Bank of Namibia

NOTE ON UNDERSTANDING FDI PROFITABILITY IN NAMIBIA: REINVESTMENT OR REPATRIATION?[1]

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FDI inflows into Namibia increased substantially since 2009 while registering positive returns on investment. This was sustained by strong returns on investment in the financial sector on the back of a wide interest rate spread environment as well as high non-interest income. Profitability in the mining sector was generally low, mainly impacted by the developments in international commodity prices. Income repatriation was not an outlier when compared to other resource-intensive states in the region as repatriation averaged about 2.0 percent of GDP per annum over the review period. The direct contribution of FDI to employment remained low, contributing about 6.6 percent to total employment. Though limited direct employment was created by FDIEs in Namibia, jobs created indirectly are estimated to be much higher. The low direct employment by FDIEs suggests the need for the country to also attract foreign investments in labour-intensive sectors that will aid in alleviating the prevailing high unemployment rate.

1 BON Economic Notes are articles by the Macroeconomic Statistics and Analysis division on relevant developments in macro and micro economic statistics. The notes are for the purpose of stimulating economic debate and informing the public on current trends in the economy. These notes are shorter and less technically oriented than BON Working Papers.

2 The views expressed in this note are those of the authors and do not necessarily reflect those of the Bank of Namibia. For helpful comments, the authors thank the colleagues from the Research and Financial Stability Department as well as Professor Teresia Kaulihowa from Namibia University of Science and Technology (NUST). Published as part of the Bank of Namibia Quarterly Bulletin June 2020, Volume 29/1

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1. INTRODUCTION

Foreign direct investment (FDI) has become an important source of foreign financing for developing countries, representing the largest share of external capital flows. According to the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6)*, direct investment[3] arises when an investor resident in one economy makes an investment that gives control over or a significant degree of influence on a firm that is resident in another economy. The benefits of foreign direct investment are broadly acknowledged by the existing empirical literature (Novotny, 2015). FDI contributes positively to export earnings, fiscal revenue, and economic growth in the host economy. Above all, foreign investments add to employment, directly through their subsidiaries in the host economies and indirectly through the linkages created with local suppliers. As emphasized by Novotny (2015), FDI determines the competitiveness and external vulnerability of a country, particulary for those that have a high FDI stock relative to GDP.

A thorough understanding of FDI profitability and its contribution to employment creation is necessary, particularly in developing countries with high FDI participation. Foreign direct investors compare relevant factors such as policy certainty, financial systems, taxation, infrastructure as well as return on investments across multiple countries before making an investment. Like any other investment, foreign direct investment is profit-seeking. An important question to pose is how are FDI profits allocated across competing claims in the economy, i.e. whether it is reinvested in Namibia or repatriated to foreign direct investors? Equally important, is the aspect of FDI's contribution to employment. What has been the effect of the recent developments in FDI on employment numbers?

FDI inflows affect various accounts of the balance of payments (BOP) as well as employment. FDI often enters the economy in the form of greenfield investments[4] such as the construction of a new mine or expansion of foreign retail store branches in the host economy. This is captured as capital inflows in the financial account of the BOP. At the same time, depending on the motive of the FDI, the initial stage is also associated with a rising import bill, employment creation and a worsening trade balance. As such, the initial stage is linked to increased investment and low earnings and in some cases losses. As the new enterprises commence with production, the next stage involves improvement in the trade balance through increased export earnings. This is followed by a deterioration in the primary income balance as dividends and interest payments are made to foreign investors. Therefore, the dynamic effect of FDI flows on the BOP depends on the financial lifecycle[5] of the foreign investment which is closely tied to profitability.

This note provides a time profile of FDI profitability and its contribution to employment creation in Namibia over the past decade. Section 2 provides an overview of foreign direct investment in Namibia. Section 3 focuses on the time profile of FDI profitability in Namibia. Finally, section 4 provides estimates of FDI's contribution to employment.

2. OVERVIEW OF FDI IN NAMIBIA

Since independence in 1990 Namibia has done well in setting-up an environment favourable to attracting foreign direct investment. At the outset, the country adopted the Foreign Investment Act 27 of 1990 with the aim of attracting foreign investments through a favourable investment climate and various tax incentives. The favourable investment climate and sophisticated financial system allowed foreign direct investment enterprises (FDIEs) to easily to remit capital and profits abroad. Initially FDI inflows were relatively small. However, they picked up significantly after the Export Processing Zone[6] (EPZ) regime was introduced in 1996.

3 Immediate direct investment relationships occur when a direct investor directly owns equity that entitles it to 10 percent or more of the voting power in the direct investment enterprise.

4 Greenfield investments are the type of FDI in which the parent company creates a subsidiary in different country, this type of investment is associated with high risk and cost of building new factories e.g. the construction of a new mine.

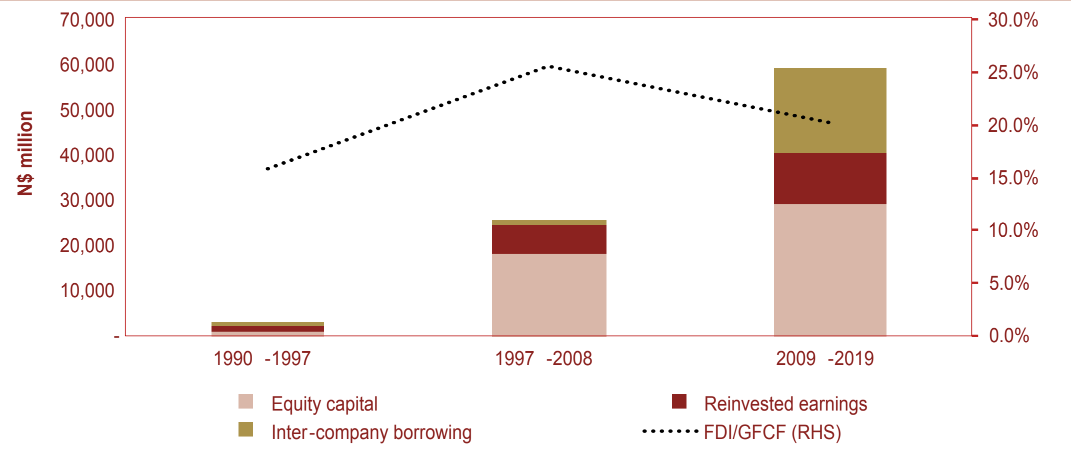
5 According to Brada and Tomkins (2009), the FDI financial life cycle involves three stages – stage 1, FDIE operates at a loss and neither is income repatriated nor reinvested. Stage 2, FDIE begins to register profits as production ramps up, thus most profits are reinvested to expand operations. As the FDIE reach maturity, the last stage entails increased profits repatriation and declining reinvested earnings.

6 The main objective of the EPZ regime was to attract and promote foreign investments in the manufacturing sector through various tax and non-tax incentives that included, inter alia, corporate tax holidays. The regime will be phased out and replaced by the Special Economic Zone (SEZ) dispensation (MoF, 2019).

FDI inflows into Namibia increased substantially from 1998 to 2008. FDI inflows averaged about 25.6 percent of Gross Fixed Capital Formation (GFCF) between 1998 and 2008. During this period FDI flows into Namibia amounted to N$25.2 billion, mainly made up of equity capital and reinvested earnings (Figure 1). The former included notable new and large foreign investments in the manufacturing sector such as the Skorpion Zinc Refinery, Ramatex Textiles, Hardstone Processing and Namcot Diamonds (Bank of Namibia, 2006). The latter was due to the good performance by existing FDIEs which resulted in increased reinvestment of earnings in the domestic economy.

Over the past decade, FDI inflows remained robust, sustained by new large investments in the mining sector. Notwithstanding the financial crisis of 2009, FDI has been the largest source of external financing over the past decade, and the most robust to economic and financial shocks (Figure 1). This is due to the fact that FDI has a longer time horizon compared to other investment. In absolute terms, FDI into Namibia cumulatively amounted to N$59.4 billion between 2009 and 2019, driven by new greenfield investments in the mining sector, mainly in uranium, gold and copper mining. The strong growth in GDP between 2010 and 2015 led to increased foreign investments in the wholesale and retail and financial sectors as most FDIEs expanded their operations across the country. However, as a ratio of GFCF, FDI flows declined to 20.0 percent (Figure 1) between 2009 and 2019 from 25.6 percent observed between1998 and 2009. This reflected the relative increase in domestic investment, particularly the strong growth in public sector investments as a policy measure to counter the negative effects of the 2009 financial crisis.

Figure 1: FDI flows into Namibia

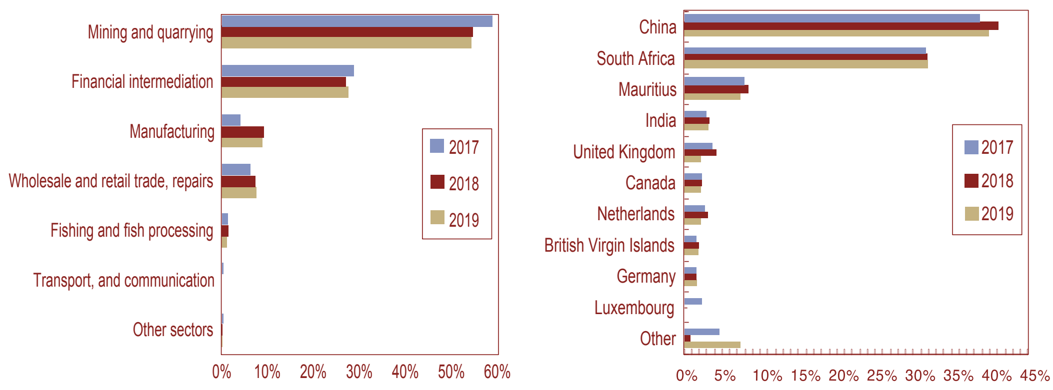


FDI inflows in the form of intercompany debt has become a major source of finance to FDIEs in Namibia from 2009 to 2019. Although equity remained the largest source of FDI, intercompany debt became an attractive form of foreign financing for the newly established and loss incurring FDIEs. Moreover, the decline in interest rates as well as the increase in liquidity globally made the cost of debt much cheaper than the cost of equity, making it easier for multinationals to support their subsidiaries with debt. In this regard, the share of intercompany debt increased to 18.6 percent of total FDI financing, up from 3.8 percent observed between 1998 and 2008. The growing intercompany debt in Namibia is in line with Lehman (2002) and IMF (2019) who suggested that the form that FDI financing takes is largely determined by tax considerations. Considering Namibia's higher tax rate,foreign direct investors prefer financing their FDIEs through debt because interest on debt is deductible from the affiliate's taxable income, therefore reducing the tax burden compared to the cost of equity that is non-deductible. Notwithstanding tax considerations, low profitability is an equally important factor that contributes to a high share of intercompany borrowing (Ramb & Weichenrieder, 2005).

Figure 2 (a-b): FDI stock by sector and country

The mining and financial intermediation sectors account for over 80 percent of Namibia's FDI stock, which mainly originated from China and South Africa.

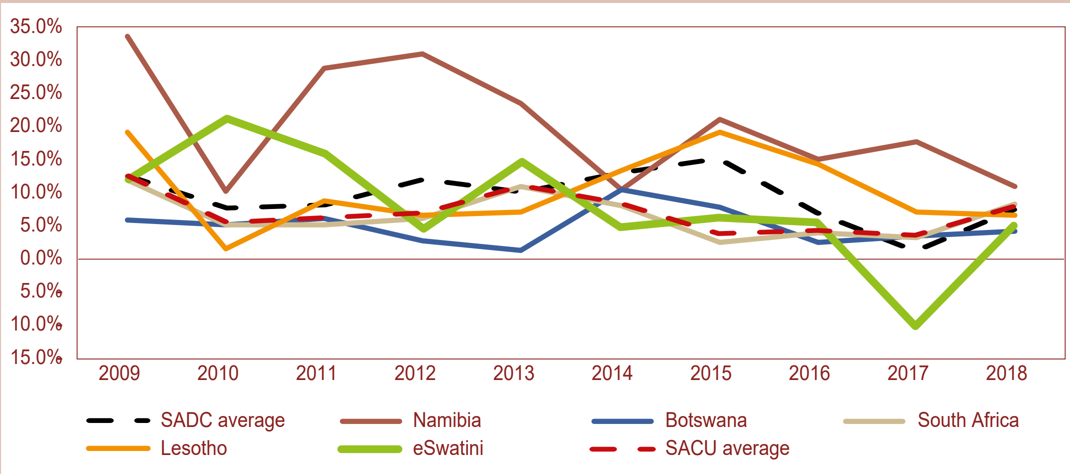
a. By recipient sector *b. By FDI investor country*



Source: Bank of Namibia

A significant share of Namibia's FDI was in the mining and financial intermediation sectors. The two sectors accounted for over 80 percent of Namibia FDI stock during 2017 to 2019 (Figure 2a). The mining and quarrying sector continues to dominate Namibia's *resource-seeking* FDI due to the abundance of natural resources. Major sources of investment in this sector were from China, Mauritius, Canada and the Netherlands (Figure 2b). Moreover, the close proximity to South Africa resulted in lucrative *market-seeking* FDI in the financial intermediation as well as wholesale and retail trade sectors. FDI in the manufacturing sector, which is largely *efficiency-seeking,* remained relatively low, accounting for less than 10 percent of the total FDI stock. Despite tax incentives and a tax free EPZ dispensation the manufacturing sector had little success in attracting investment. This can be partly explained by rising input costs, particularly high labour cost, water and electricity, as well as a deterioration in the ease of doing business (IMF, 2019).

Figure 3: Figure 3: FDI inflows in selected economies as percentage of gross fixed capital formation



Namibia's FDI inflows since 2009 have been relatively high when compared to other SACU[7] and SADC member states. Although FDI inflows have been on a downward path, Namibia performed better than most SADC and SACU countries in attracting foreign direct investment between 2009 and 2018. As a percentage of GFCF, the country's FDI inflows averaged about 20.2 percent, which was higher than the SADC and SACU's average of 9.4 percent and 7.0 per annum, respectively.

7 The Southern African Customs Union consists of five Member States namely, Botswana, Lesotho, Namibia, South Africa and Swaziland.

3. DEVELOPMENTS IN FDI PROFITABILITY

Measuring FDI profitability

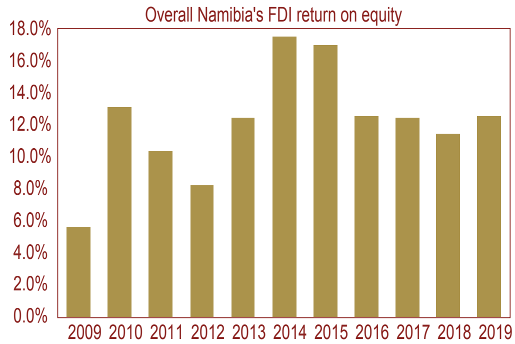
Foreign direct investment profitability is commonly proxied by return on equity (ROE) of foreign direct investment affiliates. This study measures profitability by using ROE which is typically the net income after tax divided by total equity of the FDIEs. The net income accruing to foreign direct investors and capital in the form of equity at book value was used to derive ROE. It is measured by operational income after tax excluding revaluation gains and losses. Total equity provided by foreign investors includes share capital, share premium, reserves, and retained earnings. To compute the ROE, the data was based on the Balance of Payment survey of foreign owned enterprises focusing on the financial, mining and manufacturing sectors for the period 2009 to 2019.

FDI profitability

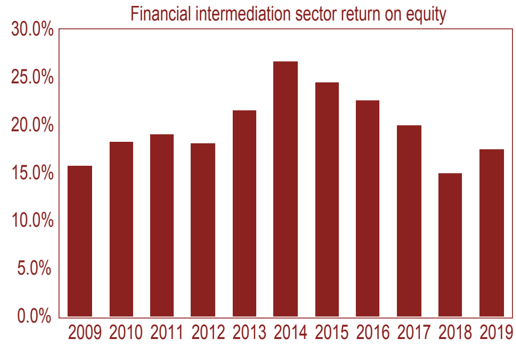
The overall ROE of FDIEs in Namibia has been positive between 2009 and 2019, mainly driven by profits made by Entities in the financial intermediation and manufacturing sectors. Figure 4 presents the overall ROEs of Namibia's foreign owned enterprises since 2009. During this period, the return on equity averaged 12.1 percent per annum, indicating farely strong returns on investment by foreign owned enterprises. However, the ROEs differed substantially at the sectoral level. The strong profitability was maintained by increased profits from foreign owned firms operating in the financial and manufacturing sectors. On the contrary, the returns on investment in the mining sector were low and more volatile than in the other sectors.

Figure 4 (a-d): Overall FDI ROE

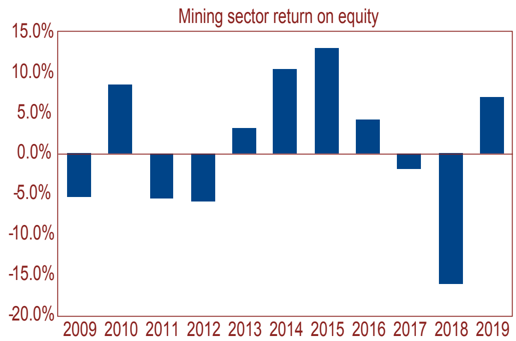
a. Overall FDI ROE was largely positive, albeit lower in recent years compared to its highest point in 2014,…



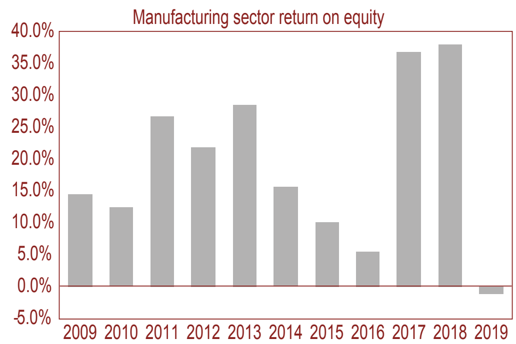
b. … largely supported by the profitable, sound and healthy foreign owned firms in the financial sector.



c. The mining ROE recorded fluctuations as net losses were experienced in the industry in some years.



d. The manufacturing ROE was largely positive, ascribed to high net profits of the mineral processing companies.



Source: Data computed by authors using Balance of Payment statistics

Figure 4b suggests that from 2009 profitability in the financial intermediation sector was higher compared to other sectors. The financial intermediation sector is heavily dominated by large and profitable foreign owned institutions. The sector's profitability as measured by ROE averaged 19.9

percent per annum over the review period, indicating a sound and healthy financial sector. This was partly supported by a wide interest rate spread environment as well as non-interest income received (i.e. fees and charges) over the last decade. Since 2015, the growth in net income after tax was outpaced by the growth in equity which led to the decline in the ROE of the financial sector. As banks gradually increased their capital buffers in order to improve their ability to withstand potential adverse shocks in line with the requirement of the Bank of Namibia and the Basel III supervisory framework. Despite the downward trend in the ROE the sector remained resilient amidst the low economic growth environment in recent years.

Profitability in the mining sector was mainly impacted by the developments in international commodity prices. The strong dependence on commodity prices is due to the fact that Namibia has a large number of marginal mines with low ore concentrates. The sector recorded an average ROE of 1.0 percent per annum between 2009 and 2019 (Figure 4c). The low ROE was due to extreme net losses recorded on occasion, as the sector experienced numerous challenges over the years. These include the global recession of 2009 which affected the sector negatively as both the diamond and copper industry recorded severe losses in 2009. Copper prices plunged to their lowest levels during 2009, resulting in the largest copper mine being placed under care and maintenance. For the past decade the uranium industry continued to face headwinds as uranium prices never recovered to the pre-2007 levels following the 2011 Fukushima Daiichi nuclear disaster and thus remained consistently low, over the review period. As a result, several uranium mines were placed under care and maintenance over the years. The high operating cost also continued to affect the industry's profitability. The recent huge investments in the uranium industry were associated with large initial losses conforming with the existing literature on the FDI financial life cycle (see Brada and Tomkins, 2009). Costs tend to be high as production is scaled up towards capacity at a new venture, while the weak prices of uranium presented further headwinds. Nevertheless, beyond price considerations certainty of supply also seems to be an important factor in the uranium-nuclear value chain. Despite the low overall ROE of the mining industry, the precious commodities like diamonds and gold recorded positive ROEs over the years.

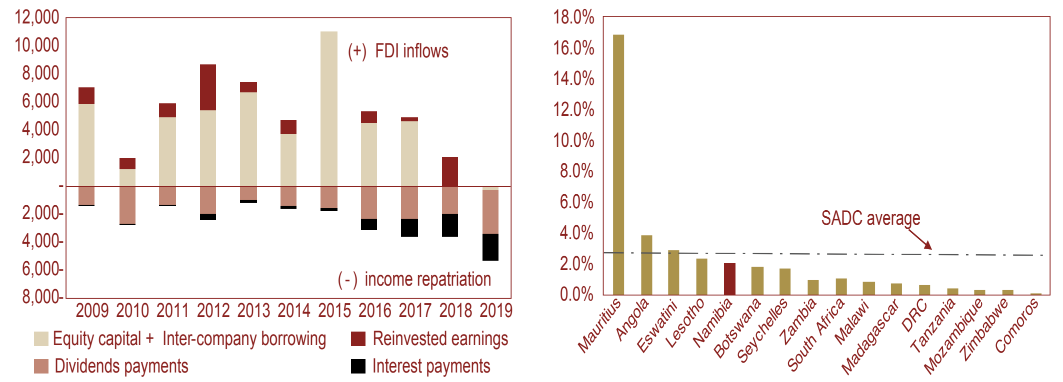
The manufacturing sector recorded high but volatile returns on equity, underpinned by developments in mineral processing industry. Namibia's inward FDI in the manufacturing sector is concentrated in the mineral processing industry, especially in diamond polishing, refined zinc and processing of copper. The ROE for the sector mirrored developments in commodity prices, particularly the international prices of zinc and copper. The sector's profitability as measured by ROE averaged 19.0 percent per year between 2009 and 2019.

Is FDIEs income reinvested in Namibia or repatriated to parent companies?

Figure 5 (a-b): FDI inflow and income repatriation

a. Income repatriation increased in 2019, while reinvested earnings remained low.

b. Income repatriation to direct investors was broadly in line with other SADC and SACU member states.



Source: IMF & *Namibia Balance of Payment statistics*

Income repatriation by FDIE's in Namibia was primarily driven by mature entities through dividend payments between 2009 and 2019. Since 2009, income repatriation by FDIE's averaged about 2.0 percent of GDP per annum. Income repatriation to foreign direct investors constitutes dividend payments, reinvested earnings[8] and interest payments on intercompany debt. Income repatriation was mainly in the form of dividend payments that reflects the return on investment distributed to foreign shareholders. Namibia's dividend payments as a percentage of GDP was on average 1.5 percent between 2009 and 2019. FDIEs in the financial sector and enterprises in the mining sector, specifically diamond mining remained the main drivers of foreign dividend payments. This are mainly mature entities that have been in operation for quite some time. Furthermore, interest payments surged, reflecting the increase in total intercompany borrowing. As a result, total interest payments accruing to related foreign lenders increased from 0.04 percent of GDP observed in 2009 to 1.1 percent of GDP in 2019.

Reinvested earnings were generally lower compared to income repatriation. This was mainly due to large enterprises in the mining sector accumulating huge losses over time that offset the profits retained by the rest of the industry. Since most of the investments are of recent and are still in their initial stage, low earnings are expected and in some cases even losses (Brada and Tomkins, 2009). These losses created a downward bias on the total reinvested earnings.

Namibia income repatriation to direct investors was broadly in line with other SADC and SACU member states. On average, income repatriation as ratio of GDP was about 2.3 percent and 2.0 percent for SADC and SACU member states, respectively, with Namibia's ratio slightly lower. Of interest is the higher repatriation ratio for non-resource-intensive countries such as Mauritius, eSwatini and Lesotho were FDI is largely *efficiency-seeking*. For these countries, FDI is highly concentrated in the service and manufacturing (textile industry) sectors which yield relatively superior returns on investments and therefore, resulting in higher income repatriation. This is not the case for the majority of countries with *resource-seeking* FDI such as Namibia as the returns on investment were generally weaker on the back of international commodity prices.

4. FDI CONTRIBUTION TO EMPLOYMENT

As the flow of FDI into Namibia rose, the number of people employed by FDIEs increased, although remaining low as a ratio of total employment. Foreign owned enterprises directly employed 47 359 (including contractors) persons in 2019 compared to the 30 577 persons employed in 2009 (Table 1). This translates into 16 782 new jobs, mainly from the wholesale and retail; mining; manufacturing and financial intermediation sectors. FDIEs accounted for about 6.6 percent of total employment in 2018. This is largely explained by the fact that FDI is skewed towards sectors such as mining and quarrying and financial intermediation, which are more capital and high skill intensive. Excluding the informal sector, employment by FDIEs was on average 15.6 percent of total formal employment.

8 Reinvested earnings are imputed transactions in the BOP and therefore treated as an outflow on the current account that comes back as an inflow in the financial acocunt

Table 1. Estimate of employment in FDIEs for selected sectors, 2009 to 2019

Sectors	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Change 2009-2019
Employment in FDI Enterprises	**30,577**	**36,124**	**38,241**	**39,464**	**43,071**	**46,326**	**45,338**	**45,064**	**47,648**	**47,799**	**47,359**	**16,782**
Wholesale retail and repairs	**9,273**	**11,569**	**10,878**	**12,727**	**12,911**	**15,568**	**16,195**	**16,301**	**16,878**	**17,603**	**17,193**	**7,920**
Mining sector	**8,196**	**10,427**	**12,170**	**11,619**	**13,397**	**13,214**	**14,037**	**12,419**	**13,439**	**12,434**	**12,737**	**4,541**
Permanent Employment	5,997	6,495	6,507	7,024	6,767	6,927	7,931	8,479	8,725	8,331	8,096	2,099
Contractors & Temporary employees	2,199	3,932	5,663	4,595	6,630	6,287	6,106	3,940	4,714	4,103	4,641	2,442
Financial sector	**5,337**	**5,387**	**5,565**	**5,780**	**5,970**	**6,318**	**6,690**	**7,127**	**7,196**	**7,426**	**7,412**	**2,075**
Permanent Employment	4,486	4,608	4,673	4,858	5,122	5,231	5,524	5,902	6,122	6,371	6,268	1,782
Temporary employees	134	224	322	301	204	357	375	331	173	192	200	66
Manufacturing	**3,044**	**3,629**	**4,247**	**4,161**	**5,515**	**4,895**	**4,655**	**5,029**	**5,546**	**5,222**	**5,326**	**2,282**
Fishing sector	**5,444**	**5,668**	**5,951**	**5,799**	**5,922**	**7,062**	**4,552**	**5,082**	**5,490**	**5,977**	**5,635**	**191**
Total Employed	**-**	**-**	**-**	**657,584**	**682,597**	**708,895**	**-**	**676,885**	**-**	**725,742**	**-**	**-**
FDI employment/ total employment	-	-	-	6.0%	6.3%	6.5%	-	6.7%	-	6.6%	-	-

Source: authors' computation and estimation with data obtained from BON surveys of foreign owned enterprises, NSA and Chamber of Mines and Energy. (-) indicates that no data is available for those years. Total employment is based on several LFS that were not carried out each year.

Foreign investment in the wholesale and retail trade sector generated most of the jobs in FDIEs. Table 1 shows that the wholesale and retail trade sector had the highest number of jobs despite the sector having one of the lowest amounts of FDI stock. The sector managed to create at least 7 920 new jobs between 2009 and 2019. This reflects the growing contribution of the sector to GDP and employment creation since it's service oriented. The growing number of new malls[9] contributed to jobs created in this sector as some of the big tenants are FDIEs. Moreover, the manufacturing sector added about 2 282 new jobs employment between 2009 and 2019, which were mainly concentrated in non-metallic minerals.

Foreign owned enterprises do not only create direct employment but also generate indirect jobs. This is mainly through the linkages created with local suppliers. Measuring the indirect employment created - normally referred to as the "multiplier effect" is difficult. As such, the employment multipliers estimated in Humavindu and Stage (2013) were used to derive an estimate of jobs created indirectly by FDIEs in Namibia. The study found that for every job created by FDIEs, 2.5 indirect jobs are created. This was derived using sectoral multipliers that are associated with high foreign investments. In this regard, indirect jobs created by FDIEs was estimated to be around 117 601 which translate into 16.2 percent of total employment. Although limited direct employment is created by FDIEs in Namibia, jobs created by FDIEs indirectly are higher due to the multiplier effect through backward and forward linkages.

9 These includes amongst others, big malls like the Grove Mall, the Steps, Dunnes Mall in Walvis Bay, MegaCentre, Platz am Meer in Swakopmund, Otjiwarongo Mall and the expansion of Wernhill.

5. CONCLUSION

The note found that FDI profitability in Namibia was positive, sustained by strong returns on investments in the financial sector, while employment in FDIEs increased between 2009 and 2019. The high profitability in the financial intermediation sector was due to the wide interest rate spread environment as well as lucrative non-interest income. Despite some downswings in ROE, profitability in the manufacturing sector was generally high as enterprises in the mineral processing industry remained lucrative. Although FDI into the mining sector rose, profitability was generally low as the returns were strongly affected by international commodity prices. This was further worsened by large initial losses at new ventures as costs tend to be high when production is scaled up towards capacity. With regard to income repatriation to foreign direct investors, Namibia was not an outlier when compared to other SADC member states as repatriation by FDIE's averaged about 2.0 percent of GDP per annum over the review period. Reinvestment of earnings, however, was relatively low, biased downwards by the performance of the mining sector.

Foreign direct investment enterprises direct contribution to employment remained low as FDI was concentrated in the mining and financial sector which are more capital and high skill intensive. Employment in FDIEs rose between 2009 and 2019, albeit contributing only 6.6 percent to Namibia's total employment. Over a third of employment in FDIEs was from the wholesale and retail sector although the sector had the smallest contribution in terms of FDI. Though limited direct employment was created by FDIEs in Namibia, employment numbers created indirectly are estimated to be much higher. The low number of employees in FDIEs suggest the need for the country to also attract *efficiency-seeking* foreign investments that will aid in alleviating the prevailing high unemployment rate. Namibia should focus on attracting FDI in the manufacturing of complex products as its more employment intensive and geared towards global markets.

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