help of foreign partners could be attractive. However, foreign investors' pessimism over Russia's economic prospects and the political crisis in Ukraine must be overcome. Despite various MoUs no foreign partners have yet invested in the established rapid development territories.

CONCLUSION

Although it is hardly possible to give an accurate indication of the success of a long-term policy consisting of a wide range of initiatives, Russian investment policy over the last two decades has seen more failures than triumphs. Outward FDI became the mechanism of capital flight from the country; most FDI inflows were the result of high economic growth rates and rising oil prices rather than government efforts; and most government initiatives aimed at attracting FDI failed to return any significant results.

Russia is now in the process of transforming its investment strategy. At least four shifts are taking place:

- from a focus on attracting European investment to a focus on attracting FDI from the APR countries, primarily China;
- from European Russia playing a key role in attracting FDI to the rapid development of the Eastern territories;
- from using fragmented and politically determined ad hoc instruments to attract FDI to implementing comprehensive mechanisms (rapid development territories) in the Russian Far East; and

- from a fragmented and passive policy to promote outward FDI to the active policy that is necessary within the EEU.

At the moment all four shifts reflect the objectives and expectations of the Russian authorities rather than changes in Russia's position in global FDI flows. They have only recently been followed by concrete measures and are still far from complete. Their success is not evident, especially given the negative trends in the country's economic development. With the crisis in Russia–West relations, both inward and outward FDI in Russia is especially sensitive to political risks. Despite this, Russia still has significant potential to attract FDI from abroad and serve as an important source of FDI to neighbouring countries.



Christopher Wood

Diversion and Agglomeration:

Regional Dimensions of South Africa's Investment Promotion Policies

EXECUTIVE SUMMARY

South Africa's investment strategy aims to both grow and diversify the economy, with particular emphasis on the development of manufacturing industry. While traditional approaches such as investor protection are included in the strategy, it is strongly focused on strategic industrial policy aimed at encouraging investment in priority sectors. This has implications for South Africa's neighbours. As by far the largest economy in the region, South African policy has potential as both a catalyst for investment flows into Southern Africa and to divert investment from regional partners. This paper investigates this duality and the central role South African policy plays in the direction of investment flows in Southern Africa. It is in four parts. First, it explores trends in South African investment; second, it examines the three pillars of South Africa's investment policy – investor protection, investment incentives and special economic zones. The third part looks at the regional impact of these policies and the final section considers efforts to co-ordinate investment policy in the region.

INTRODUCTION

The 'Africa Rising' narrative is defined by diversity. While some threads – such as infrastructure bottlenecks and diversification challenges – are common to Africa's 54 states, each country's

development path is different. The legacy of a complex political history, arbitrary colonial boundaries and difficulties in civic development is seen not only in Africa's continued developmental challenges but also in the creation of markedly different economic structures among close regional neighbours.

This disparity is especially notable in the case of South Africa. South Africa accounts for 63% of the total gross domestic product (GDP) of the 15 member countries in SADC, a dominance reinforced by the country's much more diversified economic structure supported by a far more developed infrastructure network. South Africa's gross fixed capital formation is eight times that of its immediate neighbours Botswana, Lesotho, Namibia and Swaziland (BLNS). Domestic income inequalities in the larger economies further complicate the picture and despite its size, the number of people in South Africa living on less than \$2 a day is almost twice the total population of the BLNS.

The relationship between diversity in economic scale and base competitiveness on the one hand, and investment patterns on the other, is complex. More competitive countries, including those with the ability to undertake large incentive programmes, may divert investment from their less developed neighbours. At the same time, however, these major 'hub' economies also offer their smaller neighbours large export markets, direct investment spillovers and linkages into global supply chains that would otherwise be too competitive for them to enter. Large developing states in underdeveloped regions must calibrate their regional integration efforts so as to balance these spillovers, guarding against excessive dominance while stimulating investment flows into their neighbours.

This paper will explore that challenge with reference to South Africa as a hub economy in the Southern African region and its role in diverting and catalysing investment flows, especially as regards ways in which South African investment promotion policies distort the already unbalanced flow of investment to the region. There are four parts. The first gives a brief account of recent South African investment, detailing investment patterns and policy since 1994; the second examines South African investment promotion policy. The third explores the possible regional impacts of investment policies, with particular focus on the Motor Company of Botswana as a case study in the risks and opportunities of investment projects in unequal regions. Fourth and finally it considers some possible scope for South African regional investment co-operation.

SOUTH AFRICAN INVESTMENT TRENDS

Investment patterns since 1994

Promotion of foreign direct investment (FDI) was identified as a government priority as South Africa emerged from international isolation in the early 1990s. Towards the end of the apartheid regime the country had experienced rapid outflows of capital, particularly during the 1980s. Between 1984 and 1988, 20% of UK firms and 225 US companies left the country and in 1985 portfolio investment inflows virtually ceased.¹ Isolation gave way to uncertainty during the 1990s as investors awaited the outcome of the political transition and attempted to gauge the economic direction the newly elected ANC government would take.

In an effort to rebuild confidence in South Africa as an investment destination after the transition, the administrations of presidents Nelson Mandela (1994–1999) and Thabo Mbeki (1999–2007) embraced a raft of liberal reforms. These included broad reforms to the macroeconomic environment – such as the reduction of import barriers and the loosening of capital controls – and the introduction of specific investment protection and promotion measures. These included safeguards on property rights under the constitution, the development of a non-discriminatory legal regime and the conclusion of a range of bilateral investment treaties (BITs). Twenty-seven BITs were signed in the five years following 1994 and by the end of the Mbeki administration a total of 45 treaties had been agreed.² These arrangements were complemented by South Africa's accession to a series of multilateral international agreements such as the General Agreement on Trade in Services, the Agreement on Trade-Related Investment Measures, and the Agreement on Trade-Related Aspects of Intellectual Property Rights concluded in the run-up to the establishment of the WTO in 1995.

These reforms were successful in building confidence during a very uncertain transition period. FDI stocks increased 537% in the first 10 years of democracy and continued to grow in the following decade (see Figure 1).³ Those initial high investment levels were perhaps to be expected as the country emerged from its long period of international isolation and the disinvestment that had accompanied it. Much of the post-1994 investment boom should therefore be understood as the market's adjusting to the end of isolation, largely reflecting investors' assessment of the fundamentals of the South African economy rather than their response to the new government's policy; the period after the end of apartheid

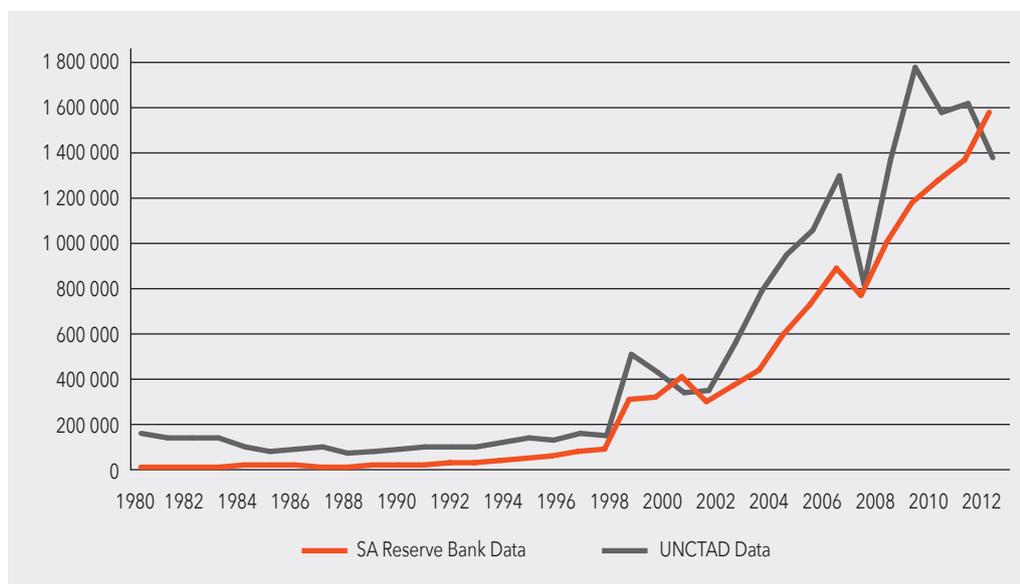
1 Gelb S & A Black, 'Foreign direct investment in South Africa', in *Investment Strategies in Emerging Markets*. Cheltenham: Elgar Publishing, 2004.

2 UNCTAD (UN Conference on Trade and Development), 'International Investment Agreements Navigator', UNCTAD Investment Policy Hub, <http://investmentpolicyhub.unctad.org/IIA>.

3 Due to the unreliable nature of FDI data, figures from both the South African Reserve Bank and UNCTAD are given. For further information on problems associated with collecting FDI data, see Fujita M, 'A critical assessment of FDI data and policy implications', in *Transnational Corporations*, 17, 2. Paris: UNCTAD, 2008.

also coincided with growing internationalisation of finance and an increased interest in developing economies as possible investment destinations.

Figure 1: FDI stocks in South Africa



Source: South African Reserve Bank, Online Statistical Query, 'KBP5550J: Foreign liabilities: Total direct investment'; UNCTAD FDI/TNC database, 'Inward and outward foreign direct investment stock, annual, 1980–2013

FDI patterns after the initial adjustment were very unpredictable. A number of substantial headline deals account for the spikes in the graph in Figure 1; the 1997 surge reflects the partial privatisation of the state telecommunications company Telkom, while the post-2001 upswing was due largely to Anglo American Corporation's acquisition of diamond producer De Beers.⁴ The upward trend after 2007 partly reflects the purchase of 20% of leading banking and financial institution Standard Bank Investment Corporation by Industrial and Commercial Bank of China and Walmart's purchase of a controlling stake in retail chain Massmart. The downturn after 1998 reflects the after-effects of a crisis sparked by the rapid depreciation of the South African rand and the subsequent imposition of capital controls, while the 2008 dip reflects the slowdown associated with the global financial crisis of that year.⁵

4 Arvanitis A, 'Foreign direct investment in South Africa: Why has it been so low?', in *Post-Apartheid South Africa: the First Ten Years*. Washington, DC: IMF (International Monetary Fund), 2005.

5 Bhundia A & L Ricci, *op. cit.*

Discontent with investment trends

Despite these positive trends, the broader investment picture attracted substantial criticism from elements in government and the ruling party, which laid the foundation for a shift in investment promotion witnessed at the start of the administration of President Jacob Zuma in 2008. Three complaints in particular came to the fore.

The first is the relatively small scale of investment and its weak social impact. Although investment into South Africa is positive and growing it lags behind that of leading emerging countries, particularly other members of BRICS. Figure 2 shows how South Africa's FDI, seen alongside that of its fellow BRICS members, compares favourably with India but trails the rest. Deflating the FDI figure to account for the differing GDPs of the other member countries, however, shows that South Africa leads the group (see Figure 3). Although this logic is perhaps somewhat circular (that is, higher FDI flows would tend to increase GDP), the position nevertheless demonstrates that South Africa reached a level of FDI attractiveness relatively early in its post-1994 development.

Perhaps more pressing than the overall figures are perceptions of the social impact of growth, particularly regarding employment creation. South Africa suffers from persistently high unemployment. At present this stands at 24.3%,⁶ a figure that rises to 35.8% under an expanded definition that includes discouraged labour, and is even larger for previously disadvantaged and vulnerable groups such as black Africans (39%) and the young (63.6% for those aged between 15 and 24).⁷ There is some evidence, including the results of a recent study by the consultancy Deloitte South Africa, that South African FDI does have a substantial social impact; the Deloitte study ranks South Africa second among the BRICS in this respect. The persistence of high unemployment during periods of booming FDI growth, however, has created a perception that current investment patterns are ill fitted as a means of combating South Africa's social challenges.

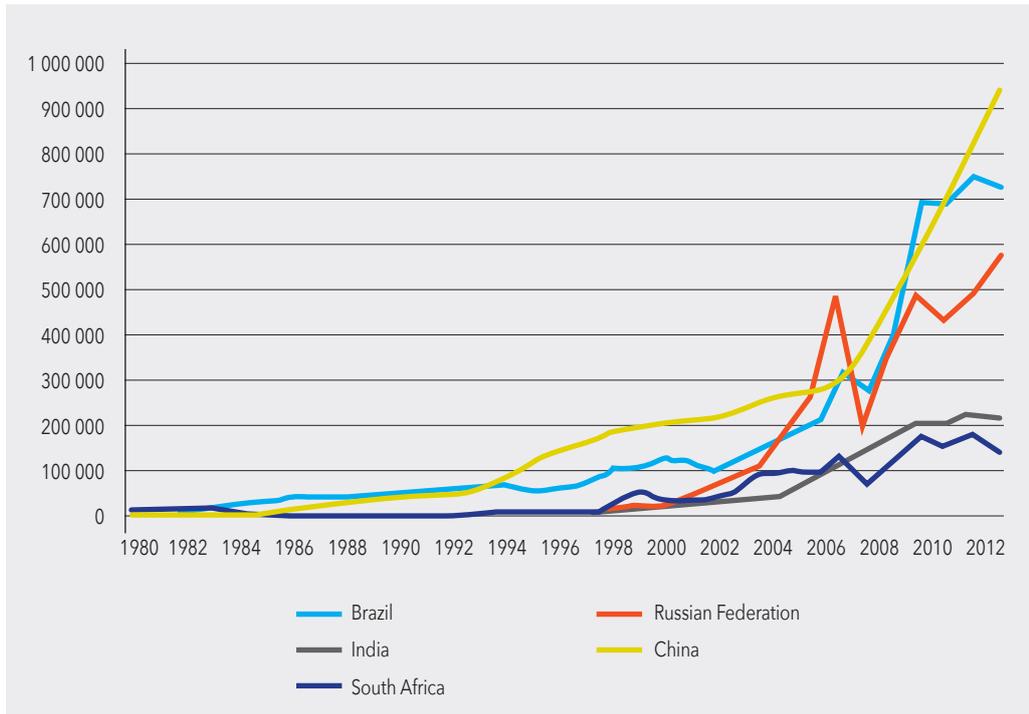
The second common complaint concerns sectoral imbalance. Investment tends to flow towards the established mining, finance and retail sectors, which together account for 60% of total investment since 1994.⁸ Although it is acknowledged that investment in these sectors can create efficiency gains and may provide resources for expansion, its direct impact on job creation is uncertain. It is also uncertain to what extent this investment creates additionality, given that these sectors are driven respectively by natural resource availability and domestic demand and that there is a robust and under-utilised domestic financial services industry that itself could have facilitated domestic investment in these sectors. Encouraging growth

6 StatsSA (Statistics South Africa), *Quarterly Labour Force Survey*, Quarter 4. Pretoria: Government Printer, 2014.

7 *Ibid.*

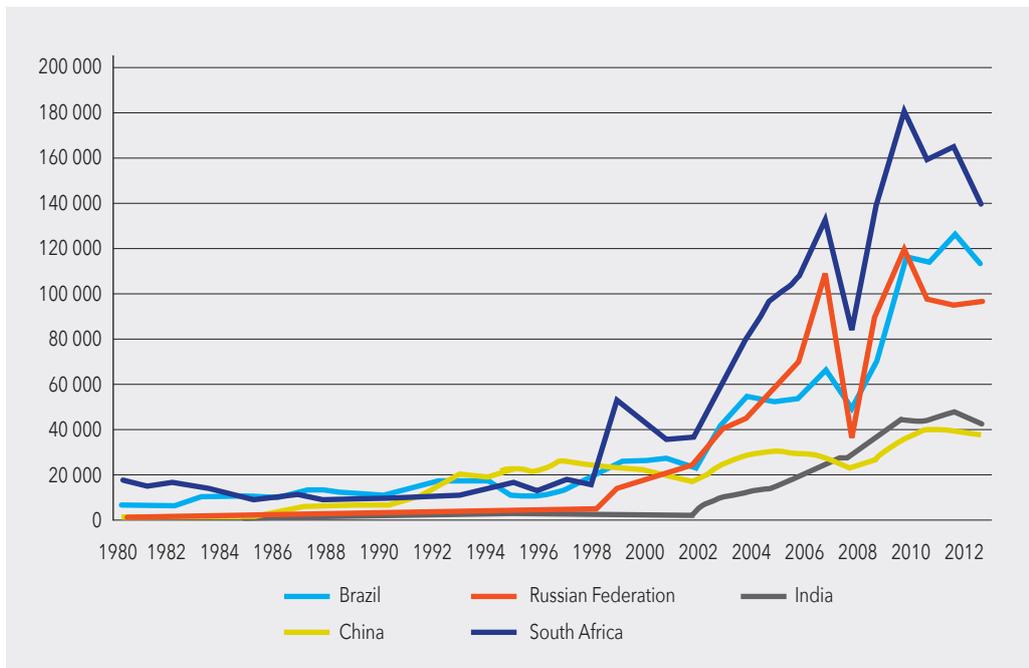
8 Wocke A & L Sing, 'Inward FDI in South Africa and its policy context', *Columbia FDI Profiles*. New York: Vale Columbia Center on Sustainable International Investment, 2013.

Figure 2: FDI stocks in BRICS



Source: UNCTAD FDI/TNC Database, 'Inward and outward foreign direct investment stock, annual, 1980–2013'

Figure 3: FDI stocks in BRICS, deflated for GDP size



Source: UNCTAD FDI/TNC Database, 'Inward and outward foreign direct investment stock, annual, 1980–2013'; World Bank World Development Indicators, 'GDP (Current US\$)'

in high-employment sectors, notably manufacturing, is a central priority of the government's development strategy. The perception of weak investment in manufacturing is one of the primary driving forces behind a shift of emphasis towards the sectoral distribution of FDI rather than FDI growth per se; yet this concern is not fully reflected in the data, which shows manufacturing as comprising an impressive 28% of total FDI stocks.⁹ A large proportion of this manufacturing investment, however, is in capital-intensive projects such as the construction of large steel smelters, which do not have the job- and skills-creation benefits of higher value-added production. This imbalance within manufacturing, broadly defined, might therefore drive concerns about sectoral distribution as great as those over an excessively narrow distribution of FDI as a whole.

The third frequently voiced complaint refers to the nature of investment into South Africa. 'Greenfield' investment (ie, new productive organisations and facilities) represents a small fraction of the country's total FDI. The overwhelming preponderance flows into the country as portfolio investments, which are often criticised as having weak job-creation benefits and sub-optimal effects on productivity improvements. The government has shown particular scepticism as regards the benefits of portfolio investment, noting in the second paragraph of a 2011 review of cross-border investment:¹⁰

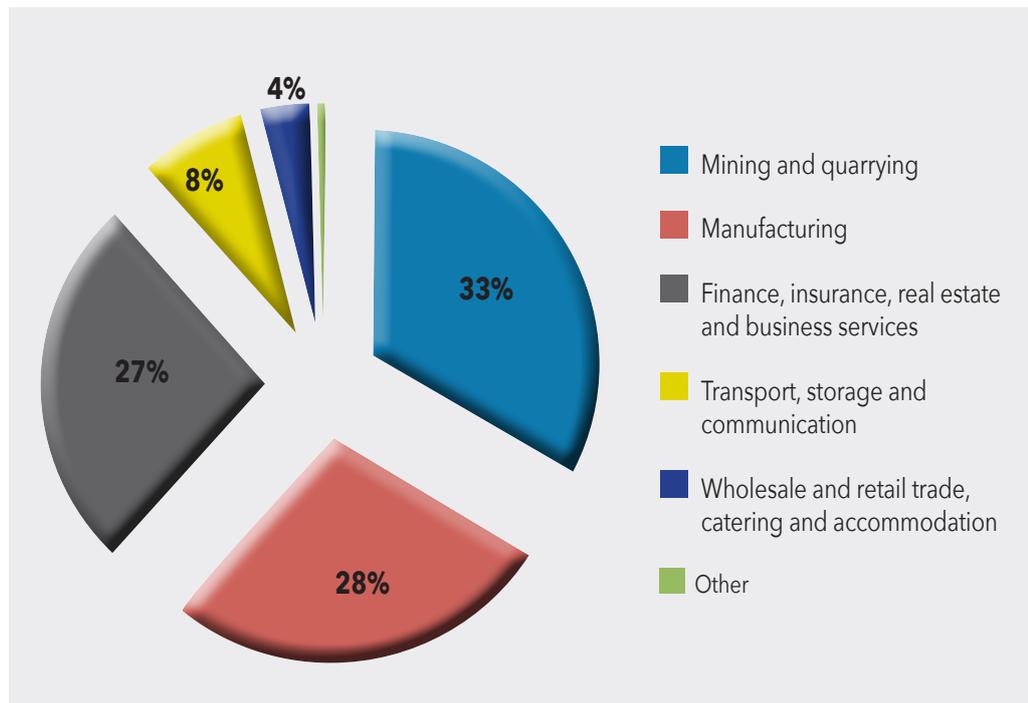
However, while greenfield investment (which mainly involves the establishment of a new business and investment in new productive capacity) is generally beneficial for the host economy, there are other forms of investment as well, some of which carry costs for the host economy. In particular, in the acquisition of existing domestic businesses, the benefits of foreign investment must be balanced against possible risks for local employment and production as the domestic firm is integrated into the foreign parent company or even re-domiciled, as well as broader economic concerns that may arise from a shift in ownership and control of successful local firms.

Two factors account for the perceived weakness of greenfield investment. The first is that only a small fraction of investment outside the primary sector is export-orientated (that is, of the kind which tends to lead to the development of additional physical infrastructure). Market-seeking investment, which dominates in South Africa, is more likely to favour the purchase of local firms. Secondly, the South African market is relatively concentrated, characterised by large competitive oligopolies in sectors such as retail trade, banking and telecommunications. Entry by foreign investors into such markets without a local partner would be prohibitively expensive; recognition of this encourages the purchase of existing commercial infrastructure rather than the construction of new facilities.

⁹ *Ibid.*

¹⁰ South Africa, National Treasury, *A Review Framework for Cross-Border Direct Investment in South Africa*, discussion document. Pretoria: Government Printer, 2011, p. ii.

Figure 4: Sectoral distribution of inward FDI stock in South Africa, 2009



Source: Wocke A & L Sing, 'Inward FDI in South Africa and its policy context', *Columbia FDI Profiles*. New York: Vale Columbia Center on Sustainable International Investment, 2013

SOUTH AFRICAN INVESTMENT POLICY AFTER 2008

In response to these and other criticisms, South Africa's approach to FDI promotion has changed significantly under the Zuma administration. Focus has shifted from attempting to maximise the flow of FDI to attracting certain types of desirable investment that target social problems. The highest priority within this shift is an attempt to attract more value-added production, with industrialisation regarded as essential to overcoming chronic unemployment. A 2013 estimate calculated that the manufacturing sector received 94.6% of total investment incentive spending.¹¹

This shift and its impact on neighbouring states can best be understood with reference to three major policy areas: investor protection regimes, investment incentives, and the rise of special economic zones (SEZs). This paper's focus on these three issues naturally omits a great many important investment promotion initiatives; those not considered include the Gateway into Africa programme (which offers preferential rules for companies headquartered in South Africa, with the aim of enlarging the country's role as an entry point to doing business in Africa), local government investment promotion policies (at provincial and municipal levels), the creation of marketing schemes and one-stop investment hubs, and more general fiscal policy measures such as certain preferential tax rates, rebates and write-offs.

¹¹ Calita E, Wallace S & L Burrows, 'The Impact of Tax Incentives to Stimulate Investment in South Africa'. Working Paper, 19. Stellenbosch: University of Stellenbosch, 2013.

Investor protection

The regulatory cornerstone of South Africa's new approach to investor protection is the Promotion and Protection of Investment Bill, currently undergoing revision pending a vote in Parliament. The bill codifies a domestic legal regime to protect investors and replaces the existing BIT network. South Africa's BITs are gradually being allowed to expire; thus far agreements with the Benelux countries, Germany, Spain and Switzerland have been allowed to lapse. Some members of the international community, notably from those countries that did not have BITs with South Africa, have praised the bill but it has also encountered significant criticism.

Two of its provisions have come under particularly strong censure. The first is its removal of recourse to investor–state dispute settlement, against the background of concerns about the unbalanced nature of international arbitration and fears that the international Investor–State Dispute Settlement (ISDS) legal mechanism might be used to challenge policies aimed at redressing the injustices of apartheid. The second is a provision in the bill that allows the government to take action in the 'public interest', a contested term that critics fear gives the government too much scope to act against investors.

These concerns are set against a political backdrop in which more radical political parties call for the nationalisation of South Africa's mines and in which the government has previously attached conditions on major investments. The purchase of local retailer Massmart by the US-based retailer Walmart is a notable example. Although investors such as Walmart do not require prior approval to enter South Africa the government made use of various mechanisms, notably the Competition Commission, to block the deal until assurances on worker protection and local content sourcing were in place. Other legislative efforts may be regarded as indicative of a move away from an unconditional accommodation of international investment. Recent legislation concerning the private security industry, for example, includes provisions restricting foreign companies from owning majority stakes in any firm associated with the industry; and blanket restrictions on foreign ownership of land were recently announced to great applause in Zuma's 2015 'state of the nation' address.

Despite such concerns, evidence suggests that BITs and related investor protection efforts have had little impact on investment patterns in South Africa; indeed there is very little evidence of BITs promoting investment anywhere.¹² The global political consensus on ISDS seems to be fracturing; countries with open economies such as Australia are raising concerns in the context of the Trans-Pacific Partnership (TPP) and various European countries are opposing ISDS in the Transatlantic Trade and Investment Partnership. The South African

12 UNCTAD, 'The Role of International Investment Agreements in Attracting Foreign Direct Investment to Developing Countries', UNCTAD Series on International Investment Policies for Development. Geneva: UNCTAD, 2009.

court system remains relatively independent and operates within a legal framework generally sympathetic to business, in which property rights are protected in the constitution. The political will required to embark on expropriation of private property seems weak and the ruling ANC has consistently rejected talk of any form of nationalisation.

On balance, the shift to a public interest approach to investment may be understood not as a precursor to nationalisation or excessive government intervention, but rather as an attempt to give the government greater freedom of action in two areas. The first is to legislate on controversial but essential issues such as the government's black economic empowerment (BEE) programme, which places restrictions on hiring and labour sourcing as part of an attempt to redress racial wealth inequalities. The second is to impose conditions on foreign investors in an effort to promote larger domestic spillovers. The model for this approach might be the Walmart deal, in which the government used the competition authority to attach local content and worker protection conditions on the acquisition of Massmart in an attempt to generate wider domestic value from the deal.

Incentives

Table 1 highlights the current batch of incentives that assist in attracting and/or retaining FDI, based on a recent publication from the Department of Trade and Industry (dti). The document does not cover all available incentives; in particular it omits those still available but in the process of being discontinued. It does, however, highlight the incentives the government wishes to promote, hence it is a good indicator of broad policy direction.

The dti lists a total of 22 incentive programmes covering four thematic areas: developing small, medium and micro enterprises; empowering women; industrial development; and incentivising trade, export and investment. The 22 programmes come in various shapes and sizes: some cover grants towards the expansion of firms while others focus on research, or on promoting specific industries such as film and television. Of the 22 on offer, eight are available to foreign investors; the remaining 14 domestic programmes roughly divide into incentives aimed at empowering 'previously disadvantaged' groups (including women and racial groups disadvantaged by apartheid) and those aimed at upgrading traditional industries that have struggled to remain globally competitive (notably textiles).

With the exception of the foreign investment grant offered under the dti enterprise investment programme, all foreign investment incentives are targeted, with six incentives focusing on specific sectors (manufacturing, business process services, infrastructure, film and television) and the remaining seven dealing with specific types of FDI such as

greenfields and 'brownfields' (ie, the acquisition of existing operations). Five of the seven are aimed at compensating for the costs of upgrading, expanding or maintaining physical business infrastructure. Although these grants are useful in encouraging investment they are notably different from 'flat' industry incentives because they assist in overcoming barriers to initial investment rather than subsidise direct returns from the investment itself. In one sense, therefore, although they may not encourage new investment the grants can support the implementation of a pre-existing decision to invest in South Africa. The remaining two incentives, on the other hand, explicitly attempt to make investment in certain sectors more attractive, assisting in offsetting the costs involved in operating respectively in the business processes and the film and television sectors. The focus is clearly on the manufacturing sector, which attracts slightly less than 95% of all incentive spending.¹³

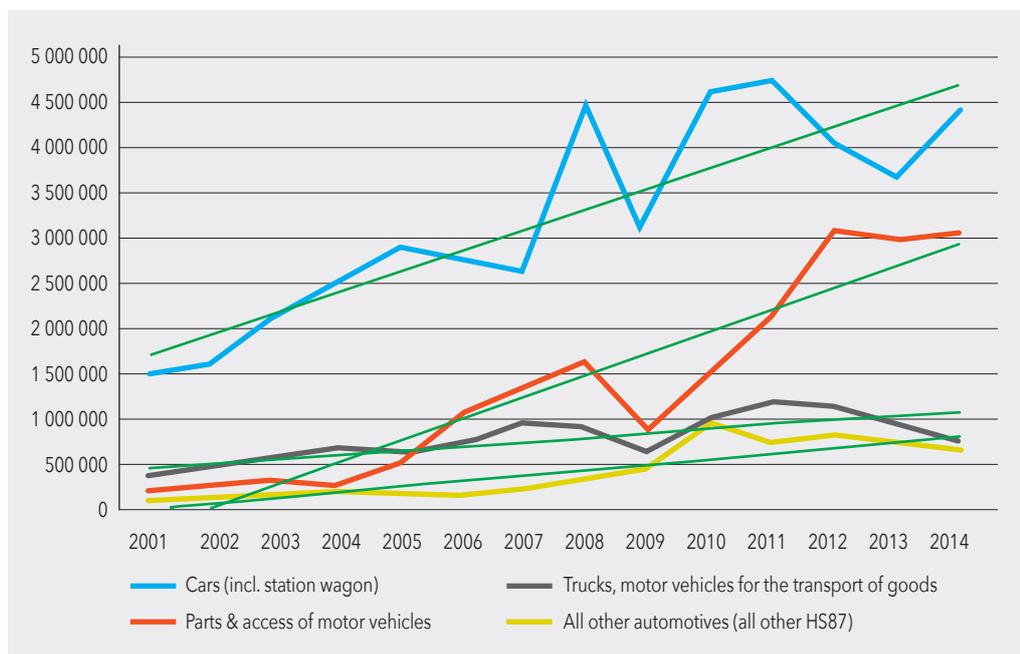
The most notable omission from the list is the Motor Industry Development Programme (MIDP), first introduced in 1995, which offers incentives to attract manufacturers of finished automobiles and automotive components. It is generally regarded as the most successful investment incentive programme in South Africa and is excluded from the list only because it is in the process of being replaced by a similar but updated scheme. The MIDP's primary incentive is the award of import tax rebate certificates equal in value to the firm's total automotive exports; hence a firm exporting 1 000 cars would be able to import 1 000 cars duty-free, thus circumventing tariffs on light automobiles that ranged from 25% to 65% during the lifetime of the programme.¹⁴ Similar incentives are offered for the export of automotive components, although rebate percentages and tariffs are lower. The MIDP also offers a range of supplementary incentives, such as rebates based on the value of capital investment.

Since the introduction of the MIDP exports of finished light automobiles have grown by a factor of 25 and exports of components 12-fold; industries that are part of the sector's value chain, such as catalytic convertor or leather seat manufacture, have also experienced high growth. Figure 5 shows the growth of various automotive sectors. Automotive exports comprise an impressive 10% of South Africa's total exports, but the sector's importance is far bigger than this figure suggests because the industry is precisely the kind the government wants to promote: industrial manufacturing for export. The MIDP experience is particularly important insofar as it is evidence in support of views within government that favour a strong, direct role for the state in developing new industries.

13 Calita E, Wallace S & L Burrows, *op. cit.*

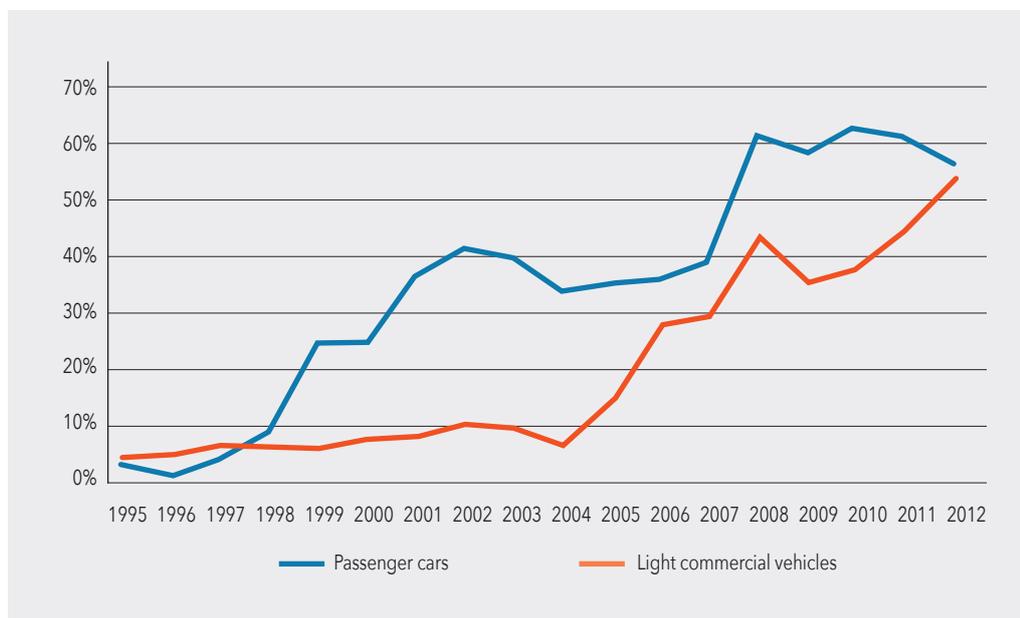
14 Flatters F, *The Economics of MIDP and the South African Motor Industry*. Pretoria: TIPS (Trade & Industrial Policy Strategies), 2005.

Figure 5: South African automotive exports



Source: UNCTAD/WTO, International Trade Centre, Trademap, www.trademap.org

Figure 6: Percentage of South African automotive production for export



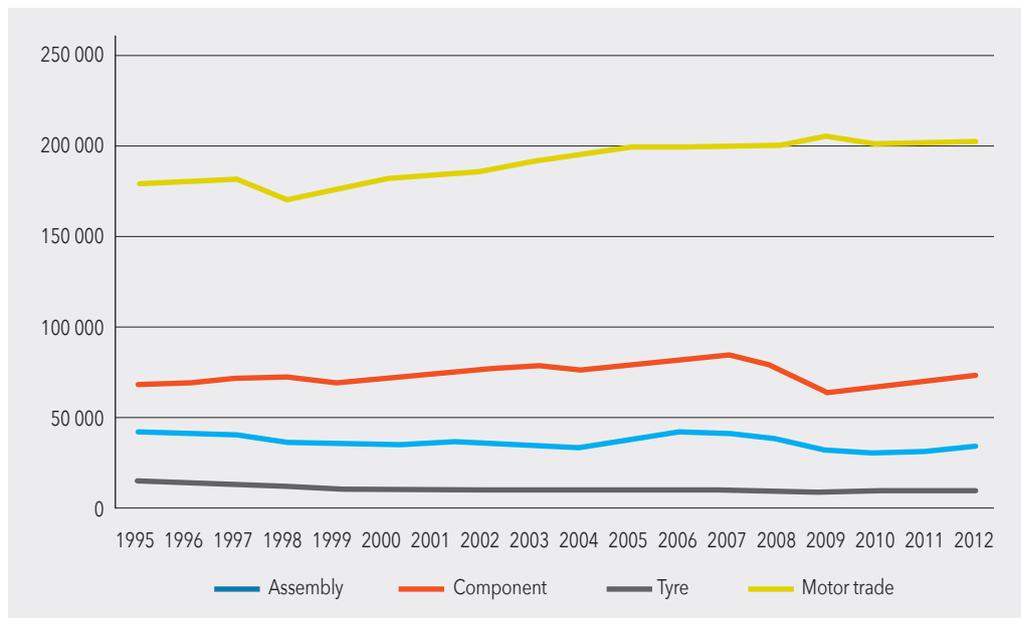
Source: Barnes J & A Black, 'The Motor Industry Development Programme 1995–2012: What Have We Learned?', paper presented at the International Conference on Manufacturing-led Growth for Employment and Equality, Johannesburg, May 2013

An increase in exports has not, however, been directly translated into overall growth in the motor sector itself because of the effect of exports having replaced production for domestic sale. This is partly driven by the nature of the MIDP, which rewards motor companies for exporting by removing barriers to the sale of imported vehicles in the local market. It is also affected by a certain level of rationalisation of the industry and the direct reduction of tariff barriers over the lifetime of the MIDP. Figure 6 shows the shift in the proportion of automobiles produced for export.¹⁶

Partly as a result, job creation in the industry is lacklustre. Figure 7 shows the evolution of employment in select automotive production processes.¹⁷ At the industry's peak in 2007 the sector had added 34 800 jobs following on the implementation of the MIDP.¹⁸ Many of these posts, however, were lost in the downturn following the 2008 global financial crisis – reflecting the downside of the sector's shift to greater reliance on exports, hence foreign demand.

The MIDP is in the process of being phased out amid concerns that it is vulnerable to a challenge in the WTO, but it will be replaced by the similarly structured Automotive Production and Development Programme.

Figure 7: Employment by sub-sector in South African automotive production



Source: Barnes J & A Black, *op. cit.*

15 Currency code for the South African rand.

16 Barnes J & A Black, 'The Motor Industry Development Programme 1995–2012: What Have We Learned?', paper presented at International Conference on Manufacturing-led Growth for Employment and Equality, Johannesburg, May 2013.

17 Barnes J & A Black, *op. cit.*

18 *Ibid.*

Table 1: South African investment incentives

Incentive	Target industry	Description	Grant scale
Manufacturing Competitiveness Enhancement Programme	Manufacturing and related industries	Assists in upgrading of productive facilities, processes, products and work skills; and assists in Industrial Development Corporation interventions in saving distressed enterprises	Calculated on a tiered percentage of Manufacturing Value Added
Business Process Outsourcing and Off-shoring Incentive	Business process services	Base grant incentive paid over three years for each job created, with graduated incentives for jobs created above certain thresholds	
Manufacturing Investment Programme	Manufacturing	Reimbursable cash grant for the upgrading, expansion or building of new productive facilities	Up to 30% of cost of investment
Foreign Investment Grant	Not targeted	Compensates foreign investors for the cost of moving machinery and equipment to South Africa	Maximum ZAR ¹⁵ 10 million (\$726,674.26), 15% of the value of new equipment, or actual cost of relocation
Critical Infrastructure Programme	Infrastructure	Cost-sharing grant for projects designed to improve critical infrastructure, particularly infrastructure to support investments that would otherwise not occur	10%–30% of total development costs, capped at ZAR 30 million (\$2.18 million)
Automotive Investment Scheme	Automotive	Grant assistance for the development of new investment in established automotive and component manufacturers	Taxable grant of 20% of the value of the investment, with additional grant of 5–10% available for projects making a 'more significant' contribution
Section 12I Tax Allowance Incentive	Not targeted	Tax allowances for greenfield and brownfield projects	ZAR 500–900 million (\$36.34–65.45 million) for greenfield projects, ZAR 350–550 million (\$25.45–39.99 million) for brownfield projects, with additional allowances for employee training
Film and Television Incentive	Media		20% of qualifying South African production expenditure with additions if post-production takes place in South Africa

Source: South Africa: dti (Department of Trade and Industry), *A Guide to DTI Incentive Schemes 2012/13*. Pretoria: Government Printer, 2013

Isolating the specific impact of the MIDP on the growth of the automotive sector and the effect of investment incentives in general is difficult. This is partly due to the complexity of disentangling the ramifications of South Africa's transition from apartheid-era isolation, but it is also a result of the generally favourable global economic climate during the lifetime of the MIDP, which might have driven some of this growth regardless of the incentives under the scheme. Nevertheless, some broad conclusions can be drawn.

Firstly, the MIDP is widely considered a major success of South African industrial policy. The automotive industry has grown in scale and competitiveness, has created spillover benefits from related industries and has contributed to job creation. Although the MIDP is an example of the successful use of economic incentives, however, it is difficult to extend this lesson to other programmes, given that the MIDP is so much larger in scale than any other incentive. Perhaps one further programme on the scale of the MIDP is feasible, but anything beyond that would require a significant redistribution of resources from other parts of the budget.

Secondly, most academics are sceptical of the benefits of investment promotion incentives other than the MIDP. Some cite basic doubts about the capacity of such programmes cost-effectively to attract investment; others raise more specific concerns such as the lack of awareness of programmes, the high administrative costs involved in participating in incentive programmes and uncertainty on the continuity of programmes. The last issue is particularly important, because most incentives are time-limited to between five and 10 years. While this provides a check against over-reliance on incentives it is often shorter than the planning horizon of potential investors.

Thirdly, some complain that the incentives on offer will have an effect only if accompanied by various structural changes, notably the implementation of strong investor protection but also including supporting measures such as lowering trade barriers, reducing the regulatory burden of programmes such as BEE, and improving infrastructure. Some of these points, such as the need for improvements in electrical supply and infrastructure, attract broad agreement but others are more contested.

The MIDP is a case in point. In most established framings of the global value chain (GVC) narrative the automotive sector would best be helped by lowering trade barriers to allow the smooth flow of components and improve competitiveness in GVCs. Yet the MIDP only works because of trade barriers – it incentivises exports through exemptions from import restrictions. On a broader scale the costs involved in policies such as BEE are often seen as unpalatable to investors; but policies of redress are widely recognised as essential not only in improving social justice but also to maintaining social stability and containing broader

and more strident calls for redistribution of income. Undoubtedly investors want structural reform that lowers costs; but costs are lowest in efficient, stable economies and many of the costs foreign investors in South Africa face are designed to fund programmes meant to work towards this goal.

IDZs and SEZs

Regulations for the creation of SEZs were set out in the Special Economic Zones Bill of 2012, introduced in Parliament in 2014 and now being debated. SEZ policy builds on the more limited effort to create industrial development zones (IDZ), introduced during the transition from apartheid in the Manufacturing Development Act of 1993 (Act 187 of 1993). By international standards the IDZ incentives were limited. They included tax relief on customs duties, goods for storage, and certain productive inputs; attempts to simplify customs procedures; and limited incentives on the development of productive sites and infrastructure.

Four IDZs were opened, each targeting a strategic industrial hub. The Coega and East London IDZs serve the Eastern Cape's automotive manufacturing hub, with the East London IDZ sited directly adjacent to the Mercedes Benz assembly plant and almost entirely comprising original equipment automotive manufacturers.¹⁹ The IDZ at Richards Bay is based on the town's importance as a port for raw materials exports and aims to encourage their beneficiation; and the OR Tambo IDZ at Johannesburg's largest airport primarily targets the air transport industry.²⁰

IDZs in South Africa are widely considered to have been a failure. They stimulated around ZAR 11.8 billion (\$857 million) in investment but did so at the cost of ZAR 5.3 billion (\$385 million) to the national government.²¹ The combined total expenditure on IDZs by national and provincial governments is estimated at ZAR 9.3 billion (\$675 million) between financial years 2002 and 2013; it resulted in 5 137 direct jobs (33 000 if short-term construction work is included),²² putting the price of each direct job at ZAR 1.8 million (\$130,789.78) over the period, or ZAR 13,750 (\$999.13) a month.²³ The OR Tambo IDZ is yet to attract any investment and as of 2013, that at Richards Bay had only one large investor (Tata Steel), although agreements are in place with three additional firms.²⁴

19 Chinguno C, 'An evaluation of South Africa's industrial development zones', in Bernstein A (ed.), *Special Economic Zones: Lessons for South Africa from International Evidence and Local Experience*. Johannesburg: Centre for Development and Enterprise, 2011.

20 *Ibid.*

21 Bernstein A (ed.), *op. cit.*

22 South Africa, dti, Policy on the Development of Special Economic Zones in South Africa. Pretoria: dti, 2012.

23 This figure is rounded for illustrative purposes only and assumes that IDZs have run from 2002 to 2013. Construction of IDZs does not align with financial years.

24 Chinguno C, *op. cit.*

Some good news from the IDZs is that their failure has largely been attributed to the limited nature of the policy. They offered few traditional SEZ incentives such as preferential corporate tax rates, specific investment incentives and discounted land costs, or the easing of labour or environmental regulation.²⁵ The IDZ policy may, however, have proved a useful testing ground in that it is a limited package that allows the government to better understand the nuances of running such zones. This experience might then inform policy on the more substantial SEZ rollout currently under way. Beyond incentives, numerous additional lessons have been flagged by the dti, such as the importance of introducing some flexibility into funding models and improving stakeholder co-ordination.²⁶

Under the 2012 bill the much-revised SEZ framework offers improved incentives. They include a preferential corporate tax rate of 15% (against the national average of 28%) as well as additional tax and customs incentives; tax relief for building expenditure; the offer of special employment incentives; and the creation of a 'one-stop shop' to provide easy access to the bureaucratic channels necessary to SEZ operations and exports.²⁷ According to the dti, the new policy sees the development of four distinct types of SEZ. These are²⁸

- Free port: duty-free area adjacent to a port of entry where imported goods may be unloaded for value-adding activities within the [SEZ] for storage, repackaging or processing, subject to customs import procedures;
- Free trade zone: duty-free area offering storage or distribution facilities for value-adding activities within the [SEZ] for subsequent export;
- Industrial development zone: purpose-built industrial estate that leverages domestic and foreign fixed direct investment in value-added and export-oriented manufacturing industries and services; and
- Sector development/specialised zones: centred on development of a specific sector or industry through the facilitation of industrial infrastructure, incentives and technical and business services, primarily for the export market.

Five new zones are to be added to the existing four IDZs and a fifth under construction in Saldanha Bay. A special SEZ fund will be created to finance the development and operation of the zones, working with private investors to implement the projects. The SEZs will be overseen by a board of 15 that includes representatives of the dti, the Department of Public Enterprises, the National Treasury, South African Revenue Service, the Industrial Development Corporation, the power parastatal Eskom and the transport utility Transnet; as

²⁵ *Ibid.*

²⁶ dti, *op. cit.*

²⁷ dti, 'Industrial development', http://www.thedti.gov.za/industrial_development/sez.jsp.

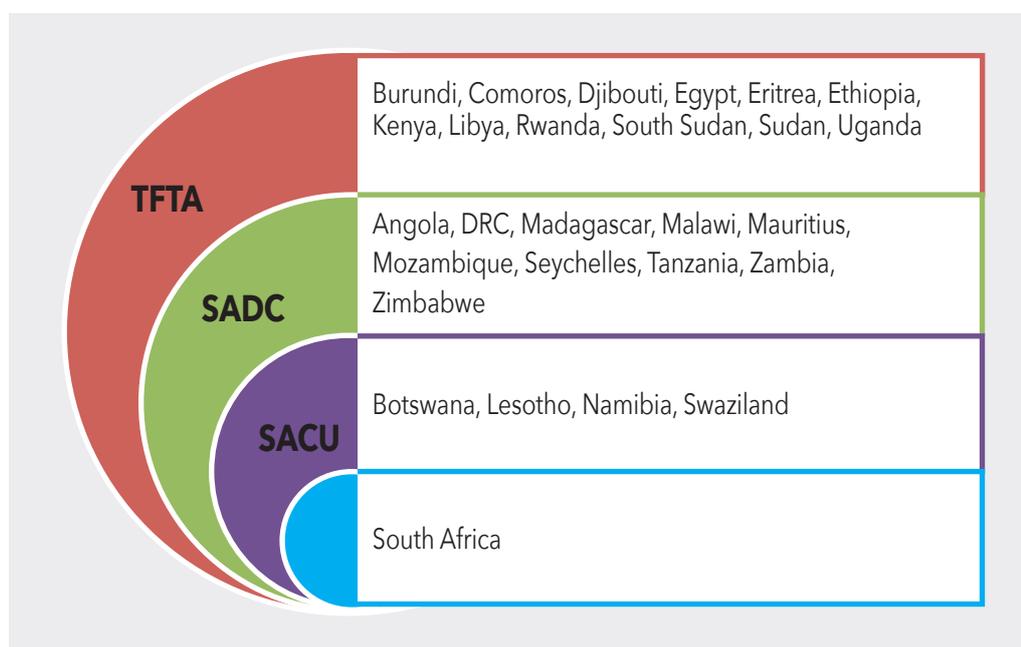
²⁸ dti, *op. cit.*

well as representatives of organised business, labour, civil society and other specialists in the field. Following the broader shift to investment for diversification, the main stated priority in the SEZ bill is the development of 'manufacturing sector and tradable services'.²⁹ Attracting FDI is third on the priority list.

REGIONAL IMPLICATIONS OF SOUTH AFRICAN INVESTMENT POLICY

South Africa considers itself part of a broader sub-Saharan Africa region and participates in forums such as the AU, the New Partnership for Africa's Development and the Tripartite Free Trade Area (TFTA) negotiations. However, the region in which South Africa is most influential is undoubtedly Southern Africa, including SADC and – even more importantly – the Southern African Customs Union (SACU), the country's customs link with neighbouring states. Figure 8 maps out the countries involved in these blocs. The present study focuses primarily on the SACU countries as the most integrated with South Africa and therefore most directly affected by spillovers from South African policy. SADC will be referenced mainly to give a broader regional picture.

Figure 8: South Africa and regional economic communities



Source: Author's compilation

Although very diverse, in economic terms the Southern African region broadly falls into two categories: 'emerging' and 'frontier' markets. Emerging markets are larger states with some nascent diversification, as witnessed by growing services and manufacturing sectors; in Africa

²⁹ Republic of South Africa, Ministry of Trade & Industry, Special Economic Zones Bill. Pretoria: Government Printer, 2013.

they include the likes of Kenya, Nigeria and Botswana. Frontier economies are undiversified, often reliant on mining and agriculture activities and often with small domestic markets, which limits their capacity to develop economies of scale in domestic demand-driven sectors. They include countries such as Namibia, Swaziland and Mozambique. Some African states bridge the divide, notably Angola, which posts high growth rates but is virtually a single-commodity economy dependent entirely on oil.

The distinction between the two types is important because the impact of FDI policy is often difficult to disentangle from the naturally unbalanced FDI flows that result from widely differing economic fundamentals between countries in the region. FDI is overwhelmingly driven by basic economic considerations: market-seeking investment looks to a large and growing consumer base, export-seeking investment seeks high productivity and commodity-seeking funds pursue resource availability. Policy plays only a supporting role in exacerbating or reducing these expected imbalances. Frontier economies in Southern Africa may see some investment diversion resulting from South African FDI policies but this is likely to be small. Most investment heading into these markets is seeking specific resources and is not subject to the sway of competitive policies. Emerging markets, however, may be in direct competition with South Africa and may therefore suffer a direct impact from the latter's domestic investment policy.

The Motor Company of Botswana

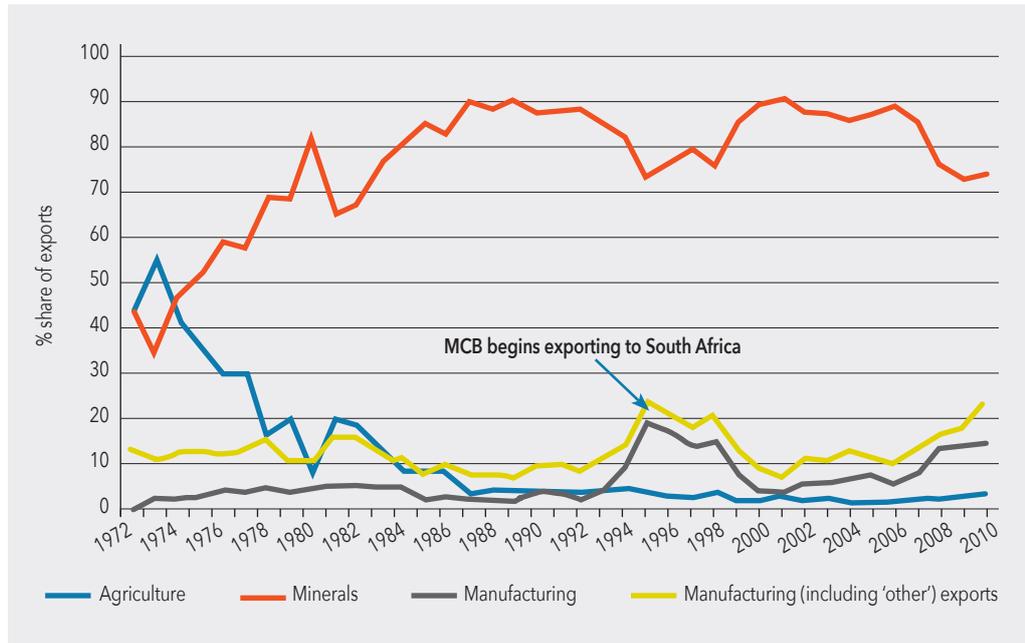
Botswana offers a useful case study on the possible diversion effects of South African investment policy. It is a small emerging economy, often hailed for its business-friendly operating environment, abundant natural resources and relatively high level of development (with good infrastructure and a per capita GDP higher than that of South Africa). Botswana's FDI is dominated by a traditional focus on mining and an emerging finance sector (the two together account for 80% of FDI stocks)³⁰ and like most countries in the region, its approach to investment is predicated on a desire to attract more diverse, value-added investment.

Figure 9 highlights the breakdown of Botswana's export basket, with a clear spike in exports in manufactured goods between 1990 and 2000.³¹ This was thanks to the short-lived Motor Company of Botswana (MCB), a franchised assembly plant for Hyundai motor vehicles destined for the South African market. The plant was funded by the Botswana Development Corporation and two private banks and employed around 600 people in the capital Gaborone. MCB seemed to encapsulate the ideal of the industrialisation dialogue dominant in the region: that of the developmental state guiding the creation of high-value added production for export.

30 KPMG, 'Botswana risk profile', <http://www.kpmg.com/Africa/en/KPMG-in-Africa/Documents/Botswana.pdf>.

31 Grynberg R, 'SACU Revenue Sharing Formula, Diversification and the Automobile Industry'. Gaborone: BIDPA (Botswana Institute for Development Policy Analysis) (forthcoming).

Figure 9: Botswana exports by type



Source: Botswana Institute for Development Policy, 'Report on Export Diversification Policies for Export Success in Botswana'. Gaborone: Boccim (Botswana Confederation of Commerce Industry and Manpower), 2013

In 2000 MCB declared bankruptcy, having produced only 7 000 vehicles in the preceding two years (in the face of a break-even requirement of 15 000 units annually).³² A large part of this failure was due to mismanagement by MCB's unscrupulous owners (who would later be charged with fraud and other malfeasances) but a further significant aspect was the effect of South African policy on the operation. Thirteen years after the closure of MCB, Hyundai opened a plant in Benoni, near Johannesburg, which undertook the assembly of partial-knocked down kits, mirroring the work done in Gaborone. Unsurprisingly, the initiative sparked familiar accusations about South Africa's role as the economic bully of the region. Botswana's president at the time MCB closed down, Quett Masire, would later claim that the country's Hyundai plant was 'sabotaged by South Africa'.³³

Two features in particular of South African investment policy came in for criticism. The first was a protectionist bent that saw South Africa block imports from Botswana, its fellow SACU member. SACU rules of origin require goods to have 40% in local value added, a level difficult to reach for assembly plants predicated on assembling partial-knocked down kits. In the face of rules of origin complaints from Pretoria, the MCB plant faced tariffs of 54%³⁴ and reportedly accepted a voluntary quota of 1 000 vehicles a month into South Africa.³⁵ Given

³² Grynberg R, *op. cit.*

³³ *Ibid.*

³⁴ Based on tariff rates for 1999 on product line 87032390.

³⁵ Grynberg R, *op. cit.*

Botswana's small domestic market MCB's viability depended on tapping into the South African market, and these restrictions were devastating to its ability to do so.

The second problem arose from the large subsidies offered under the MIDP. The part played by the MIDP in the collapse of automobile manufacturing in Botswana might seem counter-intuitive, as the MIDP applies to Botswana as well; because it is based primarily on tariff rebates and SACU has a common external tariff, the five SACU countries all qualify for MIDP incentives. MCB was not producing for export outside SACU, however, and so failed to qualify for the highest incentives under the MIDP. Furthermore it found itself facing competition from efficient foreign producers that had circumvented import barriers by establishing factories in South Africa. The MIDP's unique structure makes it a complex case for understanding the regional effect of investment incentives but in essence, MCB exports found themselves in competition with subsidised rivals benefiting from the MIDP.

The case of MCB clearly highlights the dual role played by South Africa in the region. The company could not have existed without sales to the South African market, but this potential for attracting investment was offset by the distortions resulting from South African policy. The drive to create good quality jobs in the South African manufacturing sector gave rise to policies that undermined similar ambitions in Botswana.

South African policymakers do seem to appreciate the inherent inter-connectedness of regional growth. They know that South Africa cannot develop if its neighbours stagnate but long-term visions of regional development struggle to overcome the immediacy of simple short-term calculations such as moving the Hyundai plant from Gaborone to Benoni. Commitment to regional integration is often expressed in terms of grand development visions but in practice it runs up against the more hard-nosed implications of cases such as MCB. On that metric, South Africa's role in the region is less than clear.

South Africa as an investment driver

Of course, this single example does not capture the full picture of South Africa's role in the region. Leaving aside funds from tax havens,³⁶ South Africa is the single largest investor in the BLNS.³⁷ Figure 10 shows the dominant role South African FDI plays in SACU; although some of this investment is in natural resource extraction, particularly mining in Botswana and agriculture in Swaziland, the services sector is the most dynamic regional investor. The Standard Bank group is the principal financial services institution in the BLNS and South African firms are dominant in telecommunications and retail services. The high

³⁶ Luxembourg is technically the largest investor in Botswana: De Beers has its headquarters in the Grand Duchy.

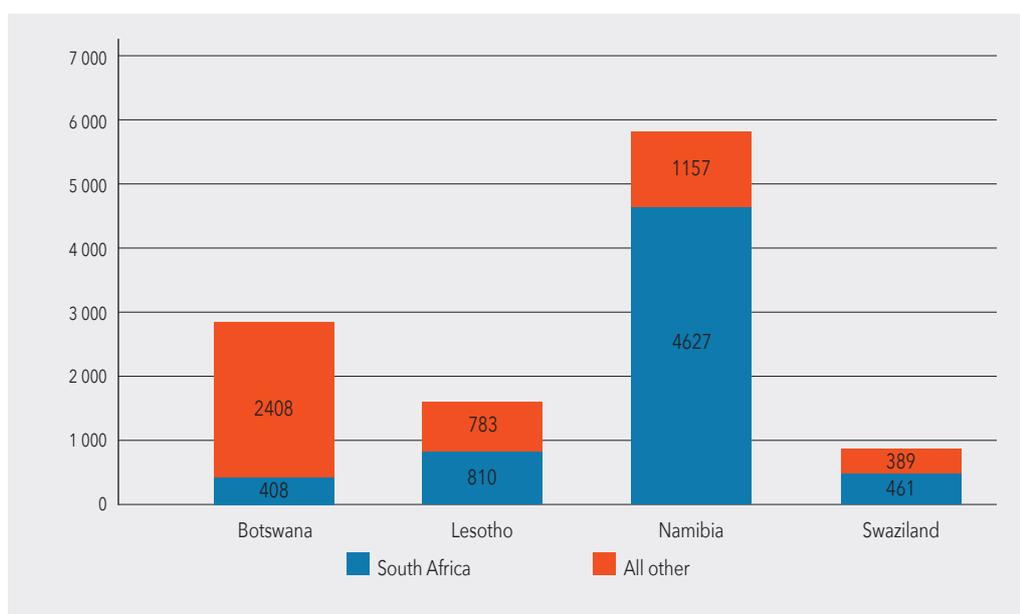
³⁷ UNCTAD FDI/TNC Database, 'FDI flows in the host economy, by geographical origin'.

level of investment in customer-facing services firms is often cited as a factor in feeding an impression of regional dominance by a South African 'Big Brother'.

Although South Africa's investment in neighbouring countries is the most direct means by which the country drives regional investment, arguably the more important factor is the extent to which the presence of South Africa encourages outside investment in neighbouring countries. In this context South Africa can be thought of as playing a role in creating three investment 'gateways'.

First, the BLNS can be seen as a gateway to South Africa. This certainly was so for MCB, which was developed off the back of SACU preferential access to the South African market. SACU's tariffs are generally low, so it is unlikely that investors would be encouraged to set up shop merely for purposes of 'tariff hopping', except in a few protected industries such as automotive assembly. Nevertheless, the presence of the South African market may drive investment in neighbouring countries, for example by firms looking for lower-wage production centres. Investment for South African market-seeking should show up in the trade figures, but those numbers do not support the idea of a particularly important role for this type of investment. All BLNS countries run a large trade deficit with South Africa and none of them exports much by way of value-added goods.

Figure 10: BLNS FDI stocks by country of origin (\$ million)

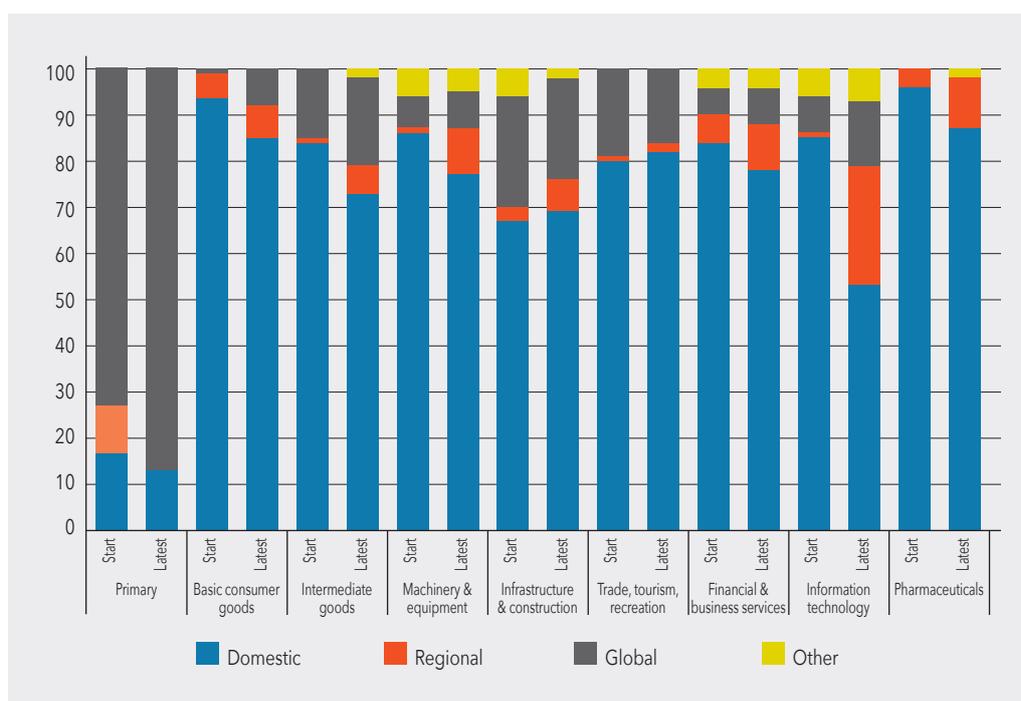


Source: UNCTAD FDI/TNC database, 'FDI flows in the host economy, by geographical origin', <http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Country-Fact-Sheets.aspx>

Second, South Africa can be understood as a gateway to the BLNS. South Africa has traditionally promoted an assumed role as a gateway to Africa, offering a base of operations characterised by strong skills and infrastructure from which to base investment projects in less well-developed parts of the continent. This framing of South Africa as a gateway to the continent is not entirely accurate but it certainly does appear to apply more narrowly as a gateway to Southern Africa.

There is a clear tendency for market-seeking foreign firms that have established a presence in South Africa to expand into the subregion. Figure 11 shows the destination for goods produced by firms in various economic sectors at the start of their investment and later on. All sectors, with the exception of primary goods, show a clear tendency to expand further into the region once established in South Africa. While not a linear trend, firms that targeted the domestic market on entry were more likely to extend their operations into the region than those that targeted the export market on entry; this is perhaps an indication that expansion into the Southern African region tends to be favoured by market-seeking firms looking to extend their reach. This trend is also seen in company size: smaller foreign firms are more likely to expand into the wider region than are large multinationals, which favour global markets. On balance this data, although not painting a full picture of South Africa's role, seems to indicate that the country is a gateway to the Southern African consumer market but not necessarily to the Southern African industrial space.

Figure 11: Shifting market orientation of investment in South Africa, by sector



Source: Gelb S & A Black, 'Foreign direct investment in South Africa', in *Investment Strategies in Emerging Markets*. Cheltenham: Elgar Publishing, 2004

Third, South African can be considered as a gateway for the BLNS to the rest of the world. The rise of the GVC introduces new dynamics to regions with wide disparities in economic development. Whereas previously, constrained by barriers such as weak infrastructure, least developed countries would struggle to enter global markets, they can now make use of infrastructure in neighbouring countries through the development of regional value chains (RVCs). In the case of Southern Africa, the productivity advantages of South Africa's more developed economy meld with the natural advantages of the BLNS to drive their exports. Although most countries in sub-Saharan Africa are stuck at the low end of these value chains, the chains nevertheless offer the scope to enter into sectors that would otherwise be prohibitively difficult to reach.

The motor industry again offers a useful case study. While still a very recent trend, South Africa is increasingly importing automotive components from neighbouring states. This is most noticeable in the case of Botswana, from which South Africa buys wiring harnesses and batteries. Other products, such as materials from Botswana and Namibia's large leather goods industries, may also find their way into South African-built cars. At the moment it is difficult to gauge how deep this level of integration is, but there is clear potential to develop RVCs across the Southern African region, which can be particularly beneficial to smaller states such as Lesotho or Namibia, which might struggle to enter global markets directly but can do so through the South African productive hub.

Although there are obvious channels through which neighbouring countries could benefit from the close proximity of the larger South African economy, the impact on investment is not clear. Market-seeking investment that targets the South African market is likely to establish itself in South Africa. RVC development does carry potential to grow neighbouring markets but the national value chain within South Africa is still under-developed. Large sub-national regional discrepancies offer similar advantages (ie, lower wages or natural resources) to regional states. South Africa's role as a service provider certainly improves the investment climate in the region but it does not substantially affect the competitive balance of productivity-sensitive investment between South Africa and its neighbouring states. On the whole, South Africa can play a major role in driving development in the region, but it is not clear whether or not this catalytic effect is large enough to create substantial social change.

Risks arising from South African policy

The risks associated with the relative scale of the South African economy and the potential associated distortions arising from its policy are difficult to measure. Beyond idiosyncratic cases such as MCB, evidence is scarce because the complaint is based on the counter-

factual proposition 'if it were not for South Africa, our investment would be much higher'. Nevertheless, the perception in the region is certainly that the presence of South Africa could complicate efforts to attract high-quality investment. This perception, tied to broader concerns regarding South Africa's regional hegemony, can stymie regional co-operation efforts in the field of investment policy.

Given the evidence thus far, it seems safe to say that market-seeking investment is not significantly open to distortion from investment policy, for two reasons. First, the South African market seems the obvious main attraction, with regional markets either secondary or considered as part of a single SACU market. Second, market-seeking investment does not seem to make much use of investment incentives; and most incentive programmes are aimed at value-added production and focus on export promotion.

Although there is little data on what motivates inward FDI flows to SACU, surveys show that roughly 80% of sales for foreign firms operating in South Africa are focused on the domestic market. South Africa accounts for 93% of SACU FDI stocks, hence this picture probably can be extended to the region as a whole.³⁸ This explains only the proportion of sales and is not scaled to the size of the company; many larger firms are more globally focused and from this information cannot be understood as market-seeking.

Added to this uncompetitive market-seeking investment is resource-seeking investment. FDI flows into Africa have usually centred on resource extraction, a motivation still prominent in SACU and even more so in the broader SADC region. Luxembourg, which in this context can be understood as a proxy for De Beers, accounts for 68% of total FDI stock in Botswana, driven by the country's large diamond deposits.³⁹ Angola and Mozambique have each experienced FDI booms over the past decade but almost all of this have been directed to oil and gas extraction.

On balance, therefore, it appears that FDI inflows that might be subject to distortion from South African policy – that is, efficiency-seeking investments – are only a very small proportion of the whole. Although a lack of data again makes it difficult to understand the scale of this competitive investment, it might be that at present it represents only a small fraction of total FDI. This should mollify numerically inclined economists, but it does not reduce the political appeal of the high value-added, job-creating investment that is contained within this portion of total FDI. Against the backdrop of political systems that favour this kind of investment, the scarcity of inflows on offer might be of even greater concern, particularly because many of the uncompetitive flows are believed to have weak

38 Gelb S & A Black, *op. cit.*

39 UNCTAD, FDI/TNC database, Botswana Table 1, FDI flows in the host economy, by geographical origin, <http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Country-Fact-Sheets.aspx>

40 KPMG, 'Monitoring African Sovereign Risk: Botswana Snapshot, 2013 Quarter 1'. Gaborone: KPMG, 2013, https://www.kpmg.com/Africa/en/KPMG-in-Africa/Documents/2013%20African%20Country%20Reports/KPMG_Botswana%202013Q1.pdf.

social benefits. Diamond mining in Botswana, for example, accounts for 40% of GDP⁴⁰ but creates only 4% of employment.⁴¹

Before considering incentives, some core competitive indicators, including the effects of investor protection, must be considered. Figure 12 shows the rankings of SADC countries in the World Bank's Doing Business Report, with SACU states highlighted in blue. For several countries the advantages of a more business-friendly environment are attenuated by problems specific to them. For example, logistics costs are restrictive for landlocked countries such as Botswana and Zambia, currency volatility hampers Malawi and Zimbabwe and political uncertainty clouds prospects for the likes of the Democratic Republic of the Congo and Swaziland.

These structural efficiency disparities, combined with the dominance of immobile investment, mean that only a small pool of investment is influenced by policy. To understand the competitive effect of this policy, Table 3 compares investment incentives across SACU members. It is purely indicative – based largely on marketing by investment promotion bodies – and may exclude other incentives; it definitely excludes those available under SEZ policies.

Two factors immediately become apparent. The first is that most incentives in the BLNS are more aggressive than those in South Africa, particularly in SEZs. Whereas South Africa tends to moderate costs through tax relief and investment support, the BLNS offer full tax breaks in many cases and the removal of almost all restrictions on movement of capital and profits. These more substantial incentives are possibly the result of higher costs associated with lower levels of development and the consequent need to set incentives higher to compensate. They could also result from competitive pressure from South African incentives, although this seems unlikely, particularly in the case of SEZs, given that the policies of many countries in the region predate South Africa's. The second observation is that most incentives offered by the BLNS are much less narrowly targeted; although there is a general effort to support manufacturing (broadly defined), most incentives set out to capture whatever investment they can, a situation that offers quite significant opportunities to target gaps in the South African incentive web.

41 Zizhou F, 'Linkages Between Trade and Industrial Policies in Botswana', Industrial Policy Thematic Working Group. Pretoria: TIPS, 2009.

42 Woolfrey S, 'The SADC Model Bilateral Investment Treaty Template: Towards a New Standard of Investor Protection in

Table 2: Ranking of SADC countries, World Bank Doing Business Report, 2015

Economy	Ease of doing business ranking
Mauritius	28
South Africa	43
Botswana	74
Seychelles	85
Namibia	88
Swaziland	110
Zambia	111
Mozambique	127
Lesotho	128
Tanzania	131
Madagascar	163
Malawi	164
Zimbabwe	171
Angola	181
Democratic Republic of the Congo	184

Source: World Bank, 'Doing Business Report', 2015, <http://www.doingbusiness.org/>

Table 3: Investment incentives in the BLNS

	Botswana	Lesotho
Preferential tax rates	15% tax rate (rather than 22%) for manufacturing firms, International Financial Services Centre accredited firms, and innovation hub firms	10% corporate tax on manufacturing profit generated from exporting manufactured goods outside SACU; a maximum manufacturing corporate tax rate of 10% on profits for intra-SACU trade
Tax holidays	0% tax holiday for five to 10 years	
Capital controls	No foreign exchange controls	No withholding or advanced corporation tax on dividends distributed by manufacturing firms; easy repatriation of manufacturing profits
Training incentives	Discretionary tax breaks and training grants by the Development Approval Order through the Ministry of Finance and Development Planning	Training costs allowable at 125% for tax purposes
VAT and duty		VAT rate of 14% (ensuring harmonisation with South Africa)
Capital investment		

Sources: Botswana Investment & Trade Centre, <http://www.bitc.co.bw/incentives-investors>; Lesotho National Development Corporation 'Incentives', <http://www.lndc.org.ls/incentives/>; Namibian Embassy US 'Investment incentives', <http://www.namibianembassyusa.org/page/investment-incentives>; Namibian Ministry of Industrialization, Trade & SME Development. 'Incentives', <http://www.mti.gov.na/incentives.html>; Investors Guide to Swaziland, http://www.africanbondmarkets.org/fileadmin/Countries/Swaziland/Swaziland_Investment_Promotion_Authority/Swaziland_investment_guide_2011.pdf

Namibia	Swaziland
80% tax allowance on income derived from exporting manufacturing goods	
18% tax rate for 10 years	10% corporate tax rate for 10 years for companies in qualifying industries (including manufacturing, mining, agri-business, tourism, and international finance services)
Non-resident shareholder's tax of 10%, and tax-exempt dividends to Namibian companies and resident shareholders	Liberalised repatriations of capital and profits
Additional deduction from taxable income of 25–75%; industrial studies available at 50% of cost	150% rebate for approved human resources training
Import or purchase of manufacturing machinery and equipment is exempt from VAT	Exemption from duty for capital goods imported and used in the production of final products, and raw materials used in exports beyond SACU
Factory building written off at 30% in first year and balance at 8% for 10 years; allowance for land-based transportation by road or rail of 25%	50% allowance in the first year and 10% annual allowance for plant and machinery used in manufacturing; 40% first year and 4% annual for buildings used to house manufacturing; further allowances on hotel construction, employee housing and farming

REGIONAL CO-ORDINATION OF INVESTMENT POLICY

The regional investment landscape may be defined by three factors. The first is uncompetitive investment: the great majority of investment into sub-Saharan Africa is not interchangeable with that into other locations around the world. Market-seeking and resource-seeking investment dominates, with a minority of investment flows driven by the region's export competitiveness and potential. The second factor is unbalanced fundamentals: economic parameters ranging from market size to productive efficiency are uneven across the region and most pronounced in the case of South Africa. The disparity between South Africa and its SACU and SADC neighbours means that flows of market- and efficiency-seeking investment are likely to be so unbalanced as to exacerbate regional inequalities. Third, there is an imbalance in policy capacity: the scale of South Africa's investment incentives limits the ability of neighbouring governments to use their policy structures to attract investment. Initiatives may work in niche industries or when set in co-ordination with South African policy but otherwise they risk being out-spent by South Africa's incentives. All three factors must be borne in mind when crafting regional investment policy.

Regional economic communities in general struggle to co-operate on investment policy, which is sensitive to the regulatory and fiscal priorities of individual countries. Southern Africa is no exception. Nevertheless, two SADC initiatives are broadly aiming to promote convergence on investment-related issues. The first, the SADC Model Bilateral Investment Treaty (Model BIT), aims to create a regional standard for the drafting of 'next-generation' BITs. It is not a prescribed model but is available to any country in the region. Drafted in co-operation with the Winnipeg-based International Institute for Sustainable Development and released in 2012, Model BIT aims to be a next generation treaty and includes provisions targeted at alleviating common concerns associated with investment agreements. For example, Model BIT narrows the scope for using the Organization for Economic Cooperation and Development's Fair and Equitable Treatment standard, a favourite prop of claimants in international arbitration proceedings thanks to its broad scope for interpretation that employs governance standards rather than investor rights as the basis on which to assess claims.⁴² The scope for private business claimants is further limited by the absence of investor-state dispute settlement rights, which are replaced by recourse to state-state dispute settlement. The Model BIT also provides for host states to impose regulatory measures in the pursuit of development and places obligations on investors regarding environmental safeguards, human rights and various social conditions. More traditional provisions such as restrictions on direct expropriation are included but give states broader powers, notably in the definition of compensation against a 'fair and adequate' standard rather than a 'fair market value' standard.

The Model BIT is a powerful starting point to respond to evolving complaints against BITs, with no obligation for SADC states to use the new template. Despite this, there are limits on its capacity to drive regional investment policy. First, the main way in which the Model BIT mechanism can bring about change is through its use in negotiating future BIT agreements, which at the moment are not on the cards. In South Africa particularly, opinion has swung firmly against BITs and towards domestic regulation of foreign investment. The Model BIT may assuage some of the concerns underlying this trend but it cannot have a serious impact unless core opinions on the value of BITs shift considerably and states begin to sign new agreements. Second, the logic underlying the regionalisation of investment protection (rather than promotion) policies is not quite clear. While regulatory convergence in the region makes it easier for investors with a presence in one country to move to another, most regulatory barriers do not explicitly concern investment. The core barriers cover a range of industry-specific rules and some broader rules on labour, company registrations and so on. At present, regional co-ordination of investor regulation does not seem capable of creating a simple channel through which investment in one country can move to the wider region.

Other integration efforts, although not directly targeting investment, play a significant part in creating a regional investment market. For example, the SADC Financial Services Investment Protocol (FIP) adopted in 2007 is a broad-ranging effort to harmonise the financial services sector, ranging across payment and clearance systems, insurance and securities trading to central bank regulation and exchange control. FIP reflects the apogee of rapid internationalisation of finance with minimal regulation. It also pre-dates the Zuma administration and subsequent moves by the South African government to cancel BITs and build an investment regulatory regime that accrues power to government. Perhaps for this reason FIP Annex 1, concerning investment, offers extensive regional protection of the type available under old-style BITs. This includes the right to ISDS, broad demands for 'prompt, adequate and effective' compensation for expropriation and the inclusion of the controversial 'fair and equitable treatment' standard.

FIP is a case study in the limits of regional co-operation on issues such as investment. Although it may have been acceptable in 2007 when governments were in general agreement with its provisions, it is unlikely to survive the more recent tack in thinking on investment protection in the region, particularly in South Africa. Already questions have been raised about the legal applicability of the agreement (although in theory its commitments are binding on all SADC states) and it is widely expected that the protocol will be revised to reflect the changing investment regime at national level. Regional agreements that are applied only when all concerned are happy with them are of extremely limited utility. The degree of

certainty required by investors cannot be found in protocols that change with opinions.

Beyond SADC, some regional investment co-operation is evident in the sub-region of SACU and the macro-region of the TFTA. SACU has no formal investment co-operation; it is limited by the severity of the economic imbalance between South Africa and the BLNS and by the weak institutional capacity of an institution that is essentially just a trade agreement. SACU does, however, share access to South African initiatives that make use of tariffs as incentives for investment (notably the MIDP). Under the latest treaty other SACU states should have an equal say in setting tariff policy once they have established bodies that can govern this process, perhaps modelled on South Africa's International Trade Administration Commission (ITAC). Efforts to develop ITAC bodies in BLNS countries would create scope for greater engagement on how to use the common external tariff to promote investment across the region.

The TFTA is a more complex proposition. Investment is not one of its three pillars (respectively market access, infrastructure development and industrial development); and it is generally believed that the political will behind efforts to reach deep agreement on regulatory convergence of the kind sought in other mega-regional negotiations such as the TPP is weak at best. Nevertheless, the market access pillar does include negotiations on trade in services and mention has been made of cross-border investment's being a priority in the agreement. Investment promotion in the TFTA is seen more as linked to the core benefits of the deal itself – a large integrated consumer market from Cape to Cairo – rather than to specific provisions on investment governance or incentives.

CONCLUSION

Deepening co-operation on investment policy will be difficult. Internalising the benefits of regional integration in trade, even when there is very compelling logic behind building an integrated market, has been a fraught political process. That logic is much less clear in the case of investment policy. Why should politicians in South Africa support industrial development in Botswana rather than their own impoverished North West province? And why should the likes of Botswana re-direct scarce resources from domestic incentives towards regional initiatives that might dilute their impact? The immediate answer – creating shared wealth that reinforces growth across the region – is easy to arrive at in theory, but considerably more difficult to present convincingly to voters.

Nevertheless, the situation outlined in this paper – of a region in which economic inequalities

Southern Africa', Trade Brief No. D14TB03/2014. Stellenbosch: Tralac (Trade Law Centre), 2014.

can make investment policy an unbalanced zero-sum game – seems to call for active policy measures to ensure that South Africa’s investment initiatives spark regional agglomeration effects rather than national diversion. Policy in this regard will have to be cost-effective and easy to implement at the regional level and also must play to some shared benefits for all concerned. Possible initiatives could include:

Incentives along value chains: Inducements at various stages across value chains are mutually reinforcing. Incentives to promote export of cars would be even more attractive if the vehicles included components made more effective by incentives granted parts manufacturers further down the value chain. Support across value chains also allows governments to share the fiscal burden of incentives. Some level of co-ordination along a handful of value chains will reach into the imbalances in the region and allow smaller countries to share in the growth promoted by South Africa’s investment policy.

Developing a SEZ network: SEZs are ubiquitous across the region. They should tap into the tendency of investment in one SACU (or possibly SADC) member country to move to the wider region. Developing relationships between the management of different SEZs can encourage firms located in successful SEZs to consider investing in others in the region. Some level of harmonisation in the processing of entry into SEZs might also encourage such expansion. Successful SEZs should be seen as gateways to the SEZ network in the SADC region.

Developing tariff bodies in the BLNS: Using tariff walls and import rebate certificates is a controversial approach to investment promotion but one that is likely to remain popular in the region after the success of the MIDP. Regionalising the benefits of these initiatives would be much easier if the BLNS develop the institutional capacity to enact their rights under the SACU agreement to take part in the process of setting tariff policies, which would boost their influence in this important dimension of investment policy.



Sustaining Regional Integration in South America:

The Case of Mercosur

EXECUTIVE SUMMARY

Supported as it is by a wide range of organisations and structures, regional integration has long been a goal in South America but its realisation has proved difficult. The region's largest integration effort is the Southern Common Market (Mercado Común del Sur: Mercosur), a free trade agreement with ambitions to become fully integrated as a common market. The past decade, however, has brought a succession of serious challenges; they include currency crises in the two largest members, a growing number of trade disputes, and disagreements over the suspension of Paraguay and the admission of Venezuela. This paper explores these tensions and examines the sustainability of the integration project, focusing on the future of Mercosur. The first part reviews the history of integration in South America; the second examines some of the challenges facing Mercosur; the third offers a few case studies on how these challenges have played out and the fourth presents some conclusions.

INTRODUCTION

The idea of regional integration is far from new to South America. Arguably, economic and political integration as a policy objective has its roots in the revolutionary visions of the Venezuelan nationalist Simón Bolívar (1783-1830) and the Argentine independence leader

José de San Martín (1788-1850), both of whom envisioned a United States of Latin America. More formally, however, regional economic integration did not appear on the agenda of South American states until World War II ended in 1945; and the 21st century brought with it shifts in the political and economic landscape which in turn influenced the formation and nature of Latin America's regional integration processes. Mercosur, one of several initiatives that represent this changed thinking, had its beginnings in a series of bilateral trade agreements between Brazil and Argentina. It has since grown to include Argentina, Brazil, Paraguay, Uruguay and Venezuela and is South America's largest regional integration project.

Mercosur at present exists only as a customs union and free trade area but has ambitions to become a common market. According to the World Bank the grouping accounts for about 72% of the territory of South America (12.8 million km², three times the area of the EU), 70% (275 million) of the South American population and 77% of South America's 2012 gross domestic product (GDP) (\$ 3.18 trillion out of \$ 4.13 trillion).¹ Many observers consider Mercosur capable of giving the region much higher global economic status. Politically it can foster greater regional unity, better promote members' interests in multilateral negotiations and ultimately improve the wellbeing of their people.

Although Mercosur has achieved considerable success – between 1990 and 1997 intra-bloc trade grew fivefold from \$4 billion to \$20 billion² – 20 years after its foundation it is still struggling to sustain and deepen its integration. The union began to experience problems in the wake of the 1999 devaluation of the Brazilian real and an Argentine economic meltdown in 2001. The global economic crisis of 2008-2009 was a challenge to the union's stability, in part due to a growing number of trade disputes between member countries over tariff barriers and increased protectionism and unilateral actions. Furthermore, disputes arising from Paraguay's 2012 suspension from membership and the admission of Venezuela to the bloc have raised fresh concerns about its future.

This paper analyses some of the threats to the stability of Mercosur. It starts by briefly discussing the history of regional integration in South America and examines some of the difficulties that faced integration processes prior to the early 1980s, when the foundations were being laid for the initiatives of the 1990s. Many of these problems were to re-emerge later.

The second section will review some present obstacles to the sustainability of Mercosur; the third will discuss examples of how these issues have played out (specifically those that

1 Brazil, Ministry of Exterior Relations, 'Mercosur', http://www.itamaraty.gov.br/index.php?option=com_content&view=article&id=6252:mercosur&catid=143&Ivlang=en&Itemid=434

2 Biswaro J, 'The Quest for Regional Integration in Africa, Latin America and Beyond in the Twenty First Century: Experience, Progress and Prospects. Rhetoric versus Reality, a Comparative Study.' Brasilia: Fundacao Alexandre De Gusmao, 2011.

arose in the wake of the 2008-2009 crisis) and look at the institutional hurdles the union must overcome. This section also deals with issues of unilateralism – centring on the increasingly protectionist trade policies of key Mercosur members and their effect on other member states – and with trade negotiations and the challenges of membership and changes in the Mercosur agenda. The final section offers some conclusions and lays out some possible outcomes.

THE PROCESS OF REGIONAL INTEGRATION

Although it is tempting to relay the entire history of South America's regional integration and its complementary institutions, for this paper it is necessary only to focus on those institutions and events that helped form the foundations of Mercosur. For this purpose the process of regional integration may be divided into two phases: the 'old regionalism' from 1945 to the 1980s and the 'new' or 'open' regionalism that took hold from the 1990s onward.

Old regionalism

South American integration in the period described as old regionalism can be seen as grounded in the structuralist school of thought⁴ through which national development processes are largely the function of the state, which supplies and manages all necessary elements of economic development, provision of infrastructure and industrial planning. Essential to this process was the encouragement of industrialisation through import substitution, a policy aimed at breaking away from the legacy of Latin American nations as solely exporters of primary goods.⁵

One of the first formal attempts at economic integration during this period was the Asociación Latinoamericana de Integración (Latin American Free Trade Association: Lafta), founded in February 1960 through the Treaty of Montevideo signed by Argentina, Brazil, Chile, Mexico, Paraguay, Peru and Uruguay. Bolivia, Colombia, Ecuador and Venezuela joined later.⁶ Signatories to the treaty agreed to the elimination of all tariffs, duties and associated charges on all trade between members while differentiating between 'sensitive' and 'non-sensitive' national goods. Lafta functioned on the Most Favourite Nation principle, which requires that any preferential treatment accorded a non-member be extended to other members.⁷

3 *Ibid.*

4 Birch M, 'Mercosur: the road to economic integration in the southern cone', *International Journal of Public Administration*, 23, 5–8, 2000, pp. 1387–1413.

5 *Ibid.*

6 *Ibid.*

7 *Ibid.*

Although the agreement met with some success in its early stages, with intra-regional trade increasing from 8% in 1960 to 13.6% in 1975, progress had slowed by the end of the 1960s⁸ as discord among members increased. By the early 1970s very few states had lowered tariff barriers and as a result the deadline for full integration was extended to 1980. The larger member states (Brazil, Argentina, Mexico and Chile) were anxious to move more quickly with tariff reductions to enable them to enlarge their markets, hence their industrial base. As trade barriers fell and trade among member countries grew, however, many smaller members felt that most of the benefits of integration were accruing to their more industrialised counterparts.⁹ According to Kaltenthaler¹⁰ the failure centered on the commitment by many South American states to a policy of import substitution and the resistance of governments (or powerful private interest groups) to reducing tariffs on products regarded as 'key' or 'strategic'. In response to discontent among many of the smaller states, Colombia, Chile, Peru, Venezuela, Ecuador and Bolivia came together through the 1969 Declaration of Cartagena to form the Andean Pact. Kaltenthaler¹¹ believes that the economic and political climate of the time was not favourable for regional integration. Moreover the establishment of military dictatorships in the 1970s and early 1980s and an increase in civil unrest in Argentina, Chile, Uruguay, Paraguay, Brazil, Peru and El Salvador, among others, presented a further important barrier to integration and co-operation in general.¹²

In August 1980 members of Lafta, feeling that it needed to be reformed, signed the Montevideo Treaty that replaced the original grouping with the Asociación Latinoamericana de Integración (Latin American Integration Association: LAIA). One reason for this reconstituted vision was the emergence of democratic institutions throughout Latin America in the mid- to late-1980s. A new generation of democratic leaders saw regional integration as a way to stabilising the region at the same time as encouraging more political homogeneity on the continent, in particular the 'southern cone' in which Brazil and Argentina came to re-establish their fractured relationship.

In recognising the historical trade patterns and different levels of economic development of member states, the LAIA arrangement permitted tariff reductions to be negotiated bilaterally or multilaterally among small groups of countries, without requiring that they be extended to all members. Like its predecessor, however, LAIA also failed to achieve significant regional

8 *Ibid.*

9 *Ibid.*

10 Kaltenthaler K & F Mora, 'Explaining Latin American economic integration: The case of Mercosur', *Review of International Political Economy*, 9, 2002, pp. 72–97.

11 *Ibid.*

12 *Ibid.*

economic integration, in large part due to import substitution. According to Anastasios Valvis:¹³

The continuous strong antagonism between different states with similar inward-looking development strategies led the old regionalism and the LAIA agreement to failure [sic]. National markets did not open and, as a consequence, the explicit goal of diverting third party imports to intraregional production and export did not actually happen.

By the early 1990s it was clear that old regionalism and import substitution industrialisation policies for the most part had failed. Lafta and LAIA had proved unsuccessful partly due to their structure but also under the pressures arising from the economic and political uncertainty prevailing on the continent. Nevertheless, out of the failure of those institutions was born a new form of regional policies that became known as 'open' or 'new' regionalism. This period saw the resurgence of the Andean Community (Comunidad Andina) and the creation of Mercosur, both groupings established to give national economies a better footing in the international economic system while also developing regional trade.

New regionalism

Under the pressure of economic hardship resulting from the 1980s Latin American debt crisis, countries in the region began scrutinising an alternative model of structural economic reform. This came by way of a wave of new preferential trade agreements throughout the region in what would come to be described as the beginning of the period of 'new' regionalism. The rationale for reform (as it was later for Mercosur) was the notion of open regionalism, which was very different from the largely protectionist and inward-orientated model of regional integration followed from the 1960s and 1970s (the old regionalism). The term 'new regionalism' was first articulated by Gert Rosenthal, former president of the Economic Commission for Latin America, who described it as a policy framework which promotes forms of economic liberalisation and deregulation that are aimed at improving regional competitiveness.¹⁴ Economic liberalisation and socio-political democratisation would become the primary objectives of regional integration efforts. During this time many new regional agreements emerged and existing ones took new forms; they varied in nature, with some pursuing the idea of a common market and others seeking free trade agreements.

13 Valvis A, 'Why is it worth rethinking Latin American integration?', in *Regional Integration in Latin America*, Institute of International Economic Relations, 2008.

14 Schirm S, *Globalization and the New Regionalism: Global Markets, Domestic Politics and Regional Co-operation*. Cambridge: Blackwell, 2002, pp. 136–168.

Mercosur, although an outcome of several national policy shifts and attempts at regionalisation, in many ways was driven by the governments of Argentina and Brazil. Those countries believed that it was the formation of strategic alliances rather than rivalries that would promote the economic development and competitiveness of the region while greatly reducing its dependency on the US.¹⁵

Rivalry between the two major regional powers, Argentina and Brazil, dates back to the era of European colonisation and for this reason has been a key factor in developments in the entire Southern American region (in particular the establishment of Uruguay and Paraguay as states). For the past 50 years their disagreements, although falling short of outright warfare, have been far-reaching – particularly as they concern the two countries' influence in buffer states, their respective nuclear capabilities and the considerable hydroelectric resources of the Parana River. From the early 1980s, however, relations between them began to improve, an easing that culminated in the signing of the 1985 Iguazu Declaration which formally ended their rivalry and formed the basis for future co-operation in energy, arms control, nuclear installations and other areas necessary to advancing economic integration.¹⁶ One result of the Declaration was the establishment of a high level joint committee, leading to the Argentine-Brazilian Integration Act signed in 1986 in Buenos Aires. Under the leadership of presidents Raúl Alfonsín of Argentina and José Sarney of Brazil the act created the Programme for Economic Integration and Co-operation (Programa de Integración y Cooperación Económica Argentina-Brasil: PICE) under which 24 bilateral protocols were signed over three years. PICE was structured around negotiations over sectoral agreements covering specific areas such as capital goods, food, technological co-operation and the iron and steel, nuclear and automobile manufacturing industries. Following on this, in November 1988 Brazil and Argentina signed the Treaty for Integration, Co-operation and Development setting the stage for a common market between them within 10 years.¹⁷ In 1990 Paraguay and Uruguay were invited to participate in the establishment of such a market.

These moves towards increased co-operation coincided with more widespread regional democratisation; indeed it might be said that regionalism and democratisation were mutually reinforcing. In Brazil and Argentina it was the emergence of civilian governments after extended periods of dictatorship that encouraged re-commitment to regional integration and bilateral co-operation as a means of securing the region and consolidating the democratisation process. By 1985 for the first time Argentina, Brazil and Uruguay all had democratic governments, which allowed for improved bi- and multilateral relations in the region.

¹⁵ *Ibid.*

¹⁶ *Ibid.*

¹⁷ *Ibid.*

On 26 March 1991 Brazil, Argentina, Paraguay and Uruguay signed the Treaty of Asunción, providing for the creation of Mercosur.¹⁸ The treaty has been formally amended once, through an additional protocol known as the Protocol of Ouro Preto, signed in December 1994. Among other things, this established the foundation for a customs union with a common external tariff, covering 85% of goods traded by bloc members with third countries.

For the first decade Mercosur was regarded as one of the most successful attempts at regional integration in the developing world and the most durable in South America.¹⁹ Its success was attributed to unprecedented levels of intra-regional trade and to what was considered the effective negotiation of common external tariffs, which in 1995 resulted in the launch of Mercosur as a customs union proper.

There are three distinct phases in the evolution of Mercosur. The first was driven by the groups that were decisive to its creation; the founder members saw a need to encourage trade flows in the region and to integrate into the global market.²⁰ The second phase extended over the first decade of the 21st century and was marked by the installation of popular governments such as that of President Luíz ('Lula') da Silva in Brazil, which brought with them new ideas and strategies for integration that were more South-South orientated and more mistrustful of global neoliberal policies. Graciela Rodríguez considers that the rejection by its members of the 2003 proposal for a Free Trade Area of the Americas, a US-driven scheme for free trade between all countries in the Americas (excluding Cuba), gave the Mercosur bloc a strong sense of identity and a renewed commitment to the project.²¹ This period also saw the creation or conclusion of meetings and agreements on wider non-economic issues such as social development, youth and women's affairs, democratic governance and human rights. Socio-economic institutions established at this time included the Mercosur Structural Convergence Fund, a financing mechanism for infrastructure in the region, and the Mercosur Social Institute, more directly concerned with issues of social development.

The third and current phase began with the 2008 global economic crisis. The main distinguishing feature of this stage has been the effect of the crisis on unilateral and regional trade policies.²² Many Mercosur members turned to protectionist policies to protect their economies and as a result have become less committed to the pursuit of common solutions and economic policies; institutional processes have stagnated and there has been an increase

18 Gardini G, *The Origins of Mercosur: Democracy and Regionalization in South America*. New York: Palgrave Macmillan, 2010

19 *Ibid.*

20 Rodríguez G, 'Mercosur: What kind of integration is possible?', in Berrón G et al, *Rethinking Regionalisms in Times of Crisis*. Rio de Janeiro: Transnational Institute, 2013, p. 17.

21 *Ibid.*

22 *Ibid.*

in disputes over trade and customs issues. It is this, present phase of its development that will present Mercosur with the challenges reviewed more closely in the following sections.

EMERGING CHALLENGES

One of the most commonly cited reasons for the weakness of Mercosur has been its institutional basis. According to Luigi Manzetti, until now Mercosur has relied heavily on inter-governmental institutions rather than supra-governmental structures.²³ Although many argue differently, Manzetti considers that supranational institutions are essential and that they should be strengthened in order to establish a secure and fair common market, which is the primary aim of Mercosur. They assist in the harmonisation of domestic policies and create the common juridical norms that guide and regulate the integration process. Arguably, Mercosur's institutional weakness is the outcome of failures in other, past integration attempts such as the Andean Pact; the general effectiveness of which and its ability to resolve problems were believed to have been limited by excessive bureaucratisation.²⁴

Hence to remedy past mistakes, Mercosur policymakers opted for a more pragmatic, less bureaucratic approach. It was hoped that giving political leaders and ministers of member countries direct responsibility for Mercosur's development during its initial stages, rather than delegating authority to a supranational bureaucracy, would make for faster decisions and more effective action. In this context it is noteworthy that although members' national parliaments ratified the Treaty of Asunción they have otherwise been passive and indeed at times bypassed altogether. The organisation's only permanent institution is the Administrative Secretariat, which has as its primary task to supply member governments with documents and information regarding new protocols and agreements. The two other main decision-making institutions, the Mercosur Council and the Common Market Group, are staffed by top-ranking representatives of each member government, such as their foreign and finance ministers. This has meant that Mercosur depends on the national agendas of members and the changing priorities of the leadership of the day. At present these countries give precedence to maintaining national sovereignty,²⁵ which has resulted in a Mercosur shaped by the principles of 'inter-governmentalism' rather than those of a supranational institution akin to the EU that could independently govern the process of integration. Paraguay and Uruguay, the two smallest members of Mercosur, are of a different opinion.²⁶ A Mercosur with stronger supranational institutions, they believe, would give them more opportunities

23 Manzetti L, 'The Political Economy of MERCOSUR,' *Journal of Inter-American Studies and World Affairs*, 35, 1993–1994, pp. 101–41.

24 *Ibid.*

25 Gomez-Mera L, 'Explaining Mercosur's survival: Strategic sources of Argentine–Brazilian convergence', *Journal of Latin American Studies*, 37, 2005, pp. 109–140.

26 *Ibid.*

to defend their national interests, which under the current system often have been undermined.

Unilateralism has proved a relatively low-cost policy option for many member states. In fact flexibility and a more case-sensitive approach have emerged at the expense of the establishment and enforcement of the union's rules and procedure. For example, between 1991 and 2002 the Mercosur Council approved 149 decisions that required incorporation into the domestic legal system of each member country but of these, 70% remained unenforced in 2002. Of the 604 resolutions approved by the Common Market Group for those same years, 63% remained in abeyance in 2002.²⁷ In the wake of the 2008 economic crisis member states – especially the biggest, Argentina and Brazil – have become far more prone to making unilateral decisions on trade policy and the application of tariffs; this has led to an increase in disputes between members.

The Mercosur decision-making process tends to have a distinctly top-down flavour with presidential initiatives as its main driving force and mechanism.²⁸ For example, the 2004 Olivos Protocol provides for resolution of disputes that may arise among its signatories regarding the interpretation and application of, or lack of compliance with, the Treaty of Asunción and the Ouro Preto Protocol.²⁹ The Olivos Protocol also created a permanent Mercosur court. Many, however, regard the court as dysfunctional: between 1991 and 1998 almost all trade disputes between members were addressed through bilateral negotiation and the most serious through direct presidential involvement. Furthermore, continuing power imbalances between Argentina and Brazil on the one hand and Uruguay and Paraguay on the other tend to destabilise the union. Argentina and Brazil have the largest economies and most political clout and as a result have the strongest influence on decisions, in particular those regarding any efforts to deepen integration.

Brazil and Argentina

The 2008 global economic crisis brought with it the widespread re-emergence of protectionism as a means of safeguarding domestic interests. Latin America and Mercosur members were no exception. According to the London-based think-tank Global Trade Alert, South America is responsible for one-fifth of all protectionist measures worldwide and Argentina and Brazil together account for 70% of discriminatory measures in the region.

27 Baumann R, *Integration in Latin America—Trends and Challenges*. Brazil Office: Economic Commission for Latin America and the Caribbean, 2008.

28 Manzetti L, *op. cit.*, pp. 101–41.

29 *Ibid.*

Clearly, the conduct of Argentina and Brazil as Mercosur's two largest members (by population and economic output) is of great consequence to the unity, stability and success of the union. Additionally their actions and their degree of compliance with Mercosur directives set crucial precedents for the bloc as a whole. Unfortunately, in the wake of the 2008 crisis they, along with other developed and developing countries, have resorted to protectionist and restrictive trade measures in order to give priority to their domestic economies. According to Mario Carranza the global crisis has managed to 'unglue' Mercosur by giving impetus to Brazil's tendency to work outside the bloc; it has provoked deeper intra-bloc trade disputes resulting from increased protectionist trade policies; and with the accession of Venezuela has called into question Mercosur's founding principles.³⁰ Mercosur is an institution created on the principles of free trade and the reduction of duties and preferential trade among its members. Despite this, Brazil and Argentina in particular have adopted protectionist measures to ameliorate the impact of the global downturn on their national industries.³¹ Although as full members of Mercosur they are restricted from making unilateral changes to tariffs, many of their actions have run counter to the fundamental principles of the union and led to serious trade disputes.

In 2012 Argentina and Brazil received members' approval to raise import tariffs on more than 200 products on which a maximum rate of 35% can be applied. According to Guido Nejamkisin this has had the effect of diluting the objective of a common tariff.³² Nevertheless the two countries have taken further unilateral actions against the bloc's rules, resulting in disputes between them. Argentina has used non-automatic licensing and new approval systems to restrict the entry of certain items into the country, the goods most affected being farm machinery and textiles from Brazil and shoes and food products from Uruguay. Sergio Abreu, a former Uruguay government minister, has stated that 'Argentina has a protectionist model, taking tariffs to 35%. It doesn't allow imports and its methodology differs greatly from the original spirit of Mercosur'.³³ Similarly Brazil has raised barriers by restricting Argentine goods such fruit, olive oil and biscuits. These and other protectionist measures have affected trade flows.

Although both countries have pursued similar protectionist methods that extend beyond their region, they have designed them to achieve slightly different aims. Argentinean policy has been more focused on increasing production and consumption of domestic goods, reducing unemployment and increasing international reserves in order to fulfil Argentina's

30 Carranza M, 'Mercosur, The Global Economic Crisis and the new Architecture of Regionalism in the Americas', Latin American Trade Network working paper, 125. Quito: Latin American Trade Network, 2010.

31 *Ibid.*

32 Gomez-Mera L (forthcoming), 'Domestic Constraints on Regional Co-operation: Explaining Trade Conflict in MERCOSUR.' *Review of International Political Economy*.

33 *Reuters*, 'Analysis: Venezuela joins trade bloc big on politics, protectionism', 30 July 2012, <http://www.reuters.com/article/2012/07/30/us-trade-latinamerica-idUSBRE86T16V20120730>

international debt repayment obligations. In order to pursue defensive industrial policies Argentina has opted for non-tariff barrier measures. These include quotas (a limitation on the import or export of certain goods over a period of time), import permits (government licences authorising import of certain goods), tax concessions and preferential loans for Argentinean products, and non-automatic import licensing (permitting the import of products only against specific criteria).

Protectionist trade policy has always been a strong feature of Brazilian administrations. Recent changes in policy were intended to protect domestic industries from increasing – and potentially de-industrialising – competition from cheap goods entering Brazil from countries such as China. The ultimate intent of Brazilian restrictions in the automotive industry, for example, has been to ensure increased investment in domestic motor vehicle manufacturing and encourage international motor manufacturers to build plants in Brazil to circumvent stringent import regulations. This policy seems to be working; companies such as BMW, Tata and Jaguar Land Rover have announced plans to build new factories in Brazil.³⁴

Both Argentina and Brazil have been under fire not only from other members of Mercosur but also the wider international community (eg, the WTO). The US, Japan and the EU among others have argued that Argentinean restrictions fundamentally violate WTO principles, as a consequence of which they have brought complaints to the WTO regarding Argentina's trade regulations, in particular its licensing requirements. The EU, which in 2013 was Brazil's biggest trading partner, also laid a case before the WTO, claiming that Brazil was placing unacceptable taxes on imports on various goods, in particular cars, as a result of which EU car exports to Brazil fell by 11% in 2013.³⁵ Similar disputes are likely to arise from countries such as Japan and the US, which have cited comparable concerns; closer to home, in 2011 Uruguay began negotiations with Brazil over the latter's 30% import tax on automobiles (for which Brazil is Uruguay's biggest market).³⁶

There is no agreement among scholars as to the direct impact that the 2008 global crisis had on regionalism in South America but according to Carranza, 'today's different economic climate will reinforce Latin America's growing tendency towards regionalist and socialist agendas, while simultaneously making it difficult for states to advance post-neoliberal political programmes.'³⁷

34 *The Economist*, 'Seeking protection', 14 January 2012, <http://www.economist.com/node/21542780>

35 *Reuters*, 'EU takes Brazil to WTO over "protectionist car taxes"', 19 December 2013, <http://www.reuters.com/article/2013/12/19/us-eu-brazil-wto-idUSBRE9BI0I320131219>

36 *Buenos Aires Herald*, 'Uruguay to discuss protectionism with Brazil', 27 September 2011, <http://www.buenosairesherald.com/article/80024/uruguay-to-discuss-protectionism-with-brazil>

37 Carranza M, *op. cit.*

Venezuela

In many ways the major changes that Mercosur has seen in the past decade have challenged the sustainability of the organisation and prompted many to question its stability. Key among these changes has been the suspension of Paraguay from the union and the inclusion of Venezuela as a full member.

On 31 July 2012 Venezuela, which had been awaiting approval for its membership in Mercosur for the previous three years, was finally granted full membership. In the same month Paraguay, one of the four founder members, was suspended from the union on account of what other members considered to be the undemocratic, though parliamentary, ousting of its president Fernando Lugo.

The admission of Venezuela marked the end of a long-drawn-out process that had begun in 2006. According to Mercosur law the admission of a new member must be approved by parliaments of all member states; Paraguay was the only country to reject the accession of Venezuela, on grounds of its concerns about the late Venezuelan president Hugo Chavez's questionable democratic credentials. The issue has caused tension within Mercosur; Paraguay argues that Venezuela's admission breaks the organisation's own rules, which require the decision to be unanimous (Paraguay's suspension was temporary and it is therefore still a full member). For Brazil and Argentina, however, the admission of Venezuela serves some strategic purpose. Not only can Venezuela make significant economic contributions to Mercosur – the oil-rich country's entry adds \$378.9 billion to the Mercosur GDP – but it is also heavily dependent on imports, trade from which Brazil and Argentina would expect to benefit.

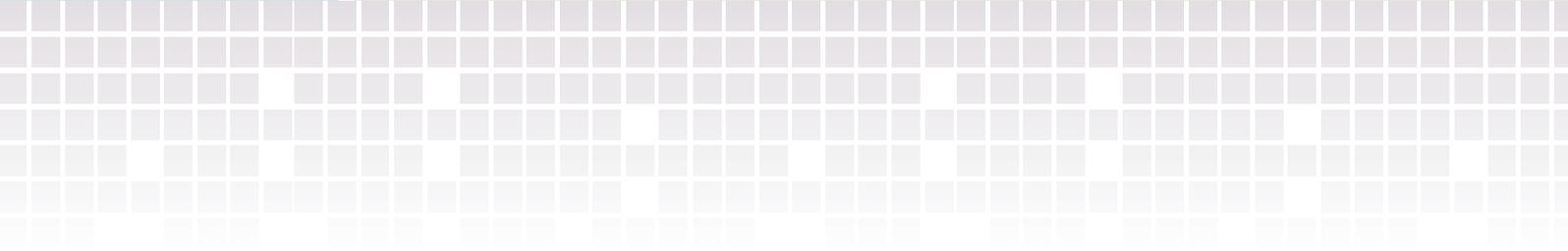
The inclusion of Venezuela may, however, call into question – or at least dilute – Mercosur's commitment to liberal democratic institutions and trade liberalisation. Chavez envisaged 'a Mercosur that prioritises social concerns,' saying, 'we need a Mercosur that every day moves farther away from the old elitist corporate models of integration that look for financial profits but forget about workers, children, life, and human dignity'.³⁸ Carried into Mercosur, such an approach would mean an increased politicisation of the union and perhaps a review of its trade policy.

³⁸ Kellogg P, 'Regional integration in Latin America: Dawn of an alternative to neoliberalism', *New Political Science*, 29, 2-2, 2007, pp. 187–209.

CONCLUSION

Mercosur has proved very resilient; although scholars and policymakers on many occasions have predicted its collapse it continues on. Examining two of the problems at present facing the union shows how many of these present challenges Mercosur has met with in the past. With the inclusion of Venezuela Mercosur has become an even larger bloc with a greater influence on integration and trade on the continent, although the new entrant may bring with it potential for ideological change. The problem for Mercosur is to overcome the flaws that have hindered its development on so many occasions thus far.

The first of these is its institutional weakness. As noted, the development of strong and permanent governance, dispute and negotiation mechanisms is the foundation of successful regional integration, allowing for policy consistency and freedom untrammelled by political agendas. The current global economic environment has also presented new obstacles. A return by Argentina and Brazil to protectionist policies challenges Mercosur principles; the two countries that in the past have so strongly shaped Mercosur still have a direct impact on its future direction. Finally, the accession to membership of Venezuela has challenged Mercosur's founding principles and potentially set it on a new path; Venezuela brings with it a more socialist agenda and therefore the potential for politicising the grouping and moving it beyond its *raison d'être*, which in essence is still an economic one.



Drivers of Regional Integration:

Value Chains, Investment and
New Forms of Co-operation

