

**The response of an Original Equipment Manufacturer to the
Motor Industry Development Programme.
A case study.**

A dissertation submitted in partial fulfilment of the
requirements of the degree of

MASTERS OF BUSINESS ADMINISTRATION

of

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by

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DECLARATION

I, Ricardo Franse, hereby declare that this research thesis is my own and original work and that all the sources have been accurately reported and acknowledged. This document has not previously in its entirety or in part been submitted at any university in order to obtain an academic qualification.

R. Franse

11 March 2006

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ABSTRACT

On the 21st September 1995, the government introduced the Motor Industry Development Programme (MIDP), in compliance with the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO). Deliberate efforts by the South African government were required to promote structural changes to the domestic motor industry by opening up the economy to international competition through a programme of tariff reduction and export promotion.

The integration of the South African automotive industry into global markets would have been extremely difficult, if not impossible, without the MIDP and it would thus be safe to conclude that the economic performance of the researched would have been close to impossible if it was not for the MIDP. The MIDP, as an economic policy, has been embraced by the researched company as a "vehicle" to drive corporate goals in terms of value creation for all stakeholders.

The research proposition that the MIDP as an economic policy has contributed to the economic performance of the researched company is examined. In this respect, Annual and Management Accounting reports were analyzed to determine the effect the MIDP has had on the researched company over the last ten years. In addition, two semi-structured interviews were also conducted with the Strategic Finance Planning executive and the Financial Controller of the company.

The results show that the MIDP has had positive spin-offs for the researched company. The same results should be valid for the other original equipment manufacturers (OEMs) in the local automotive industry that have embraced the MIDP as a vehicle to create economic value added.

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Chapter 1

Introduction

1.1 Setting of the Study

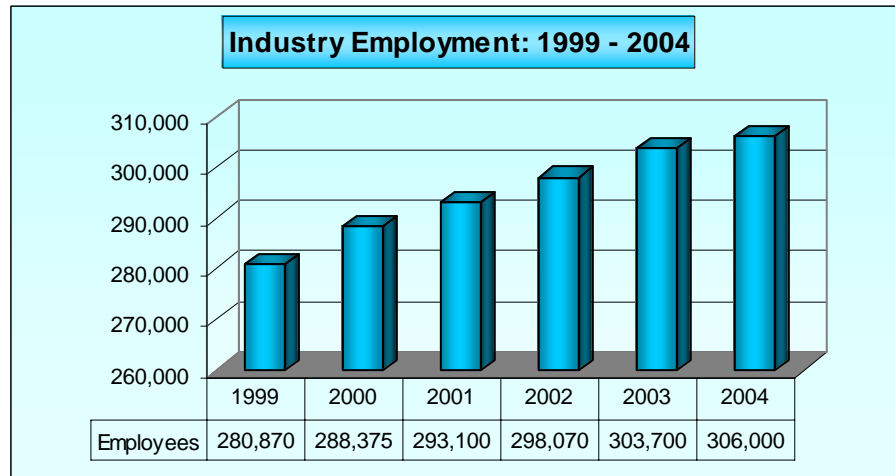
The 27th of April 2004 marked the anniversary of South Africa's first decade of democracy. The country's improved economic performance over the past decade is evident in its performance ranking as the 23rd largest in the world in 2003, up from number 51 in 2001 (DTI, 2004). South Africa was also rated eighteenth in terms of the World Competitiveness Yearbook for countries with a population of twenty million or more (DTI, 2004). This performance has been heavily influenced by government's highly effective stable economic and regulatory policies.

South Africa's Gross Domestic Product (GDP) at market prices amounted to R1 209.5 billion in 2003. The motor industry's overall contribution to the country's GDP was 6.6% in 2003 while it employed slightly more than 300,000 workers. (See Figure 1.1). The motor industry has improved on the 2003 performance during 2005, contributing 7.2% to the GDP.

Mining was formerly the larger of the manufacturing and mining sector in the South African economy with a 7.1% contribution to the GDP (Robertson, 2005). The manufacturing sector provides a locus for stimulating the growth of other sectors in the economy by achieving specific outcomes and by stimulating economic empowerment (Damoense and Simon, 2004). It is evident therefore that the South African motor industry is an important branch of the manufacturing sector, contributing significantly to

the GDP in adding value and by raising the level of employment and foreign direct investment.

Figure 1.1: Motor Industry Employment



Source: NAAMSA Annual Report, 2004

Development must be seen as taking the industry out of its current situation and setting it on a path of self-sustaining growth. Chenery and Srinivasen (1988) maintain that enhancement and/or economic growth is an integral part of economic development. The significance of economic development is therefore the sustained increase in the economic standard of living.

The following are definitions of economic development:

- Any effort or undertaking which aids in the growth of the economy.
- Institutional changes made to promote economic betterment.
- Improvements in the efficiency of resource utilization so that the same or greater output of goods and services is produced with smaller throughputs of natural, manufactured and human capital. (Unknown 1, 2005)

Developing economies suffer from lack of cost competitiveness in relation to the global economy. Third World nations or Less Developed Countries (LDCs) remain dependent on economic and political policies of dominant rich countries. Most developing economies depend on the state to create an environment of assistance and protection, as maintained by Chenery and Srinivasen (1988). Todaro (1997) argues that many developing countries do however attempt to either singularly or collectively pursue more self-reliant development strategies.

Over the last few decades, the South African automotive industry has undergone major policy reforms. South Africa's isolation under apartheid due to trade boycotts and sanctions reinforced an inward-looking, high cost and uncompetitive manufacturing production base where exports were dominated by primary products. The industry was highly inward-orientated and a large number of makes and models were produced in low volume at relatively high cost (DTI, 2004).

The rather stagnant performance of the South African automotive industry has led to a process of structural changes, aimed at enhancing competitiveness and increasing value-added production and exports. Changed government support and tariff liberalization have been significant drivers of the development and performance of the local automotive industry in recent years (Damoense and Simon, 2004).

For South Africa to realize its full trade potential from the motor industry, it was necessary to initiate a process of structural reforms, which enhances competitiveness and a capacity to compete in an increasingly integrated global economy through value-added production and exports. The aim is to move away from and become less dependent on

exports of predominantly primary products. The basic idea is to achieve sustained economic growth through secondary exports and investment expansion (DTI, 2004). The vision of the automotive industry is to establish a viable, competitive industry domestically and internationally, capable of achieving both continuous growth and sustainable job creation (DTI, 2004).

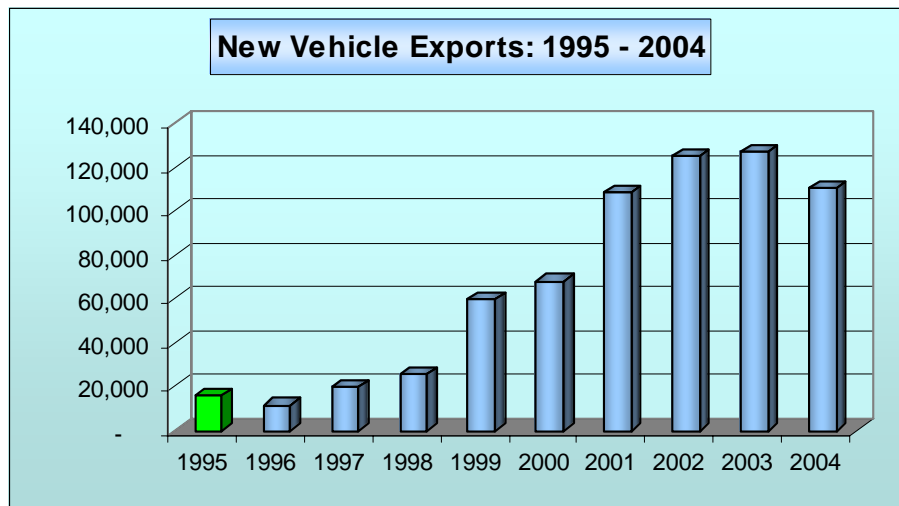
The local content programme, which ran from 1961 to 1995, was ineffective in reducing the proliferation of vehicle models, in saving foreign exchange, or in developing a local automotive industry with jobs, skills and established capacity (Damoense and Simon, 2004). The rather stagnant and poor performance of the South African automotive industry called for a new approach. On the 21st September 1995 the government introduced the Motor Industry Development Programme (MIDP), in compliance with the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO). Deliberate efforts by the South African government were therefore required to promote structural changes to the domestic motor industry by opening up the economy to international competition through a programme of tariff reduction and export promotion.

The South African strategy of becoming an internationally competitive automotive industry has thus been focusing on lowering tariffs and becoming an export-orientated industry. Figure 1.2 shows a significant increase in vehicle exports from 1995 to 2004. The structural changes to, and the protection of the domestic motor industry made it a good proposition for the domestic Original Equipment Manufacturers (OEMs) to pursue exports. Exports were promoted through a subsidy scheme based on the level of local value added. The upshot of this was a series of supply-sided measures designed to promote the adoption of world class manufacturing capabilities. The objectives were:

- to improve the domestic industry’s international competitiveness;
- to enhance the industry’s growth through exports;
- to improve vehicle affordability;
- to improve the industry’s highly skewed trade balance; and
- to stabilize employment levels.

In order to achieve these goals a series of mutually reinforcing export orientated incentives were introduced, coupled with a reduction in import tariffs. Rapid growth of exports accelerates economic growth, as claimed by Tain-Jy and De-piao (1990). They argue that because the export sector is not only more productive than the non-export sector, but also generates some external effects that enhance the productivity of the non-export sector, which in turn results in economic growth. Tain-Jy and De-piao (1990) also maintain that as exports expand, both the resource reallocation effect and externality effect lead to an economy-wide productivity increase.

Figure 1.2: New Vehicle Exports for the Period 1995 - 2004



Source: NAAMSA Annual Report, 2004

Of significance is an export incentive scheme adopted by New Zealand in the 1970s that resulted in increased sales in existing markets and additional sales in entirely new markets (Le Heron, 1980). Le Heron (1980) also claims that exporters were attracted into exporting because of assistance and, as a result, most of the exporters experienced growth in output and growth in employment.

Export expansion remains crucial to the future growth and sustainability of South Africa's automotive industry, as the size of the domestic market is relatively limited. The South African automotive industry has developed and demonstrated resilience and the potential to compete in the global economy. Recent research conducted by Black (2003) has found that rapid export expansion, considerable foreign investment and productivity improvements in the motor industry in South Africa have been strongly influenced by the MIDP programme. He also found that the automotive industry has also been the recipient of considerable foreign direct investment. The concern however is that "the imminent challenge for the local automotive industry's development is to maintain its export growth trajectory in the long-term in the absence of costly government protective incentive mechanisms" (Damoense and Simon, 2004: 251).

Christoph Kopke (in Newstoday1, 2005), a leading figure in South Africa's automotive industry, has warned that foreign direct investment in the sector will "stop dead in its tracks" if the benefits of the MIDP are tampered with. He raised concerns that the confidence of parent companies could be shaken and could lead to their halting further investments in the local economy. The motor company, BMW, has issued a thinly veiled threat to the government stressing the need for incentives once the current MIDP expires in 2012 (in Cokayne, 2005). Wolfgang Stadler, the Chief Executive Officer of BMW, (in

Cokayne, 2005) has also stressed the need for certainty on the issue, as it has a very fundamental influence on strategic decisions. Volkswagen of South Africa Communications Manager, Bill Stephens (in Newstoday2, 2005), has stressed that the South African motor industry could face a similar scenario to the local textile industry unless it becomes globally competitive by the time the motor industry development programme ends in 2012. It seems therefore that the local automotive industry is not yet mature enough to compete in an open economy with no protection and incentives.

1.2 Problem Definition and Motivation for the Study

Development must be seen as taking the industry out of its current situation and setting it on a path of self-sustaining growth. Chenery and Srinivasen (1988) maintain that exports are viewed as generating greater growth of productivity as a result of:

- greater capacity utilization;
- greater horizontal specialization as firms concentrate on a narrower range of products;
- increasing familiarity with new technologies;
- greater learning-by-doing; and
- the stimulative effect of the need to achieve greater internationally acceptable quality standards.

They also argue that rapid growth in aggregate exports has resulted in rapid growth in manufacturing's share of value. It is therefore reasonable to assume that effective organizations would pursue economic policies, which would help them to create value for all stakeholders.

Todaro (1997) maintains that the process of economic growth can be described as a result of the expansion in the productive resources and an increase in the efficiency of their use. Chenery and Srinivasen (1988) maintain that most developing economies depend on the state to create an environment of assistance. Hultman (1967) argues that international trade has often been referred to as the “engine of growth”. The gradual integration of LDCs into the global market provides an opportunity for industries to take advantage of the economies of large-scale production, made possible by expanding markets.

The proposition that rapid growth of exports accelerates economic growth has been widely discussed and tested. Economic growth in turn leads to higher profitability. Empirical evidence that supports the hypothesis includes, amongst others, studies by Feder, Nishimizu and Robinson (in Tain-Jy and De-piao, 1990). They found that exports contribute to economic growth as the export sector is not only more productive than the non-export sector, but that it also generates some external effects that enhance the productivity of the non-export sector. Export expansion results in better resource allocation, which in turn leads to increased productivity, as maintained by Tain-Jy and De-piao (1990). Feder, Nishimzu and Robinson (in Tain-Jy and De-piao 1990) also found that there is a correlation between productivity growth and export expansion.

Further research done by Bhagwati (in Balasubramanyam, Salisu and Sapsford, 1996) suggests that the beneficial effect of foreign direct investment is stronger in those countries that pursue an outwardly orientated trade policy than those that adopt an inwardly orientated policy. He maintains that a country pursuing an export promotion

strategy is likely to attract a higher volume of Foreign Direct Investment (FDI) and to promote more efficient utilization thereof than an import substitution strategy.

The research proposition is therefore aimed at looking at the MIDP as catalyst for:

- Contributing to an increase in foreign direct investment;
- Contributing to productivity improvement;
- Contributing to an increase in levels of employment and skill development;
- and
- Contributing to profitability of the automotive sector (an OEM)

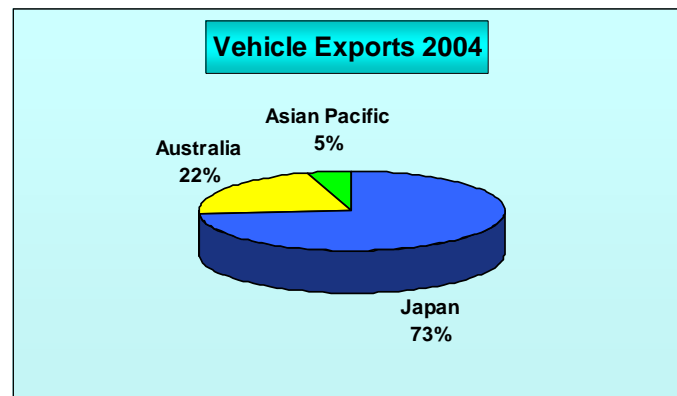
Todaro (1997) claims that where opportunities for profitable exchange arise; foreign trade can provide an important stimulus to aggregate economic growth. The MIDP as an economic policy was the required catalyst to take the motor industry out of stagnation onto a path of self-development and economic growth.

1.3 Profile of the Manufacturing Company

The motor manufacturer relevant to this research is a wholly owned subsidiary of a multinational company. Its principle activities are: the importation, manufacture and distribution of motor vehicles and components for the local market as well as the manufacture of motor vehicles and components for export markets. The company is one of three motor manufacturers in the Eastern Cape and one of seven Original Equipment Manufacturers (OEMs) in South Africa. The company employs just over 6,000 people and is one of the key players in the Eastern Cape in creating and sustaining jobs.

The company produced just over 86,000 vehicles in 2004 for sale in the domestic market as well as for the export market and achieved a 23.5% share of the passenger vehicle segment in the domestic market. This was achieved through a wide product range of domestically produced as well as imported vehicles. Vehicle exports of about 26,000 units were achieved in 2004. The units were exported to mainly the Asian Pacific Region, with Japan being the primary export destination (Figure 1.3). The company plans to export 40,000 vehicles in 2005.

Figure 1.3: Vehicle Exports in 2004



Source: Management Accounting Reports

The company also made record profits in 2004, increasing its profitability by 24% compared to the previous year. The MIDP, it can be argued, has contributed significantly towards this achievement given the fact that the company's duty liability for 2004 was just over R930 million. The company has earned export credit rebates to the value of R806 million through exports of components and fully built up vehicles. The benefits offered by the MIDP programme allowed the company to offset the duty liability through rebates earned on exports. In essence, this means that fully built up imported vehicles of about 14,000 units were imported "duty free" under the MIDP programme. However, the

company remains a net importer, meaning that the company imports more than it exports in value terms. This situation suggests that the company would prefer a strong Rand rate of exchange.

The MIDP has given the OEMs the opportunity to scale down on the number of models produced locally and to import models, which were less economically viable to produce. This shift in focus allowed the OEMs to concentrate on economically viable models and as a result could benefit from economies of scale. The company currently produces only three model types compared to five model types in the late 1990s and early 2000s. This has put less strain on investment requirements and has resulted in better capacity utilization. It has also resulted in improved quality by focusing on a narrower range of products. The discontinuation of certain models was also part of the rationalization of production platforms. The company has invested more than R3.0 billion in plant equipment and facilities over the past three years and will continue to invest more than R2,0 billion over the next two years.

1.4 Aim of the Study

The goal of this research is to understand the role that the MIDP has played in the South African automotive industry in terms of economic development. Government interventions in LDCs are not uncommon in the pursuit to create economic growth. The researcher aims to investigate why and how the researched company has responded to the MIDP as an economic policy. The researcher will employ a case study method of investigation and this will be conducted in a constructivist paradigm. The research will be of a descriptive nature.

1.5 Outline of the Study

The study is divided into seven chapters. The introductory chapter encapsulates the definition of the research problem, motivates why the research is conducted and concludes with the aim and method of the research. The other chapters are organized as follows:

1.5.1 Chapters 2 and 3 – Literature Review

The literature review is divided into two chapters: economic growth in developing countries and the MIDP as an industrial policy.

Chapter 2 – Economic growth in developing countries covers the following topics:

- Economic growth theories
- Strategy for achieving growth
- Implications of economic growth on beneficiaries

Chapter 3 – The MIDP as industrial policy (in detail)

- The importance of policy space
- The development of the policy
- The objectives of the policy and
- Key features of the policy

The literature review incorporates the theories for economic growth in less developed countries and looks at different strategies to achieve economic development. The MIDP is seen as one such strategy to achieve economic development. The literature delves into

reasons why certain theories and strategies would be pursued by different countries to achieve economic growth. The literature review is aimed at gaining an understanding of the importance of economic policies in less developed countries.

1.5.2 Chapter 4 – Research Methodology

The research methodology describes the methodology employed in the investigation of the relationship between trade policy and economic growth; export expansion and economic growth; and higher foreign direct investment through an export promotion strategy. The research methodology also describes the paradigm in which the research will be conducted. The method of data gathering is also discussed, with a strong emphasis on reliability and validity. The researcher also refers to some ethical considerations.

1.5.3 Chapters 5 and 6 – Analysis and Discussion

These two chapters contain the analysis and results of the relationship between economic growth and improved economic performance.

Chapter 5 - The researcher interprets and explains the findings of the results in detail. The main source of information was gathered through analysis of reports/documents. A comparison of the companies' results with the industry is also reported in this section.

Chapter 6 - The researcher discusses the findings and results in this chapter, with specific emphasis to the interviews conducted with the two senior executives.

1.5.4 Chapter 7 – Conclusion and Recommendations

Concerns and anomalies with regard to the MIDP programme are discussed in this chapter. The research ends with a concluding summary with recommendations for further research on the proposition between industrial policy and economic growth.

Chapter 2

Literature Review

2.1 Introduction

Economic growth can result from changes in technology or a change in an accumulation of factors such as capital and labour (Appleyard and Field, 2001). Most developing economies depend on the state to create an environment of assistance and protection as maintained by Chenery and Srinivasen (1988). Development must be seen as taking an industry out of its current situation and setting it on a path of self-sustaining growth. The process of economic growth can be described as a result of the expansion in the productive resources and the increase in the efficiency of their use (Todaro, 1997). Hultman (1967) claims that for most less developed countries, exports represent an important share of total output; hence trends in foreign sales are critical in fostering overall growth.

Developing economies suffer from lack of cost competitiveness in relation to the global economy. Third World nations or Less Developed Countries (LDCs) remain dependent on the economic and political policies of the dominant rich countries. Todaro (1997) argues however that many developing countries do attempt to either singularly or collectively pursue more self-reliant development strategies. For South Africa to realize its full trade potential; it was necessary to initiate a process of structural reforms to enhance competitiveness and a capacity to compete in an increasingly integrated global economy in value-added production and exports (Carim, 2004). The aim is to move away from and being less dependent on the export of predominantly primary products.

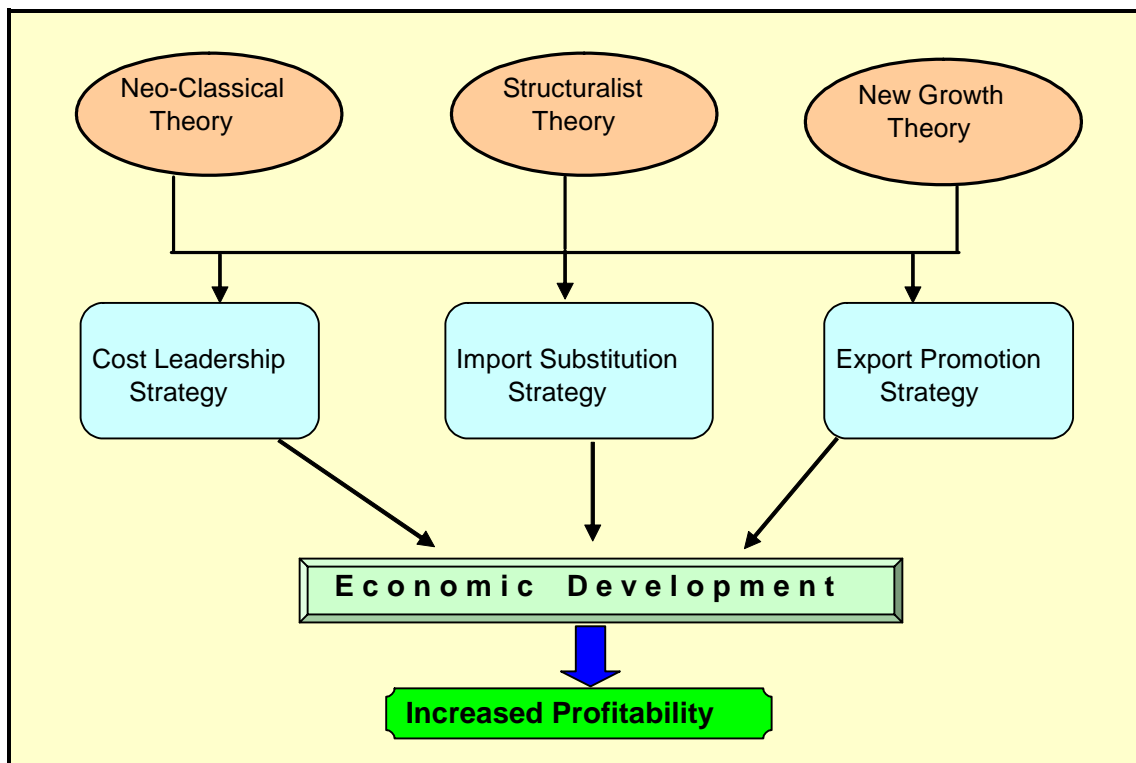
The basic idea is to achieve sustained economic growth through secondary exports and internal investment expansion. The MIDP as an economic policy is an attempt by government to stimulate the motor industry to achieve higher levels of growth, productivity and cost competitiveness. Investments in technology, people and processes are key ingredients to become world class (Bartlett and Ghoshal, 1995).

The literature review will thus focus on:

- Economic growth theories;
- Strategy for achieving growth; and
- Implications of economic growth on beneficiaries.

The nature of the review is depicted in the following diagram.

Figure 2.1: Graphical Representation of the Literature Review



2.2 The Economics of Growth: Capital, Labour, and Technology

Todaro (1997) maintains that the most common characteristics of developing countries are: (a) low levels of productivity; (b) low levels of capacity utilization; (c) high and rising unemployment levels and (d) significant dependence on exports. He maintains that the following components of economic growth are of prime importance in any society:

- Capital accumulation, including all new investments in land, buildings, physical equipment and human resources.
- Growth in population and growth in the labour force.
- Technological progress.

Balasubramanyam, Salisu and Sapsford (1996) also emphasize the importance of savings and investments; technological progress; and human capital accumulation in promoting growth.

Capital accumulation is achieved when a proportion of present income is saved and invested in order to augment future output and income. The most fundamental feature of capital accumulation is that it involves a trade-off between present and future consumption – giving up a little now so that more can be had later (Todaro, 1997). Watts (1987) also maintains that capital investment is a prerequisite for economic growth; however it must be geared towards achieving higher levels of productivity.

Investment in new factories, machinery and equipment increases the physical capital stock of a nation and makes it possible to expand on output levels. The investment in new technologies must however always be measured against the required returns. The aim must always be to add economic value for all stakeholders. The volume and efficacy of

incoming foreign direct investment will vary according to whether a country is following an export promotion or an import substitution strategy (Balasubramanyam, *et al.*, 1996). Similarly, investments in human resources can improve the quality of output as well as increase levels of productivity. A formal schooling, on-the-job training and adult basic education programmes may result in higher skill levels.

The downside of new technologies, especially when measured against one of the MIDP's objectives in creating more jobs, is that it often reduces the number of workers required to manufacture a given level of output (Watts, 1987). South African motor manufacturers however do not have an option, but must improve on productivity if they are to become more competitive.

Labour force growth: Feder, Nishimzu and Robinson (in Tain-Jy and De-piao, 1990), found that there is a correlation between productivity growth and export expansion. Labour force growth can be achieved through better utilization of existing manpower resources. The optimum utilization of resources should raise output levels and productivity accordingly. Improvements in upgrading existing resources and the acquisition of new investments can have a profound effect on the quantity and quality of output. These improved and new resources are the principal means of accelerating the growth of national output (Todaro, 2000).

Theory of the effects of technological change: Many economists regard technological progress as the most important source of economic growth, as maintained by Chenery and Srinivasen (1988). Technological change alters the manner in which inputs are used to generate output and should result in a higher level of output. The objective of any input

factor is to create higher levels of output and therefore growth. Technological progress also results from new and improved ways of accomplishing traditional tasks. Labour saving technological progress results from rapid advances in labour saving technology and thereby a saving through reduced labour requirements. Watts (1987) maintains that new technologies often reduce the number of workers required to manufacture a product at a given level of output. This effect that new technologies have on employment is in direct contrast with the MIDPs objective of increasing employment and thereby reducing the level of unemployment. However, South African motor manufacturers do not have an option; they must improve on productivity if they are to become more competitive.

2.3 Theories of Economic Growth

2.3.1 Neoclassical Theory of International Trade

Neoclassical theorists argue that through trade liberalization (opening up) of national markets, additional domestic and foreign investment is attracted, which in turn increases the rate of capital accumulation. Lall (2004) claims that the neoclassical theorists approach to economic growth is that the best strategy for all countries and in all situations is to liberalize. The integration of countries into the international economy arena, with resource allocation driven by free markets, should allow countries to realize their natural comparative advantage. Hultman (1967) also maintains that trade liberalization of national markets should yield sustainable growth. According to the traditional (old) neoclassical growth theory, growth results from:

- Increases in labour quantity and quality (through population growth and education)
- Increases in capital (through saving and investment)

- Improvements in technology. (Balasubramanyam, *et al.*, 1996)

Open economies (those with trade and foreign investments) experience income convergence at higher levels as capital flows from rich countries to poor countries where capital-labour ratios are lower and thus returns on investments higher (Chenery and Srinivasen, 1988). The neoclassical theorists argue that:

- Trade is an important stimulator of economic growth as it enlarges a country's consumption capacities, increases world output, and provides access to scarce resources and world markets for products without which poor countries would be unable to grow.
- Trade assists countries in development. This could be in terms of labour efficiency and or factor endowments.
- Trade enables countries to move outside their production possibility frontiers and to secure capital as well as consumption of goods from other parts of the world.
- Trade also enables a nation to get raw materials, knowledge, ideas, new technology, etc. with which it is relatively less endowed at lower world market prices. This can lead to more broadly based and self-sustaining growth of its industrial output.

(Todaro, 1997)

Rapid growth in exports accelerates economic growth as claimed by Tain-Jy and De-piao (1990). They reason that the export sector is not only more productive than the non-export sector, but it also generates some external effects that enhance the productivity of

the non-export sector. As exports expand, both the resource reallocation effect and the externality effect lead to an economy-wide productivity increase.

The MIDP, as an economic growth “instrument”, has been used to move away from a closed economy to an open economy in South Africa; thus striving to achieve higher levels of capital inflows and better utilization of labour. LDCs often adopt economic policies such as tariff barriers, subsidies, quotas, exchange rate adjustments, etc. to foster import substitution and to promote exports (Chenery and Srinivasen, 1988). Interest in stimulating exports by governments may be a sign that domestic growth opportunities are relatively limited and that exports offer a way to market expansion (Le Heron, 1980).

In summary, trade liberalization is essential to achieve higher levels of foreign direct investment and thus creating opportunities for increased market expansion and economic growth. Opening up a country to the global economy, exposes companies to new markets and technological opportunities.

2.3.2 Structural Change Model

The structuralist theorists focus on transforming the domestic economic structures from being heavily dependent on traditional or primary exports to a more industrialized and diverse manufacturing economy. Chenery and Srinivasen (1988) maintain that any economy has structure and that any substantial changes in terms of resource allocation will breed a structuralist and transformation programme.

Carim (2004) claims that increased savings and thereby investments are a necessary, but not sufficient conditions for economic growth. In addition to the much needed

accumulation of capital, both physical and human, a set of interrelated changes in the economic structure of a country are required for the transition from a traditional economic system to a modern one. These structural changes involve changes in economic variables such as the transformation of production; changes in consumer demand; international trade; utilization of resources; changes in socioeconomic factors; and many more.

A good example of a government acting as an agent of structural change is to be found in New Zealand, which has been very successful (Le Heron, 1980). He argues that the very large gains in manufactured exports in New Zealand were as a result of nearly 20 years of government export promotions incentives offered to manufacturing firms.

In Chenery and Srinivasen (1988), the Lewis model encapsulates that surplus labour can be withdrawn from the primary sector without any loss of output, which in turn can be transferred gradually to the industrial sector. This labour transfer and the ensuing employment growth are brought about by an expansion of the relevant sector. The speed of expansion is on the other hand dependent on the rate of industrial investment and capital accumulation.

The structural-change model recognizes the fact that developing countries are part of a highly integrated international system which can promote their development. These theorists also emphasize the shift from agricultural to industrial production, the steady accumulation of physical and human capital, and the change in consumer demands to more diverse manufactured goods (Todaro, 1997). The structural adjustment process is aimed at trade policy liberalization, deregulation, foreign direct investment and the

dismantling of policy and administrative regimes which is designed to promote industrial development (Barnes, Kaplinsky and Morris, 2004).

The South African economy has shifted towards a more industrialized production regime, which is in line with global trends, and especially with higher order developing countries. The MIDP as an economic policy is evidence of this model.

In summary, the structuralists argue that LDCs economies are transformed over time to permit new industries to replace agriculture as the engine of economic growth. The structuralist view puts less faith in free markets as a driver of dynamic competitiveness and more faith in the ability of governments to mount interventions effectively. The choice of development policies pursued by LDCs in terms of international trade and foreign assistance policies will however determine the pace of these changes.

2.3.3 The New Growth Theory

Empirical research done by Bhagwati (in Balasubramanyam, *et al.*, 1996) has found that the new growth theory powerfully supports the fact that foreign direct investment (FDI) can be a potent factor in promoting growth. He argues that the volume and efficacy of incoming FDI will vary according to whether a country is following an Export Promotion or an Import Substitution strategy. The “inefficiencies” that an Import Substitution strategy imposes on an economy are numerous. These are: (i) that it relies heavily on tariffs and quotas on trade; (ii) that it encourages the adoption of techniques of production that are widely at variance with the factor endowments of the economy; (iii) and that it provides widespread incentives for rent seeking and directly unproductive profit seeking activities (Balasubramanyam, *et al.*, 1996).

In contrast to an Import Substitution strategy, an Export Promotion strategy is likely to attract a higher volume of FDI and promote more efficient utilization thereof. The principal virtue of an Export Promotion strategy is that, except for its neutrality of policy between imports and exports, it allows for a free play of market forces and the allocation of resources on a basis of comparative advantage (Balasubramanyam, *et al.*, 1996). Hultman (1967) also argues that the growth models emphasize the dual nature of investment: its income generating role, and its productive capacity generating role.

In summary, the new growth theorists argue that foreign direct investment is critical in promoting growth. An Export Promotion strategy is also likely to achieve higher levels of FDI and more efficient utilization thereof, compared to an Import Substitution strategy.

2.4 A Strategy to Achieve Economic Growth

2.4.1 Strategic Competitiveness

The role which trade plays in economic development is pivotal. The challenge however for any country is to increase the rate at which development takes place. Strategic competitiveness is at the centre of economic development. Hitt, Ireland and Hoskisson (2003), claim that strategic competitiveness is achieved when a firm formulates and successfully implements a value-creating strategy. Amit (1986) maintains that the most important component of strategy is competitive advantage, which is defined as the unique positions an organization develops over competitors through a pattern of resource deployment and/or scope decisions. A firm's unique resources and capabilities are a critical link to competitiveness, as maintained by Hitt, *et al.* (2003).

Firms must be able to adapt quickly to changes in their competitive landscape. Such adaptation requires that a firm develop strategic flexibility. This, according to Hitt, *et al.* (2003), is a set of capabilities used to respond to various demands and opportunities in a dynamic and uncertain competitive environment. They also argue that the external environment is the primary determinant of a firm's actions. Organizations should develop strategic flexibility in all areas of their operations. Firms should accordingly develop organizational slack, which allows them some flexibility to respond to environmental changes.

"Research has shown that having an effective strategic intent and mission, and properly implementing it has a positive effect on performance as measured by growth in sales, profit, employment, and net worth" (Hitt, *et al.*, 2003: 23). Strategic intent is the leveraging of resources, capabilities and core competencies to accomplish the firm's goals in a competitive environment (Hitt, *et al.*, 2003). The question therefore is: How and why has the researched company responded to the MIDP as it has done and what was the outcome of this response in terms of economic growth and viability?

2.4.2 Cost Leadership Strategy

According to Porter (in Wright, 1987), cost leadership emphasizes the production of a standardized product at a low cost. Hitt, *et al.*, (2003) maintain that a cost leadership strategy is an integrated set of actions designed to produce a product with features that are acceptable to customers at the lowest cost, relative to that of the competition. Cost leaders therefore concentrate on finding ways to lower their cost base by constantly thinking of completing primary and support value chain activities at the lowest possible cost. Porter (in Jones and Butler, 1988) maintains that cost leadership requires aggressive

managerial action that is directed towards controlling and minimizing costs. Porter argues further that having a low cost position, yields above average returns to the firm.

A cost leadership strategy is aligned to improve labour productivity, where productivity is the amount of output created in terms of goods produced per unit of input used. Labour productivity is typically measured as output per worker or output per labour-hour. It therefore benefits a business to improve productivity, which over time lowers costs and improves the ability to compete and to make profit. (Unknown 1, 2005)

Ferreira and Rossi (2003) have found strong evidence linking trade liberalization and productivity growth. They discovered that both output per worker and total factor productivity increased after trade liberalization. As previously noted, Tain-Jy and Depiao (1990) have stressed the significance between productivity growth and export expansion. At a theoretical level; there are at least two interpretations of the correlation between productivity growth and export expansion: one stresses the economies of scale; the other competitive forces. The economies' of scale emphasizes the benefits that can be derived by means of expanding the scale of operations. Economies of scale tend to occur in industries with high capital costs in which those costs can be distributed across a large number of units of production. The most obvious method therefore to improve productivity would be increased automation, which minimizes the task that employees must perform (Unknown 1, 2005).

Manufacturers are constantly faced with challenges to improve productivity. However, on the other hand, unions are putting pressure on manufacturers not to retrench workers. In countries where domestic markets are relatively small in size, exporting becomes an

essential part of achieving economies of scale. A study by Kwon (in Tain-Jy and De-piao, 1990) on Korean manufacturing industries has also found that economies of scale is the main factor contributing to total factor productivity growth. The competitive forces argument, on the other hand, emphasizes the merits of competition. It maintains that competition forces individual firms to reduce their “managerial slack” and to operate in a more efficient manner. Tain-Jy and De-piao (1990) argue similarly that more efficient operations lead to higher productivity.

Wright (1987) has found that larger firms with greater access to resources, particularly the ones subject to capital-intensive technologies, are capable of producing at lower costs per unit. He maintains that the cumulative volume of production allows lower per-unit cost through a combination of economies of scale; the possibility of capital-labour substitution; and an incrementally increasing learning curve.

Low levels of labour productivity can be attributed to the absence or severe lack of “complementary” factor inputs such as physical capital and/or experienced management. To raise productivity, domestic savings and foreign finance must be mobilized to generate new investment in capital goods and to build up the stock of human capital through investment in education and training. Multinationals not only provide financial resources to LDCs, they also supply a “package” of needed resources including management experience, entrepreneurial abilities, and technological skills which can be transferred to their local counterparts through training programs and through a process of “learning by doing” (Todaro, 1997).

One could create economic opportunities for self-improvement, but without proper structural arrangements one cannot succeed. The South African government initiative regarding the Manufacturing, Engineering and Related Sectoral Education Training Authority (MERSETA) is one such lever used to urge firms to develop and train employees to become more efficient and competitive. A skills levy of 1% of the payroll is legally payable to the South African Revenue Services (SARS) and is used to fund Sectoral Education Training Authorities (SETAs). Companies that are serious about the developing and training of their employees are incentivized through a refund of up to 70% of the levy paid. It is therefore not surprising that companies invest huge amounts in education and training.

2.4.3 Import Substitution Strategy

An import substitution strategy seeks to learn from and gain new skills from developed countries and, at the same time, try to protect the domestic economy (Chenery and Srinivasen, 1989). The principal mechanism of an import substitution strategy is the erection of protective tariffs (taxes on imports) or quotas (limits on the quantity of imports).

The supporters of import substitution argue that protection against imported goods is necessary in order to allow domestic producers enough time to learn the business. Todaro (1997) maintains that this will ultimately result in achieving economies of scale in production and through learning by doing; lower unit costs and competitive prices can thus be achieved. The idea is that by replacing imports of certain commodities with domestic production, the economy will be so modified that it will begin to be more

independent, more resilient, more diversified, and better able to generate increasing welfare as a matter of routine (Chenery and Srinivasen, 1989).

Import substitution involves increasingly higher domestic costs per unit, as a result of cost of protection, and also a decrease in foreign exchange usage. The objective for the industry is therefore to reduce the domestic cost per unit through increased capacity utilization. The reduction in costs could happen through economies of scale, thereby contributing to efficient import substitution. An import substitution strategy could focus on the erection of tariff barriers or quotas on the importation of certain commodities, and thereafter the establishment of a local industry to produce these goods. This typically involves cooperation with foreign multinationals, which are encouraged to invest in physical goods and are given various kinds of investment incentives (Todaro, 1997).

One such incentive under the banner of the MIDP is the Productive Asset Allowance. The Productive Asset Allowance incentive provides for rebates on the duty on completely built up (CBU) light motor vehicles, to the order of 20% of the value of the investment in qualifying productive assets, spread equally over five years (DTI, September 2003). Even when the cost of production may initially be higher than that of imported goods, the rationale is that benefits will eventually be reaped through increased production and a lower cost per unit. This will result in an improved balance of payments as fewer goods are imported. The balance of the current account can be improved upon through export expansion and the limitation of imports.

Protection is a means of creating a process of development that builds on search and learning. It is therefore critical that while infant industries are in the process of maturing,

they learn to compete on an equal footing with developed countries. It is hoped that these industries will mature and be able to compete in world markets as they endeavor to lower their cost of production and become less exposed to currency fluctuations.

The benefits of an import substitution strategy lie in the ability to manufacture goods subject to economies of scale; lower labour costs; and through learning by doing and hence by becoming competitive. With enough time and sufficient protection, the infant industry will eventually mature and become competitive internationally (Todaro, 1997).

In summary, an import substitution strategy is characterized by two transitions: the first being that from a system characterized by a lack of growth to a flexible, responsive system, which takes place behind some form of protection. The second is the transition from protection to participation on a more equal footing in the world economy. It is important to know that an import substitution strategy imposes short-run costs on the economy, which is the cost of protection. An inward-looking development strategy encourages “learning by doing” in manufacturing and the development of technologies appropriate to a country’s resource endowments. Inward-looking trade policies are aimed at “restricting trade”.

2.4.4 Export Promotion Strategy

The importance of exports has increased in almost every country. This means that not only do individual countries experience the economic benefit from the international exchange of goods but, that their own prosperity is dependent on the economic prosperity of the world. This implies that the competition for markets is greater and that countries must be able to facilitate changes in their structure of production to improve efficiency

and reduce production costs. Thus, while interdependence has many inherent benefits, it also brings with it greater adjustment requirements and greater need for policy coordination among trading partners (Appleyard and Field, 2001).

Foreign trade has assumed a central role in the development plans of many underdeveloped countries. For most, LDCs' exports represent an important share of total output and hence trends in foreign sales are critical in fostering overall growth. In most development planning the importance of exports to domestic growth has been approached in terms of the acquisition of foreign exchange for the importation of goods and services (Hultman, 1967).

The South African motor industry has moved away from a very inward-looking industry to a more outward-orientated economic industry. Export expansion remains crucial to the future growth and sustainability of South Africa's automotive industry, as the size of the domestic market is relatively limited. Chenery and Srinivasen (1988) maintain that exports generate greater growth of productivity as a result of:

- greater capacity utilization;
- greater horizontal specialization as firms concentrate on a narrower range of products;
- increasing familiarity with new technologies;
- greater learning-by-doing; and
- the stimulative effect of the need to achieve greater internationally acceptable quality standards.

Chenery and Srinivasen (1998) note that growth in exports could be a major source of income growth in an otherwise relatively stagnant economy. They argue that rapid growth in aggregate exports results in rapid growth in manufacturing's share of value added. Appleyard and Field (2001) maintain that an export subsidy is often necessary as it attempts to increase the flow of trade from a country.

An import substitution and export promotion strategy intend to induce learning by doing and through productivity growth, and both emphasize the fact that economic strength requires resilience and the ability to carry through continuous adjustments in response to changing circumstances (Chenery and Srinivasen, 1989).

An example is Turkey where export incentives, trade reform and trade policies have indeed contributed to Turkey's export miracle (Arslan and van Wijnbergen, 1993). Turkey's export growth in the 1980s was an impressive 24% per annum, following its shift from an import substitution strategy towards a market-based outward orientation strategy. The four most successful East Asian export promoters (South Korea, Taiwan, Singapore, and Hong Kong) have pursued protectionist import substitution strategies sequentially and simultaneously in certain industries; but have gradually moved towards a more successful outward-orientation strategy (Todaro, 2000). An outward-looking development strategy encourages not only free trade, but also free movement of capital, workers, a multinational enterprise and an open system of communication.

Tariff protection in the South African automotive industry has been substantially reduced and the industry has made important structural changes towards ensuring greater efficiencies and lower costs. Le Heron (1980) argues that when assistance is generous the

financial risks connected with exporting are reduced. The MIDP has now been in operation for 10 years and has successfully contributed to the automotive industry's integrated emergence from isolation to a global competitor that is a source of high-technology, high quality automotive products for demanding world markets. Income generated from exports is a significant catalyst in creating demand for domestically-produced manufactured goods. The general outward-orientation of this manufacturing sector in which the trade balance improved between 1995 and 2004 was mainly due to the MIDP (Barnes, *et al.*, 2004).

The extension of the MIDP until 2012 is based on the need to maintain and enhance the South African automotive industry's attractiveness as a foreign investment destination and production base for exporting built-up vehicles and components. It was also necessary to maintain the momentum of exports and to secure the continued viability of domestic vehicle and component manufacturing.

The extension of the MIDP to 2012 will provide the motor industry a window of opportunity to further improve on efficiencies. It would however demand of the manufacturers that they continue improving on reducing the cost of producing cars. The improvement of the infrastructure of the harbours is also critical to ensure that distance to export markets plays a less important role in terms of cost competitiveness. Logistic cost is one of the major disadvantages that the South African motor industry faces when compared to foreign competitors (DTI, 2004).

(i) International Trade

International trade has often been referred to as the “engine of growth”, as maintained by Hultman (1967). One of the most important roles that foreign aid plays in less developed countries is the transfer of foreign exchange, which relaxes the balance of payments constraint and makes it possible for countries to import more (Chenery and Srinivasen, 1989). Development therefore could be fast tracked through increased trade and thus increased foreign exchange. Exports are important as they enable the importation of capital goods necessary for investment and prevent balance of payment problems, which seems to plague many developing countries (Todaro, 2000).

Except for increased levels in trade, the need for higher levels of direct capital investments are critical for Less Developed Countries (LDCs) if they are to improve on performance; both in terms of competitiveness and economic viability. Opening up a country to international trade means exposing the country to a new set of rules, challenges and opportunities. This requires that resources (financial, technological, manpower and intellectual) be allocated and geared towards increased levels of economic value added. Physical and financial endowments allow for the possibility of profitable trade. The gradual integration of LDCs into the global market provides an opportunity for industries to take advantage of the economies of large-scale production, made possible by expanded markets.

Cost pressures have led to the rapid integration of subsidiary firms into the multinational cost and production structures. Multinationals may however influence manufacturing plants in other countries in terms of product mix, and the level of employment (Watts, 1987). South African OEMs are under huge pressure to reduce production costs in order

to become more competitive. These OEM's have a cost disadvantage in terms of logistic costs, when compared to European plants (DTI, 2004). Completely knocked down (CKD) material is imported at huge cost, only to be exported again in the form of a fully built-up vehicle. In the absence of integration, each separate country may not be able to provide a sufficiently large domestic market to enable local industries to lower their production cost through economies of scale. Expanding export markets provide an additional stimulus to growing local demand. Hultman (1967) argues that export growth is seen as a determinant of import capacity which, in turn, is a determinant of the level of domestic economic activity.

Many developing countries rely heavily on the importation of raw materials, machinery, capital goods, and intermediate producer goods to fuel their industrial expansion and to satisfy the rising consumption aspirations of their people (Todaro, 1997). Expanded foreign exchange earnings, through improved performance, provide the means by which LDCs can augment their scarce physical and financial resources. Where opportunities for profitable exchange arise, foreign trade can provide an important stimulus to aggregate economic growth. The promotion of LDCs' exports has been cited as a major ingredient in any viable long-run development strategy (Todaro, 1997).

On the other hand, there are however certain conditions that the South African OEMs need to comply with in order to participate in international trade. The South African automotive industry is required to meet quality and environmental standards as a prerequisite for exporting vehicles or components to the international market. These standards are developed to add value to all types of business operations. It also contributes to the development, manufacturing and supply of products and services by

making it more efficient, safer and cleaner. Complying with the standard makes trade between countries easier and faster as well as safeguarding consumers and general users of the products. The South African automotive industry embraces several quality standards (DTI, 2004). One of the pre-requisites for the researched company and its suppliers is that it must be ISO9001 and/or VDA6.1 compliant to enable it to participate in the international market. These internationally recognized systems/standards strive for an acceptable standard of codification, which can be replicated through all organizations.

(ii) Effect of the Exchange Rate on LDCs

As far as the effects of the exchange rate are concerned, *the locus classicus is*: Currency devaluation is preferred in developing countries, as devaluation appears to improve both the trade balance and the balance of payments (Chenery and Srinivasen, 1989).

There has been much debate about the volatility of the Rand and its impact on the industry, especially with regard to the effect it has on exports. A question frequently asked is: What would be the most economically viable rate of exchange for the South African OEMs? An overvalued exchange rate would be preferred to attract foreign direct investment as imported goods become cheaper. On the other hand, an overvalued exchange rate reduces the returns of local exporters as they receive less domestic currency (Todaro, 1997). An overvalued exchange rate therefore has a tendency to exacerbate balance of payments problems simply because imports become cheaper while making exports more costly.

Hart (2005) argues for a strong currency, as a weak currency hides the inefficiencies of industries behind regulations. He argues that competing with countries like Japan would

require the same standard of vehicle from the South African motor industry. He believes that the South African firms indeed need to improve on their productivity to become more competitive. A strong Rand rate of exchange could also result in increased demand for cheaper fully built up (FBU) imports, which is contrary to the MIDP's objective of reducing imports and thereby the trade deficit.

Chenery and Srinivasen (1989) on the other hand argue that a devalued currency for developing economies would be preferred, especially if the aim is to expand on exports. A devaluating currency would appear to improve both the trade balance and the balance of payments. One difference between an inward-orientated versus an outward-orientated economy is that the latter would maintain a more realistic rate of exchange compared to an inward-orientated economy which would support an overvalued rate of exchange (Chenery and Srinivasen, 1989).

One of the biggest challenges the South African OEMs are facing is the volatility of the rate of exchange. The exchange rate has a profound impact on strategic decisions in terms of the level of investments in the local industry. Decisions by local OEMs to localize certain components depend heavily on the rate of exchange. It might be economically viable to localize a certain component at R/€9.0 but, uneconomical at a level of R/€8.0. Unpredictable fluctuations of the rate of exchange create serious problems for business in terms of short- and long-term development strategies (Todaro, 1997). This poses a huge challenge to the domestic OEMs in terms of their response to an unstable rate of exchange.

(iii) Foreign Direct Investment (Also strongly supported by the New Growth Strategy)

Foreign direct investment has long been recognized as a major source of technology and know-how for developing countries and can be a potent factor in promoting growth (Balasubramanyam, *et al.*, 1996). Indeed, it is the ability of FDI to transfer not only production know-how, but also managerial skills that distinguishes it from all other forms of investment; including portfolio capital and aid. Lall (2004) asserts that the export success of the second wave of Tiger economies like Malaysia, Thailand, Indonesia and Philippines have been largely driven by foreign direct investment (FDI) and less on building indigenous capabilities. The volume and effectiveness of incoming foreign direct investment will vary according to whether a country is following an import substitution strategy or an export promotion strategy (Balasubramanyam, *et al.*, 1996).

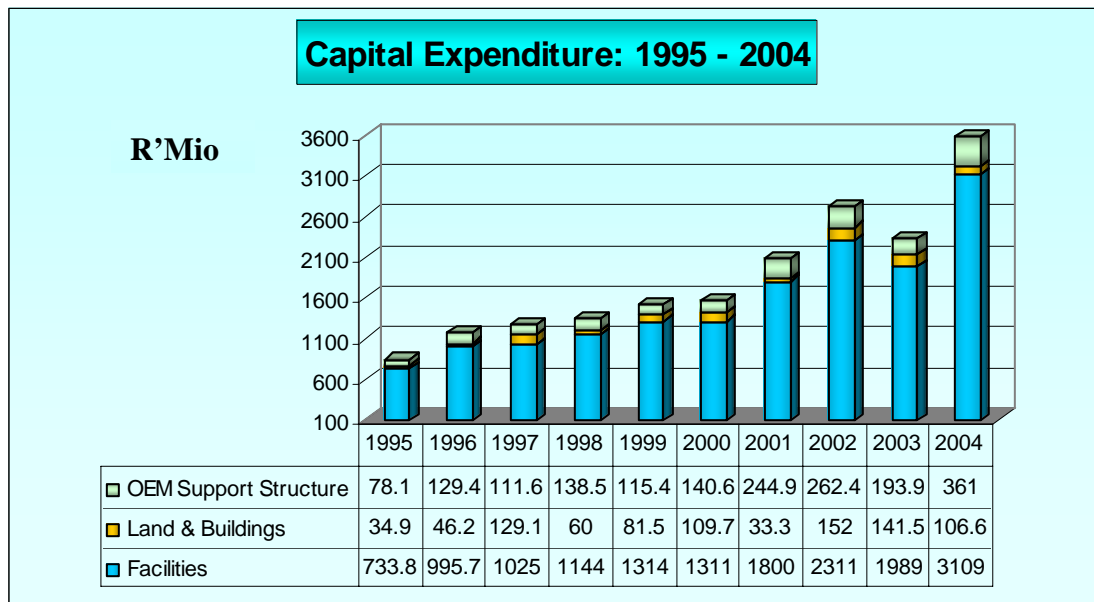
An import substitution strategy is one where the effective exchange rate on imports exceeds the effective exchange rate on exports. An import substitution strategy is however entirely policy driven as it protects the local market.

As previously noted, Balasubramanvam, *et al.* (1996) define the export promotion strategy as one which equates the average effective exchange rate on exports with the average effective exchange rate on imports. An export promotion strategy is therefore trade neutral or bias free. Balasubramanvam, *et al.* (1996) further argue that on balance, given all other factors influencing FDI flows and their effectiveness, an export promotion strategy is likely to both attract a higher volume of FDI and promote more efficient utilization thereof compared to an import substitution strategy. The incentive of FDI is simply the conjunction of cheaper costs and the export orientation. The presence of foreign multinationals in the South African economy, with their superior endowments of

technology, gives local firms the opportunity to stay abreast with new developments in technology.

The MIDP has indeed succeeded in attracting and increasing the level of foreign direct investment in the motor industry. Figure 2.2 shows the capital investment development in the South African motor industry from 1995 to 2004. There has been a steady increase in capital investment from 1995 to 2000, with a significant increase from 2001 to 2004. This sharp increase since 2001 is heavily influenced by the Productive Asset Allowance, under the MIDP, which was introduced in July 2000.

Figure 2.2: Capital Expenditure in the Motor Industry



Source: NAAMSA Annual Report, 2004

2.5 Performance of the Textile Industry

The developments in the motor industry can be best viewed when it is compared to the textile industry, which has a similar economic growth strategy.

In contrast with the auto and auto component sectors, clothing and textiles have experienced stagnant or declining production post-1995 (Kaplan, 2004). The growth of South African clothing exports to its principal market, the United States, following the implementation of the African Growth and Opportunity Act (AGOA) has been much slower than expected. There have been few new investments or very little new investments on the part of existing export-orientated clothing firms. As in the automotive industry, the clothing and textile industry is also faced with a tariff phased-down of duties, combined with reduced export incentives. The export incentive, known as the Duty Credit Certificate Scheme (DCCS), will run until the end of 2005.

The DCCS allows firms to claim a credit for goods exported and the level of incentive depends on the type of goods exported. However, while the DCCS provides a company with significant incentives, its effectiveness is constrained by a number of factors:

- The most critical factor is the limited usage to which the DCCS can be applied. A DCCS can only be used for imported inputs in respect of the domestic market and then only for the *same-stage* product or *one stage back*. This limited usage results in exporters selling their DCCS to importers at considerable discounts.
- The DCCS would be more effective if its usage could be widened. It should not only be utilized to offset duty on imports for the domestic market, but also for exports. The

DCCS could further be used not only for the import of the same product plus one stage back, but also for all imported inputs.

- The widening of the DCCS would give the exporter more possibilities for utilizing the DCCS “in-house”, rather than selling it at a discount to importers/competitors.

A significant difference of the DCCS incentive program compared to the IRCC (Import Rebate Credit Certificate) incentive under the MIDP programme is that the usage of the MIDP rebates is not as limited. The rebates earned on exports in the automotive industry can be used to offset import duty on components and or fully built up vehicles. It is however best to use an IRCC earned on vehicle exports to import motor vehicles and not components, as the IRCC will be discounted to the duty rate for components which is less than the vehicle rate (rates in 2005: 34% for vehicles and 27% for components).

2.6 Summary

International trade is not just an economic opportunity; it is a moral imperative. A competitive advantage ultimately results from an effective combination of national circumstances (the MIDP in this instance) and company strategy. Strategy is often concerned with taking actions that will lower the costs of value creation and exploring new growth opportunities in other markets. Successful execution of a strategy requires a degree of flexibility, an ability to adapt to world standards and it a long-term perspective that put building a sustainable business before short-term profitability.

Chapter 3

The Motor Industry Development Programme (MIDP)

Deliberate efforts by government were required to promote structural changes to the domestic motor industry by opening up the economy to international competition through a programme of tariff reduction and export promotion. These structural changes and the protection of the domestic motor industry almost made it impossible (irresistible) for domestic industries not to export (DTI, 2004).

3.1 Introduction

South Africa's isolation under apartheid, brought about by trade boycotts and sanctions, reinforced an inward-looking, high cost and uncompetitive manufacturing production base where exports were dominated by primary products. Over the last few decades, the South African automotive industry has undergone major policy reforms in that a process of structural changes were implemented to enhance competitiveness and to increase value-added production and exports. In addition, changed government support and tariff liberalization have been significant drivers of the development and performance of the local automotive industry in recent years (Damoense and Simon, 2004).

The development of the MIDP is geared towards enhancing export possibilities for vehicle manufacturers and component producers through a number of government support mechanisms that reduce their import liabilities. The MIDP was intended to achieve a number of objectives of which enhancing component exports, international

competitiveness, stabilizing long-term employment and attracting foreign investment are the core objectives (DTI, 2004).

Past developments in the motor industry have received considerable positive publicity in recent years. Firstly, and most importantly, this is as a consequence of rapid export expansion, initially of components and later of vehicles. A second development that the motor industry has been a recipient of, is the considerable foreign direct investment (FDI) in assembly plants and component production. Trade liberalization, globalization of markets and government support have been significant drivers of the development and performance of the local automotive industry in recent years (NAAMSA, 2004).

Volkswagen of South Africa (VWSA) recently announced a R750 million and Toyota a R1.0 billion investment in new paint shops. Earlier in 2005, General Motors (GM) announced a R600 million investment in facilities and product development to produce and export the right hand drive Hummer to mainly Europe, Asia Pacific, the Middle East and Africa. BMW supplies the world market with the BMW 3-series and Daimler Chrysler is exporting about 30,000 Mercedes C-Class vehicles. The BMW 3-series is mainly exported to the United States of America (USA) - all exports to the USA from Africa are exempted from import duties under the African Growth and Opportunities Act (AGOA).

The MIDP has played an instrumental role in promoting this scale of investment (Ryan, 2005) and has frequently been cited as a successful example of trade and industrial policy. "One successful outcome of the industry's performance has been the strong export growth of both automobiles and auto components under the MIDP, which has been

largely due to the government's protected export promotion strategies offered to vehicle and component manufacturers" (Damoense and Simon, 2004: 252).

The basic idea of an import substitution and export promotion strategy is that protection is necessary for most developing countries at some point in order to establish an internal routine that generates increasing welfare, as maintained by Chenery and Srinivasen (1989). They also maintain that exports enable the importation of capital goods necessary for investment, and prevent balance of payments problems, which seem to plague many developing countries.

3.2 The Automotive Policy

In framing a trade policy in the post-1994 era, the South African government had to respond to developmental imperatives in the context of rapid changes in the global economy (Carim, 2004). The MIDP has removed the anti-export bias that previously faced the industry and provides in addition export subsidies to exporters.

3.2.1 Importance of Policy

The issue of stimulating trade in developing countries is an old one. Each period or different situation requires unique demands and answers to fit the new circumstance (Chenery and Srinivasen, 1989). Almost all successful cases of economic development in the past 50 years have been based on creative and often heterodox policy innovations. Countries such as Taiwan and South Korea combine their outward orientation with unorthodox policies. These would include a high level of tariff and non-tariff barriers, export subsidies, domestic content requirements, and restrictions on capital flows.

Taiwan's and South Korea's exports drive was led by local firms, which were supported by a host of policies that allowed them to develop impressive technological capabilities. Their domestic market was not exposed to free trade; a range of quantitative and tariff measures were used over time to give their infant industry “space” to develop their capabilities (Carim, 2004).

China, especially in the late 1970s, also followed a highly unorthodox dual strategy, by violating every rule in the guidebook including, most notably, the requirement of private property rights. India, which raised its rate of economic growth quite significantly in the 1980s, has done so under a highly protected environment (Carim, 2004). Each country has a different model within a common context of export orientation of sound macro management and a good base of skills. Policy “space” is not only good for development; it is also good for trade. When developing countries grow their economies, they can also expand their trade volumes (Hultman, 1967).

3.2.2 Developments of the Policy

The roots of industrial policy in South Africa are to be found in the promotion of the indigenous steel industry during the 1920s. During subsequent decades, industrial policy was built around a readily recognized import substitution model. This entailed imposing heavy tariffs, which generally escalated with the degree of value added (Barnes *et al.*, 2004).

The introduction of the Local Content Programme (LCP) was for the utilization of domestic components in the production of motor vehicles. Table 3.1 outlines the four time periods and the key policy instruments. The LCP was to evolve over the phases I-

VI, which lasted from 1961 to 1995. Phases I-V were weight based, with local content levels growing from a low 15% in 1961 to 66% in 1980. The OEMs were only required to achieve the targeted local content percentage over a model range and not on every individual vehicle. The local content programme has been ineffective in reducing the proliferation of vehicle models, in saving foreign exchange, and in developing a local automotive industry with jobs, skills and established capacity (Damoense and Simon, 2004). The industry was highly inward-orientated and a large number of makes and models were produced in low volumes at relatively high cost.

Table 3.1: Developments of the Automotive Policy in South Africa

Period	Automotive Policy	Key Policy Instruments
Jun-1961 to Feb-1989	Phase I-V Local Content Programme	<ul style="list-style-type: none"> * Varying content levels implemented by weight * Excise duty rebate scheme
Mar-1989 to Aug-1995	Phase VI Structural adjustment Programme	<ul style="list-style-type: none"> * Domestic Content scheme adjusted for value targets * Import-export complementation (IEC) scheme introduced
Sep-1995 to Jun-2000	MIDP First Phase	<ul style="list-style-type: none"> * Local Content regulations abolished * Tariff phase-down for imported models and components (Imported vehicles 40% and Components 30%) by 2002 * Export credits increased * Duty-free allowance (DFA) and small vehicle incentive scheme implemented
Jul-2000 to 2007	MIDP Second Phase	<ul style="list-style-type: none"> * Tariff phase-down to continue until 2007 (Imported vehicles 30% and Components 25%) * IEC phase-down from 2003 to 2007 * Introduction of a new production-based DFA in 2000. * Introduction of a Productive Asset Allowance (PAA); to be discontinued by 2007.

Source: DTI, 2004

Despite the protective tariff cordon, it was found that the balance of payments deficits constrained growth and attempts were made to improve this ineffective protective strategy. The first major change to the long established programme of protection came with the introduction of Phase VI of the LCP. Phase VI was the first attempt to address this inward-orientated, overly fragmented industry programme.

Phase VI differed from the previous five phases in that it was based on value instead of weight. The idea was that Phase VI would reduce imports by 50% as this could be attained by promoting export growth of automotive products (Damoense and Simon, 2004). As a result of Phase VI, exports of automotive components grew significantly, although phase VI did not adequately reduce foreign usage and the automotive trade deficit increased by about 33% over a period of five years from 1989 to 1994 (Damoense and Simon, 2004).

With the election of a new government in 1994, a commitment was given to intensify industrial reform. The number of tariff codes was reduced further, and an effort was made to speed up the reduction in tariff protection, exceeding the demands of GATT (Barnes *et al.*, 2004).

Unfortunately, the rather stagnant performance of the South African automotive industry led to the introduction of a new programme. In September 1995, the government introduced the Motor Industry Development Programme (MIDP), in compliance with GATT and the World Trade Organization (WTO). The MIDP is based on the Australian automotive industry plan and it has been structured in such a way that it can draw upon

the success of the East Asian economic model where exports are promoted through a subsidy scheme based on the degree of value added.

The objectives of the MIDP are to:

- improve the domestic industry's international competitiveness;
- enhance the industry's growth through exporting;
- improve vehicle affordability;
- improve the industry's highly skewed trade balance;
- stabilize employment levels.

In order to achieve these aims, a series of mutually reinforcing export-orientated incentives were introduced, coupled with a reduction of import tariffs.

Since its inception, the MIDP had been subjected to two reviews - in 1999 and in 2002. The first phase of the MIDP ran from September 1995 to June 2000. The first review extended the programme from July 2000 until 2007, whilst the second review extended it until 2012. The key element of these reviews was the certainty in the incentive scheme, with this taking the form of declining trade facilitation support and the gradual reduction of import tariffs. The South African industrial policy has a sectoral focus aimed at encouraging the exports of – and attracting investment and technology to – those sectors that will drive industrial development in the country (Carim, 2004).

3.3 Objectives of the MIDP

South Africa's strategy to become an internationally competitive economy has focused on lowering tariffs and on becoming an export-orientated economy. The MIDP has been recognized around the world as a successful and innovative national strategy, designed to

develop automotive manufacturing and to expose the domestic market to the new environment of globalization. The export market has created a lifeline for the automotive industry whose existence was not warranted by the low volumes demanded by the domestic market alone (DTI, 2004).

The main thrust of the MIDP is:

- The development of an internationally competitive and growing automotive industry in South Africa.
- The enhancement of automotive exports and international competitiveness.
- To make a greater contribution to the economic growth of the country by increasing production and achieving an improved sectoral trade balance.
- To attract foreign investment.
- To provide sustainable employment through increased production.
- To provide high quality affordable vehicles to the South African public.
- The development of learning capabilities through globalization initiatives, by exchanging ideas and expertise.
- To create a better balance between the industry's foreign exchange usage and foreign exchange earnings. (NAAMSA, 2004)

These objectives are to be achieved by:

- Encouraging a phased integration into the global automotive industry.
- Increasing production volume through export expansion and gradual rationalization of models.

- Encouraging the modernization and upgrading of the automotive industry in order to promote higher productivity and facilitate the global integration process.

3.4 Key Features of the MIDP

The MIDP is essentially an extension of the previous industry policies (Phase 1-VI) in terms of export facilitation. The automotive industry can, through its import-export complementation scheme, earn export credits, which can be used to offset import duties. The domestic vehicle assembly should however be on the basis of completely knocked down (CKD) components as a precondition to participate in the programme. The objective is to create and/or sustain employment, to reduce import duty liabilities and to improve on the automotive trade balance.

Other features built into the MIDP are the gradual phasing down of tariffs for both completely built-up vehicles and components. Other government support schemes include a Duty Fee Allowance (DFA) and a Small Vehicle Incentive (SVI) scheme.

Tariffs on imported passenger vehicles fell from 65% in 1995 to 34% by 2005, while tariffs on imported components dropped from 49% in 1995 to 27% in 2007 (Table 3.2). The phasing down of tariffs happened faster than was required by the WTO and GATT. The lowering of tariffs has led to an increase in CBU imports (Figure 3.1) and components used in the assembly of export vehicles.

Table 3.2: Rate of Development

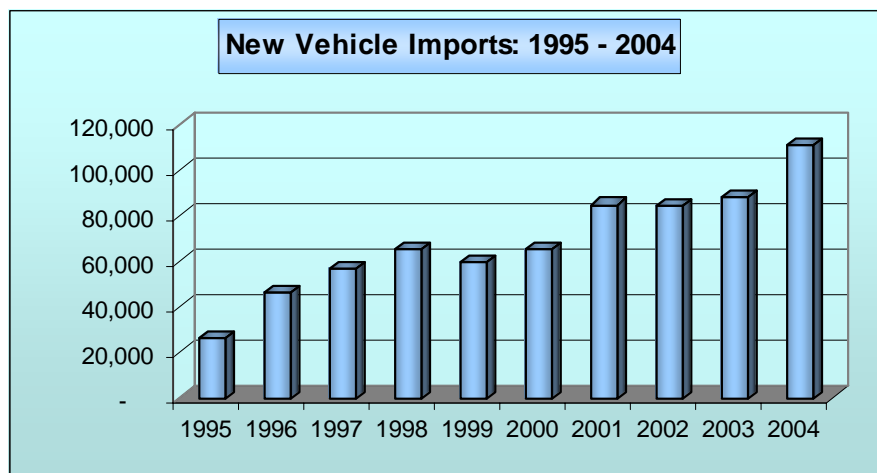
Year	CBU Duty	CKD Duty	DFA	Value of Exports for import Rebate Purposes	Productive Asset Allowance
*1994	115.0%	50.0%	n/a	100%	0%
1995	65.0%	49.0%	27.0%	100%	0%
1996	61.0%	46.0%	27.0%	100%	0%
1997	57.5%	43.0%	27.0%	100%	0%
1998	54.0%	40.0%	27.0%	100%	0%
1999	50.5%	37.5%	27.0%	100%	0%
2000	47.0%	35.0%	27.0%	100%	0%
2001	43.5%	32.5%	27.0%	100%	20%
2002	40.0%	30.0%	27.0%	100%	20%
2003	38.0%	29.0%	27.0%	94%	20%
2004	36.0%	28.0%	27.0%	90%	20%
2005	34.0%	27.0%	27.0%	86%	20%
2006	32.0%	26.0%	27.0%	82%	To be reviewed
2007	29.5%	25.0%	27.0%	78%	
2008	29.0%	24.0%	27.0%	74%	
2009	28.0%	23.0%	27.0%	70%	
2010	27.0%	22.0%	27.0%	70%	
2011	26.0%	21.0%	27.0%	70%	
2012	25.0%	20.0%	27.0%	70%	
* Phase VI					

Source: DTI, 2004

The lowering of tariffs has given component manufacturers the flexibility and the opportunity to source uneconomical, locally produced parts from foreign firms. The relaxing of trade policies and the scaling down of tariffs has also posed a threat of new entrants entering the market. However, the idea of the import-export facilitation scheme was that OEMs could earn sufficient foreign exchange by exporting, in order to offset foreign exchange purchased for the payment of imported components. Import Duty Rebate Credit Certificates (IRCCs) are issued by the Department of Trade and Industry (DTI) and are then used to offset import duty payable. One Rand of IRCC is earned for

every one Rand local value added. The purpose of the rebate is to create an improvement in global competitiveness of the motor vehicle and component manufacturing industry (DTI, 2004).

Figure 3.1: New Vehicle Imports



Source: NAAMSA Annual Report, 2004

A Completely Built Unit (CBU), with an imported price of R100,000 in 1995 would have cost the manufacturer R165,000 (65% duty payable). The same car in 2005, with the same imported price, costs the local manufacturer R134,000 (34% duty payable). The same applies to components (CKD) where the duty rate fell from 49% in 1995 to 27% in 2005.

A **Duty Free Allowance (DFA)** equal to 27% of a vehicle's wholesale price can be rebated against the duty payable on imported components used in the production of vehicles for the domestic market. The DFA is thus an allowance that subsidizes high value imported components. The DFA therefore increases the effective rate of protection

for vehicles produced for the domestic market. This is also an attempt to make the vehicles more affordable to the South African customer.

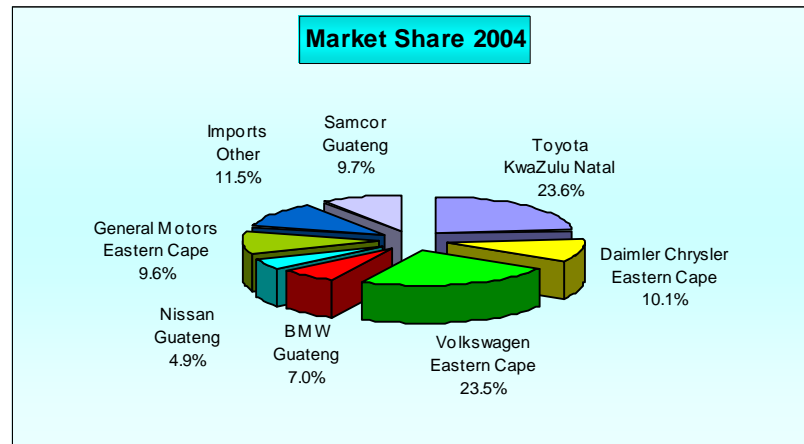
An allowance equal to 3% for every R1000 below the qualifying vehicle value of R40,000 was offered to vehicle manufacturers as a Small Vehicle Incentive. Even after the qualifying value was later increased to R44,000 no benefit was derived from this scheme, as vehicle price inflation was continually increasing.

The value of exports, exchanged for import rebate purposes, has affected the local manufacturers quite significantly. Manufacturers could import components worth R1.0 million duty free, under a one-to-one scheme prior to 2002 when they exported components worth R1.0 million. After 2002, however, manufacturers are entitled to less credits; only R0.86 million of duty-free imports in 2005 for every R1.0 million exported. This is part of the DTI's plan to phase down incentives to local manufacturers.

3.5 Structure of the Local Automotive Industry

Seven domestic OEMs produced little over 400,000 units of passenger cars and light commercials for the local market during 2004. See Figure 3.2 for the structure of the motor industry.

Figure 3.2: Structure of the Motor Industry



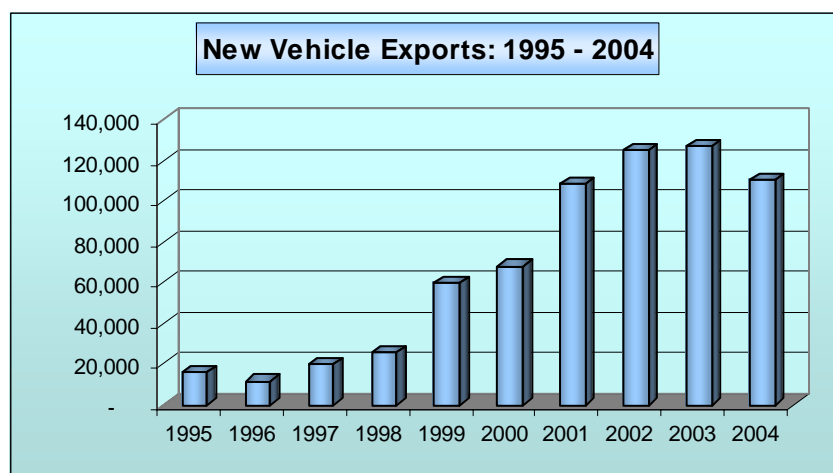
Source: Management Accounting Reports

All OEMs have become partly or wholly owned subsidiaries of world leading motor manufacturers. This has contributed to increased foreign direct investment in the local industry. Local OEMs are now fully integrated into international markets through these transnational companies. Needless to say, this has brought about huge challenges and opportunities to the local firms. The size of the domestic market is relatively small in relation to the number of OEMs. Seven OEMs produced 300,000 passenger vehicles as compared to Australia, which has four manufacturers producing about 400,000 passenger vehicles (Damoense and Simon, 2004).

South Africa's production for the export market increased more than sevenfold over the period 1995 – 2004, which indicates the strong export performance of the local OEMs. (See Figure 3.3). This development was necessary as the domestic market is relatively small in relation to the number of OEMs. The reduction of import tariffs has also made it necessary for the local OEMs to expand their export markets as the number of imported vehicles into the domestic market has also increased more than fourfold since 1995. This

is partly due to the relaxation of import tariffs and a strong Rand/Dollar and Rand/Euro exchange rate.

Figure 3.3: Vehicle Exports



Source: NAAMSA Annual Report, 2004

Labour productivity in the South African automotive industry has improved in recent years – since 1995, average labour productivity has increased by about 5% per annum (Damoense and Simon, 2004). See table 3.3 for the labour productivity development.

Table 3.3: Labour Productivity

Productivity	1999	2000	2001	2002	2003	2004
Units Produced	325,222	356,250	406,149	404,441	421,335	455,052
Employees	280,870	288,375	293,100	298,070	303,700	306,000
Units per employee	1.16	1.24	1.39	1.36	1.39	1.49
Productivity Improvement p/a		6.7%	12.2%	-2.1%	2.2%	7.2%
Average productivity improvement over period						28.4%
Average annual productivity improvement						5.7%

Source: NAAMSA Annual Report, 2004

The improvements in labour productivity could be as a result of economies of scale. BMW has decided to specialize in the 3-Series model to achieve economies of scale and to discontinue local production of the 5- and 7-Series, which are now being imported. Volkswagen of South Africa has also reduced the number of vehicle platforms from five to three with the discontinuation of the production of the Audi and the T3 bus. The full Audi range is now being imported as well as the T5 bus, the newer version of the T3 bus. Daimler-Chrysler also only produces the C-Series of the Mercedes Benz models, with the E-Class and S-Class being imported. Black (2003)

Quality performance levels are also believed to have improved, although internationally some still perceive South African quality as being inferior. This is hard to believe with export volumes and foreign direct investment on the increase. The BMW South African plant achieved a global quality award in 2002, which demonstrates high class quality in vehicle manufacturing. Productivity growth and quality improvements have been crucial in the face of dynamic transformations in the world automotive industry and South Africa's increased exposure to international competition (DTI, 2004).

3.6 Conclusion

A comprehensive framework has been adopted to review industrial policy in South Africa. One observes considerable success in this policy framework insofar as it affects the automotive industry. Carefully selected industrial policies can be effective in developing countries as has been observed in Taiwan and Korea. The MIDP, with its export-orientation outlook, gives the domestic OEMs the opportunity to participate in the global market.

The dynamics of the policy in terms of reduced incentives and tariff reductions over time, presents an opportunity to the infant OEMs to sharpen their production, technological and management capabilities to compete on equal footing with international competition once the programme expires in 2012. In addition, the Productive Asset Allowance provides incentives for capital goods imports which are targeted at export markets and which would favour economies of scale.

The Local Content Programme (LCP) was developed around the idea of an import substitution strategy, which stresses that protection is sometimes necessary for most developing countries in order to establish an internal routine that stimulates economic growth.

Exports enable the importation of capital goods necessary for investment, and prevent balance of payments problems, which seem to plague many developing countries. Most East Asian economies used infant industry protection, export subsidies and targets, credit allocation and direction, and local content rules to build their base of industrial capabilities, disciplining the process by strong export orientation.

South Africa's strategy to become an internationally competitive economy has focused on lowering tariffs and becoming an export-orientated economy. There has been strong export growth of both automobiles and auto components under the MIDP, which has been largely due to government's protected export promotion strategies afforded to vehicle and component manufacturers. Government support in terms of providing export incentive schemes has been acknowledged as one of the main reasons for rapid growth

and development of automotive industries in countries such as Australia, Brazil, India and Malaysia.

The MIDP has been recognized around the world as a successful and innovative strategy: to develop automotive manufacturing; to open up the domestic market as well to create economically viable opportunities for exports. The export market has extended a lifeline to the automotive industry whose existence was not warranted by the low volumes demanded by the domestic market alone.

Chapter 4

Research Methodology

4.1 Introduction

In order to gain a full understanding of how and why the researched company has responded to and embraced the MIDP as an integral part of its overall long-term corporate strategy; a qualitative case study approach was used because of the depth and richness it provides. This chapter will discuss the qualitative inquiry in detail and explain how it was employed in the research as well as the methods used for data collection. The discussion of the data analysis, which follows, will address important issues of reliability and the validity of the measures taken to ensure these. Ethical issues that came up during the study will also be discussed.

4.2 Goals of the Research and Hypothesis

The goal of this research is to gain an understanding of the role that the MIDP has played in stimulating the South African automotive industry. A case study has therefore been done on a motor manufacturing company in order to formulate an understanding, by using Management Accounting Reports, Annual Financial Statements, documents and semi structured interviews, of why and how the company has responded to the MIDP as an economic policy. Henning, Van Rensburg and Smit (2004) maintain that the qualities or characteristics of the phenomenon (the MIDP in this case) must be examined and analyzed for a better understanding and explanation, as a case study methodology allows for the in-depth search for understanding and detailed collection of data.

In a case study, a limited number of units are studied and the study is directed at understanding the uniqueness of a particular case (Yin, 2002). The aim of this case study is thus to optimize understanding of the case, rather than to generalize from it. Yin (2002) believes that a development of a theory prior to the conducting of a case study produces case studies that can be part of a cumulative body of knowledge rather than just isolated empirical enquiries. Government interventions in LDCs are not uncommon when creating economic growth. The incentives offered by the Department of Trade and Industry have given a lifeline to the local automotive industry. The question thus is: have the automotive industry capitalized on this business opportunity?

The research proposition is that rapid growth of exports accelerates economic growth, which in turn leads to higher profitability. The study formulates an understanding of how the industry has responded to the MIDP as an economic policy to improve profitability as well as to increase economic value added. Henning *et al.* (2004) maintain that theories are statements about how things are connected, and as a result, the researcher will be drawing on existing theories and will explain why things happened as they did. The question of how and why the researched company has responded to the MIDP is addressed by this study.

4.3 Research Paradigm

This study follows a constructivist paradigm and will be of a descriptive nature. Henning *et al.* (2004) maintain that interpretivists/constructivists concentrate on formulating and constructing an argument in order to show why and how things happened. When the aim of a case study is to verify existing theory, the study is of a deductive nature (Babbie and

Mouton, 2001). Constructivists therefore use deductive reasoning to postulate theories that can be tested in order to confirm or reject them.

Guba and Lincoln (1994) support the above view by maintaining that knowledge consists of those constructions about which there is relative consensus. They further argue that constructions are not more or less “true” in any absolute sense, but simply more or less informed. Henning *et al.* (2004) also assert that knowledge accumulates only in a relative sense through the formation of evermore informed and sophisticated constructions.

The researcher draws on existing theories to create an understanding of how the economic policy has influenced the financial performance of an OEM. The MIDP as an economic policy, with its aim of re-energizing the South African automotive industry, is thus tested against already established theories. Specific emphasis has been given to “how” the MIDP has contributed to the overall company performance, by conducting interviews and by analyzing documents. It was therefore of more importance to ask and answer *why* the researched company has embraced the MIDP as an economic policy, and examine *how* it has gone about it to effect economic change. These two research questions govern the case study.

4.4 Research Method

The researcher employs the case study method of investigation. Henning *et al.* (2004) argue that the *purpose* of a research study should be to have the most influence on the use of certain methods of data collection and especially data analysis. They maintain that methodology refers to the coherent group of methods that compliment one another and

that have the “goodness of fit” to deliver data and findings that will reflect the research question and purpose.

Henning *et al.* (2004) argue that the aim of a case study is not simply to describe the case for the sake of description, but to try to see patterns and relationships that warrant the enquiry. They further stress the importance of selecting the appropriate methods of data collection and analysis to create a “*thick description*”. This means that more than just facts and empirical content must be given, but that the researcher must interpret the information in the light of other empirical information and on the basis of a theoretical framework. Schwandt (in Henning *et al.*, 2004) maintains that an analysis must be rigorous, systematic and disciplined; which means that data analysis is about reasoning and argumentation.

“One analysis of case study methods found that those case studies using multiple sources of evidence were rated more highly, in terms of their overall quality” (Yin, 2002: 99). Yin (2002) also stresses the importance of using multiple sources of evidence; creating a case study data base and maintaining a chain of evidence to help deal with the problems of constructed validity and reliability. Triangulation of data sources and analytical perspectives are therefore applied in this study to improve the reliability and validity of the findings. The data are collected from multiple sources, including interviews, documents and reports. The researcher is cognizant of the fact that these multiple sources of evidence must converge on the same set of facts or findings.

The primary data for this case study were collected using the qualitative interview and document study methods. The documents could be drawn upon to verify the views of the interviewees, especially in terms of foreign direct investment, productivity development and financial performance.

4.4.1 Interviews

One of the most important sources of case study information is the interview. The information acquired through interviews allows for deep analysis of views and perceptions of various people. Hitchcock and Hughes (1995) assert that the value of oral evidence lies in its ability to add crucial depth to individual subjective experiences. The strength of qualitative approaches lies in their capacity for the exploration and understanding of meaning frames and subjective experiences, which are of particular interest in this study.

Semi-structured interviews were conducted with two executives of the researched company. Of particular importance was an interview with the Strategic Planning Executive and his Assistant, who are responsible for putting together the long-term strategic plans of the company. All three participants have been with the company for longer than ten years (cumulatively more than thirty years of experience) and their views and experiences have contributed to the richness of the data. The interview with the Financial Controller was necessary to get a different view or perspective. It was especially important as all strategic investment decisions, are handled by his division. From the interviews it was evident that the MIDP plays a significant role in almost all strategic investments decisions.

Henning *et al.* (2004) argue that the standard for interviews is *guidance without interference*. The interviews were guided conversations rather than structured queries, which means that it was fluid rather than rigid (Yin, 2002). An interview sheet was distributed to all the participants two days before the interviews took place. A semi-structured interview sheet was developed based on the theory, covered in the literature review, to guide the researcher to gain a comprehensive understanding of the research question (see Appendix A). The interviews were of an open ended nature whereby respondents were asked about the facts of the matter as well as their opinions about the programme. The interviews were recorded and transcribed and form part of the chain of evidence to increase the reliability of the report.

4.4.2 Document Analysis

Because of their overall value, documents play an explicit role in any data collection when doing case studies (Yin, 2002). The most important function of documents is to corroborate and augment evidence from other sources.

Documents are written for a purpose and are directed at a specific audience and can thus have certain limitations, such as the possibility of being inaccurate, incomplete and biased. As Annual Reports are specifically drawn up to be read by shareholders and stakeholders, a real possibility exist that mainly good news is reported. The researcher must therefore be mindful that documents are not the be all and end all. Annual reports are however verified and audited by external auditors. It is thus critical that the triangulation method be used whereby information recorded on documents is linked to other sources of information such as interviews. Henning *et al.* (2004) stress the

importance of using documents along with other methods to ensure reliability when doing the analysis and interpretation.

Documentary information can take many forms, but the researcher concentrates exclusively on analyzing Annual Financial reports and Management Accounting reports. Extensive document analysis is conducted, especially analysis of NAAMSA annual reports, DTI quarterly reports and economic journals. Trend analysis is conducted to establish whether trends in exports, productivity and growth are detected. The benefits of documentation is that it is stable and can be reviewed repeatedly; it is unobtrusive in that it was not created as a result of the case study; and it has a broad coverage in terms of time periods and events (Yin, 2002).

Access to unpublished material, i.e. Management Accounting Reports and Annual Financial Statements had to be treated with high confidentiality and the researcher could only proceed with the analysis of these reports after obtaining approval from the Head of Controlling. These documents have proved to be invaluable in verifying and confirming the views raised by the interviewees and has thus contributed greatly to the reliability of the findings.

4.5 Data Analysis and Interpretation

The analysis of data requires analytical skills and the ability to capture understanding of the data in writing, as maintained by Henning *et al.* (2004). They argue that by merely reporting the facts of the matter, an unwanted “thin description” will be arrived at. The data in this case study therefore has been interrogated to make meaning of it in order to

form a thick description. In analyzing the data the idea was to find a pattern in and a reason for the way in which the OEM has responded to the MIDP. This Eastern Cape OEM had been selected as a case to study because it is one of the main role players in vehicle exports and it is also a dominant player in the local passenger vehicle market. The phenomenon being studied is also contemporary and topically relevant as the MIDP was implemented as an economic policy, geared to create growth. The importance of the continuation of this programme was confirmed when it was decided to extend the programme until 2012.

Many sources of data were used to study this phenomenon. Yin (2002) stresses the importance of multiple sources of data to increase the reliability of the report. The use of multiple sources of evidence should however converge on the same set of issues. Three people were thus interviewed to increase the validity and reliability of the data. Documents, such as Annual Financial Statements and Management Accounting Reports, were also studied to ensure triangulation. The interviewees and the documents in this case were selected because of their strategic importance to the project. These sources of information could provide the information needed to address the phenomenon.

Conducting a rigorous case study requires a well prepared research design. Mouton (in Henning *et al.*, 2004) refers to design as the way in which the area to be researched is conceived and executed, and how findings are eventually put together. A case protocol was designed well before the actual research began. Issues around access to the researched company, access to management (names of interviewees), and the availability of reports were addressed before it was decided to study the MIDP phenomenon.

4.6 Ethical Considerations regarding the Interviews

The company's management have requested that the researcher be mindful of the fact that they are a private company and that sensitive information, especially profits in nominal terms, not be reported. The profitability developments will therefore be stated in percentages.

The researcher's values and the fact that he is employed by the researched company could have played a role in his interpretations of the data. However, the positive side to this is that more detailed and more specific questions pertaining to the company's response to the MIDP could be investigated. This has certainly contributed to a richer understanding of the phenomenon.

Chapter 5

Discussion of Results: Document Analysis

5.1 Introduction

Prior to 1995, the South African motor industry was too fragmented with many models and uneconomically low volumes. Vehicle manufacturers have over the past ten years substantially rationalized their operations and the number of vehicle platforms have declined from 42 at the commencement of the programme to 24 at present (NAAMSA, 2004). The researched company has achieved a 40% improvement in rationalization, by reducing the vehicle platforms from five to three. This in turn has reduced complexity and has led to improved efficiencies throughout the supply chain, which in turn has resulted in significantly higher production runs per model.

The momentous political transition to democracy in 1994 has undoubtedly impacted on all spheres of South Africa's economy and society. Trade policy, and specifically the MIDP, has progressively exposed domestic vehicle and component manufacturers to the pressures of international competition and the need for efficiency improvement; thereby facilitating greater value for all stakeholders. As liberalization and globalization gather pace, developing countries are faced with more intense competition, but also with increased opportunities, which is more important.

The MIDP has indeed revolutionized the automotive industry, which has become the largest manufacturing sector in South Africa through its contribution to the gross domestic product. Furthermore, the integration of the South African automotive industry into global markets would have been extremely difficult, if not impossible, without the MIDP (NAAMSA, 2004).

The MIDP, as an economic policy, has contributed in shifting the focus on raw material exports to increasingly higher value added manufacturing exports. The researched company has done well in many facets of economic performance, compared to the average performance of the motor industry. The development of economic growth and performance at the researched company over the past ten years demonstrates a well-executed corporate level strategy, driven mainly by an export promotion strategy.

Marais (3 Nov 2005) maintains that the MIDP has certainly contributed to an improved financial performance, due to increased levels in vehicle and component exports as well as an expanded domestic market. He is also of the opinion that it would have been close to impossible for the researched company to have achieved the level of economic value added if it was not for the MIDP.

This chapter focuses on the impact that the Motor Industry Development Programme (MIDP) has had on the researched company and argues that the MIDP has contributed significantly to the company's economic growth.

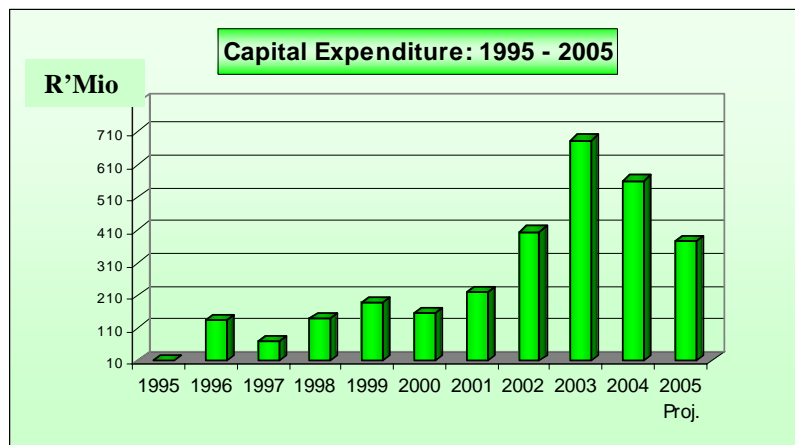
5.2 Discussion of Results

The performance of the MIDP at the researched company is best measured in relation to certain key objectives of the programme. These objectives are addressed separately under the following headings, but which relate to the propositions set out in Chapter One.

5.2.1 International Competitiveness

Over the past ten years the researched company has modernized extensively and both quality and productivity has improved. It is evident, from Figure 5.1, that the levels of capital investment have increased substantially during the second half of the period, with hardly any/or little investments for the period 1995 to 2000. The company has introduced three new models since 1999, which has been the main reason for the positive capital investment expenditure, which peaked at R684 million during 2003. It is important to note that new model introductions have a significant influence on the level of capital investments.

Figure 5.1: Capital Expenditure at the Researched Company



Source: Management Accounting Reports

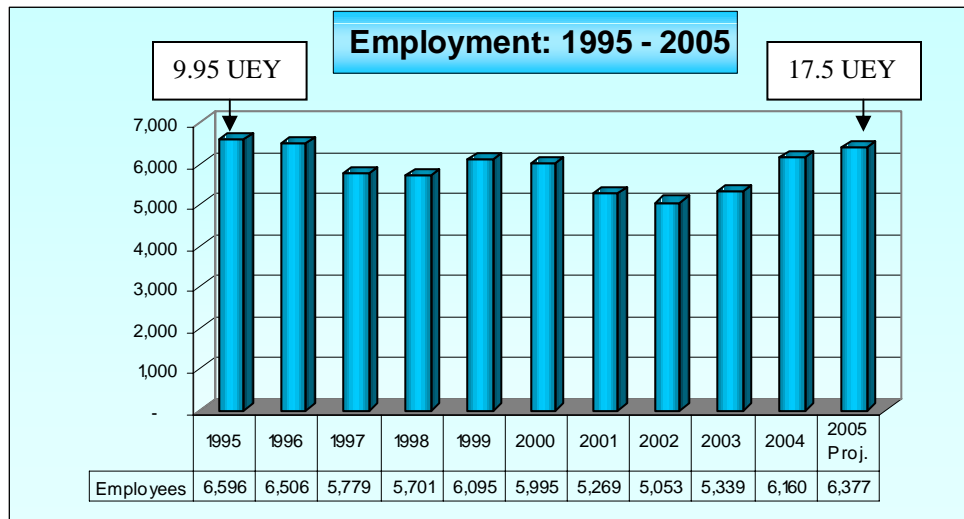
The development in capital expenditure is significant as the researched company only started exporting vehicles in the second half of this period. The company currently produces only three models compared to five models when the MIDP was introduced in 1995; two models have since been discontinued. Domestic production has therefore been rationalized substantially (by 40%) with the company focusing on economies of scale production for both the domestic market and international markets.

5.2.2 Employment

There has been much debate over the trends of employment in the automotive industry. Some believe that there has been a decrease and others indicate a stable level of employment over the past few years. However, NAAMSA (2004) reports otherwise as can be seen in Figure 1.1 on page 2. It is however interesting to note that the increase in employment occurred more in the automotive retail, distribution and servicing sectors than in the manufacturing sector (NAAMSA, 2004).

As regards the researched company, the levels of employment have decreased slightly over the past decade. Interesting though is the fact that the level of employment has increased since the start of the export programme in 1998. (See Figure 5.2).

Figure 5.2: Development of Employment



UEY = Units per Employee

Source: Management Accounting Reports

The figure shows a steady decrease in employment levels from 1995 to 1998, with a slight increase in years 1999 and 2000. One of the main reasons for the decline of employment levels since 1995 was the increased drive to improve on productivity. As a result, a number of non-core businesses were outsourced, and in particular the material handling process, seat assembly, etc. However, a positive trend in employment levels is noticeable since 2003. There has thus been a decrease in employment levels at the researched company, but a corresponding increase in employment levels further along the supply chain.

5.2.3 Productivity

It benefits a business to improve productivity, which, over time, lowers costs and improves the ability to compete and to make profits. Even with only a slight decrease in the level of employment over this period, of strategic importance is the significant

increase in productivity. The company has achieved a 6.9% per annum productivity improvement over the past decade, which is significant when it is compared to the industry average over the last five years of 5.7% (see table 3.3 on page 55 for the industry development). Figure 5.2 shows that the number of units produced per employee in 1995 was 9.95 units compared to a vastly improved figure of 17.5 units per employee in 2005.

The significance of this achievement is best measured against an industry average of 14.4 vehicles per employee in 2004 (NAAMSA, 2004). Also see table 5.1 for the productivity development at the researched company over the past decade. Except for outsourcing a few non-core businesses, the increased level of investments have also contributed to this significant improvement in productivity as maintained by Marais (3 Nov 2005).

Table 5.1: Productivity Development

Productivity Development	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 Proj.
Units Produced	65,626	67,570	58,088	50,517	80,007	74,405	75,089	77,420	78,320	88,503	111,645
Employees	6,596	6,506	5,779	5,701	6,095	5,995	5,269	5,053	5,339	6,160	6,377
Units per employee	9.95	10.39	10.05	8.86	13.13	12.41	14.25	15.32	14.67	14.37	17.51
Productivity Improvement p/a		4.4%	-3.2%	-11.8%	48.1%	-5.5%	14.8%	7.5%	-4.3%	-2.1%	21.9%
Ave productivity improvement over period											76.0%
Ave annual productivity improvement											6.9%

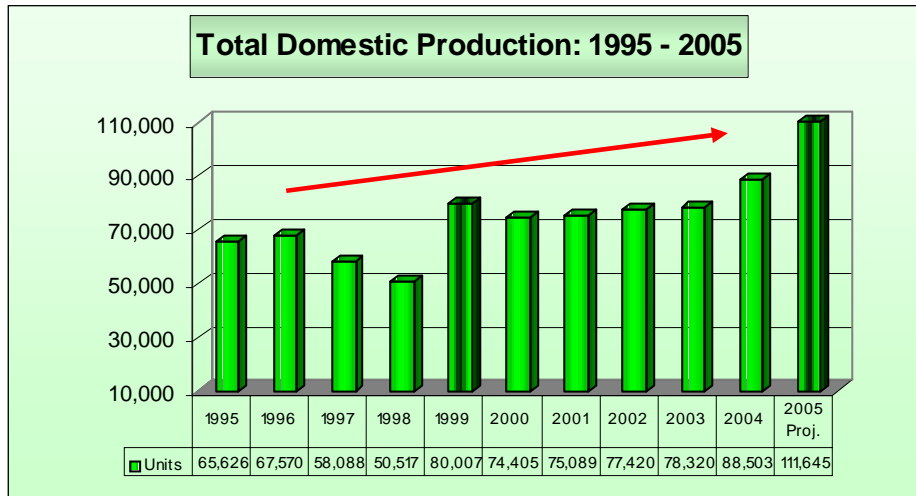


Run-out of an old model and an introduction of a new model, which presents more challenges in the early stages of production

Source: Management Accounting Reports

As labour productivity is measured as output per employee; it would be fair to say that increased levels of vehicle production have a direct bearing on the level of productivity. (See Figure 5.3).

Figure 5.3: Domestic Vehicle Production for the Period 1995 - 2005



Source: Management Accounting Reports

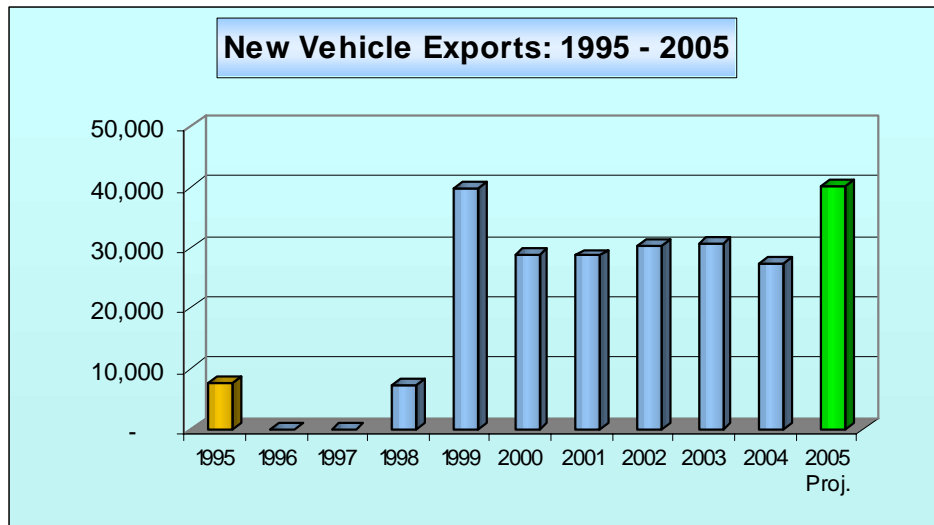
Figure 5.3 depicts three significant phases over the past ten years. The first phase is the period 1995 to 1998, which shows a significant decline in production volume of 23%. During this period the company only participated in the domestic market.

The second phase is the period 1999 to 2003, which covers the start of the researched company's participation in the international market. (See Figure 5.4 for the vehicle export development). The sharp increase of 58% in production volume from 1998 to 1999 was as a direct result of the start of a vehicle export programme to Europe. Interestingly, this period is also characterized by stable levels of production of export vehicles, which were about 30,000 units per annum from 2000 to 2004. (See Figure 5.4).

The third phase is the period 2004 to 2005. A positive trend in production volume is noticeable, as production volume increased by 42% in 2005, compared to 2003. This is

mainly as a result of an expanded domestic market and a quite substantial increase in export volumes. It is important to note that the company had stopped supplying the stagnant European markets in 2002, when it started exporting to Japan, the Asian Pacific region and to Australia in 2003.

Figure 5.4: New Vehicle Exports



Source: Management Accounting Reports

5.2.4 Vehicle Affordability

New vehicle affordability has improved substantially over the past two years in real terms, because manufacturers have virtually not increased prices of new vehicles (NAAMSA, 2004). The researched company has also not increased prices over the past two to three years and, as a result, new vehicles have become cheaper in that more options are fitted to the cars with no resultant increase in price.

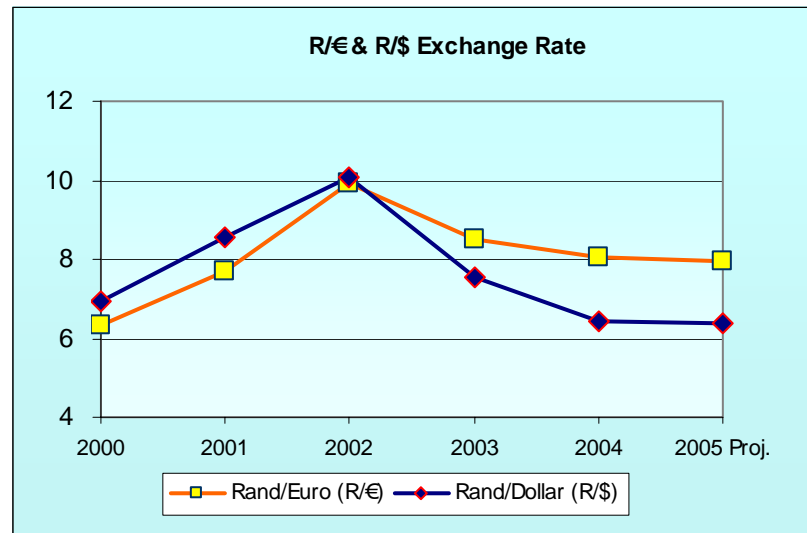
The exception though was the period 1999 to 2002 during which, as a result of the Rand's weakness, new vehicle prices were substantially above domestic inflation. The inability to raise prices over the last two years could have been as a result of the excessive pricing that happened when the Rand was very weak against other major currencies. Importantly, however, companies can minimize the exchange rate exposure by increasing the level of local material content in vehicles, which could act as a natural hedge against exchange rate fluctuations.

5.2.5 The Exchange Rate

The South African automotive industry remains a net user of foreign exchange (NAAMSA, 2004). It has also been established that the researched company is also a net importer. This, in essence, means that the improvement of the exchange rate has had a positive effect on the financial performance of the company.

A strong Rand exchange rate results in imports getting cheaper and exports becoming more expensive. As invoicing of vehicles takes place in foreign currency (in Euro for the researched company) the Rand value received for exports becomes less with an improved rate of exchange. See Figure 5.5 for the Rand/Euro and the Rand/Dollar exchange rate development. A strong rate of exchange does however not support the objective of the MIDP to reduce the country's trade deficit, as imports usually increase.

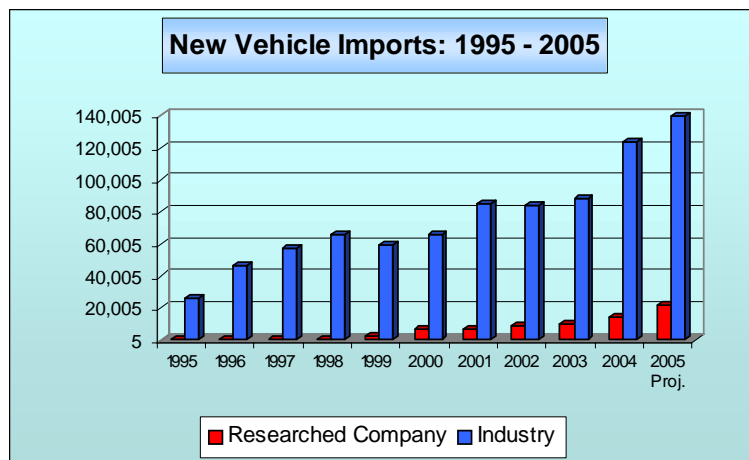
Figure 5.5: Rand/Euro and Rand/Dollar Exchange Rate Development



Source: Management Accounting Reports

The improvement of the Rand against the Euro and the Dollar has resulted in an increase of imported fully built up vehicles. The economic growth of the South African market, as well as the strong Rand has contributed to an increase in the demand for new vehicles of both domestically produced and imported vehicles (NAAMSA, 2004). (See Figure 5.6, which gives an indication of the growth of imported fully built up (FBU) vehicles). The average percentage increase of imported FBU vehicles at the researched company over the past three years is about 35%. Worth noting is the relationship between an improved exchange rate and an increase in imported FBUs.

Figure 5.6: New Vehicle Imports



Sources: NAAMSA Annual Report, 2004 & Management Accounting Reports

5.2.6 Learning Capabilities

The amount spent on training has increased fourfold from 1995 to 2005. It must however be noted that the base of the training budget in 1995 was very low. (See table 5.2 for this development). It is also important to note that all training relating to specific projects, i.e. for example the introduction of a new model, is not reported in this table.

Table 5.2: Training and Skill Development

Training and Skill Development	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 Proj.
Total R'000	3,579	3,676	2,633	3,918	8,831	9,775	14,302	12,920	13,706	15,500
% Increase		3%	-28%	49%	125%	11%	46%	-10%	6%	13%

Source: Management Accounting Reports

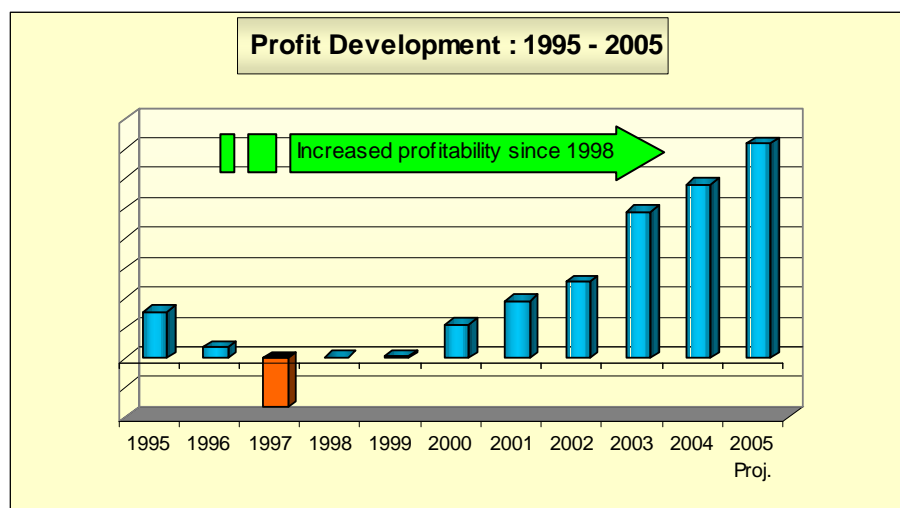
As noted by Marais (3 Nov 2005), the local automotive industry has attracted a great deal of new technology and skills (international expertise). These highly technical and

management skills are consequently transferred to the local employees, which has resulted in improved performance and an increase in employee morale. Marais (3 Nov 2005) believes that the increased levels of automation require a more highly educated and skilled employee. Employees at the researched company undertake regular visits to foreign multinationals, especially with new model introductions, to acquire the necessary skills to produce the cars locally, as well as to improve on labour productivity. Marais (3 Nov 2005) observes that investments in skill development and training have made a positive contribution to the increased levels of productivity.

5.2.7 Profitability

As noted by Marais (3 Nov 2005) and Fourie (3 Oct 2005), the MIDP has contributed significantly to the financial viability of the company. Figure 5.7 shows the profitability at the researched company over the past decade.

Figure 5.7: Profitability Development



Source: Management Accounting Reports

Please note that the researcher had been requested not to show any nominal values in the graph, but only the trend. The trend is however based on actual figures of performance. Figure 5.7 shows that there has been a significant improvement in profitability since 1998. Could this have been as a result of the MIDP? Marais (3 Nov 2005) concludes that the MIDP has most definitely contributed to the company's healthy financial performance over the past few years. All performance indicators, as discussed above, show significant improvements since 1998 when the company started competing in the international market.

5.3 Summary and Conclusion

The MIDP, as an economic policy, has been embraced by the researched company as a "vehicle" to drive corporate goals in terms of value creation for all stakeholders. It would be safe to assume that the turnaround for the company started in 1998, given the above developments. These point to: (i) increased capital expenditure; (ii) increased production volume; (iii) improved productivity development; (iv) increased vehicle exports and imports (v) and an improved profitability show that the start of the export programme was the catalyst for this significant economic value added improvement.

Chapter 6

Discussion of Results: Interview Analysis

6.1 Introduction

The strategic competitiveness and enhanced performance of the researched company has been built around the MIDP as an attractive industrial policy. As noted by Marais (3 Nov 2005) and Fourie (3 Oct 2005); the existence of the local OEM is strongly influenced by the MIDP. In fact, they believe that it would have been close to impossible to have achieved the level of economic performance if it was not for the MIDP.

The company started exporting a limited number of vehicles to the United Kingdom during 1996 and 1997. As noted by Marais (3 Nov 2005), it was a low profile strategy and was a windfall for the researched company, which came about as a result of capacity constraints experienced in Europe at that time. In essence, Europe had stopped producing a particular model whilst there was still a demand for the right hand drive model in the UK.

The researched company, having the production capacity, acted as an extended workbench for Europe by producing the vehicles locally, as maintained by Fourie (3 Oct 2005). Marais (3 Nov 2005) asserts though that the MIDP has been a significant factor in securing the export volume from an economic perspective.

Both Fourie (3 Oct 2005) and Marais (3 Nov 2005) maintain that the MIDP programme is not an incentive programme, but a self-funding scheme. The duties payable on the

importation of vehicles and/or components can be offset by using the rebates earned on the exportation of vehicles and/or components. Marais (3 Nov 2005) claims that the idea behind this self-funding scheme is that it should have no negative impact on the fiscal policy. The net effect should therefore be zero; i.e. the rebates should equalize the duties. It was thus not the intention of government to generate any revenue from the programme. Fourie (3 Oct 2005) observes that the government introduced an ad valorem fiscal duty in 1995 to recover the ± R800 million, which they had earned under the previous Phase VI programme.

6.2 Export Destination

The important question at the start of the export programme was: If capacity does become available, would it still make business sense to produce vehicles in South Africa for the export market? Fourie, (3 Oct 2005) pointed out that other market opportunities had to be explored due to the higher cost disadvantage that South African companies experience, when exporting to Europe. Apart from paying 6.5% import duties for entering the European market, South African motor manufacturers have an added cost disadvantage over foreign manufacturers, due to high inbound and outbound logistical costs.

It was therefore obvious that when the researched company started its export programme, that it benchmarked itself against manufacturers in Europe (Fourie, 3 Oct 2005). The company competed for export business (within the group) with fellow subsidiary companies in Europe. Fourie (3 Oct 2005) maintains that the cost disadvantage for the researched company, compared to the European plants, was not as significant, because

the cost structure of the European plants was not as cost effective when compared to plants in Eastern Europe.

As discussed in heading 2.3.1, the neoclassical theorists argue that through trade liberalization, countries are exposed to new markets with increased opportunities and challenges. The researched company had to investigate other market opportunities to reduce the cost disadvantage due to the 6.5% duty payable for vehicles entering the European market. As a result of the steady increase in international trade liberalization, the company started competing, within the group, against the low cost producing countries, like Asia and Eastern Europe. This fundamental change has brought about increased challenges such as to become more cost competitive. The company thus pursued a cost leadership strategy by minimizing cost to yield above average returns. (See heading 2.4.2).

The best strategy for the researched company was thus to export to markets such as Japan, the Asia Pacific region and Australia, as no duties are payable when entering those markets. This shift in market destination happened in 2003. It should be noted though that the change in strategy was also as a result of the subsequent availability of production capacity in Europe (Fourie, 3 Oct 2005).

Hit, *et al.*, (2003) maintain that companies that follow a cost leadership strategy concentrate on finding ways to lower their cost base. The degree of the cost disadvantage with regard to completely knocked down imports is dependent on the level of local material in a vehicle. Marais (3 Nov 2005) indicates that the company does not have a 100% local material content programme, and as a result, CKD material must be imported

to produce the vehicles locally. The average local material content in an export vehicle is about 45%, according to Fourie (3 Oct 2005). The imported material attracts inbound logistical costs of mainly packing and shipping costs. The duty payable is also calculated on the total imported material value and the packing cost. Marais (3 Nov 2005) maintains that the company assesses the economic viability of localizing components on an ongoing basis.

Marais (3 Nov 2005) however concludes that the benefits derived from the MIDP programme exceed the logistical cost disadvantage of about €900 per unit or R7,200 per unit at an exchange rate of Rand/Euro 8.0. He also maintains that it is also important for the researched company to prove to the group (parent company) that it makes economic sense to produce the export volume in South Africa. Fourie (3 Oct 2005) observes that there is currently more than 23 million excess vehicle capacity world wide. He further argues that if the MIDP were to be discontinued then the researched company would stop its export programme as it would not make economic sense to produce the vehicles locally, due to the high logistical cost disadvantage.

6.3 Discussion of Results

The company has shown significant improvements in quite a few areas of the business since 1998. These can be illustrated as follows:

6.3.1 Investments

The MIDP has brought about many changes in the way the company is running its business. The most significant factor is that it assisted the company to secure export

volumes, as maintained by Marais (3 Nov 2005) and Fourie (3 Oct 2005). The life cycle of vehicle models is usually between five to seven years, which means that the company is compelled to invest in new model platforms (technology) every five to seven years.

There has also been a considerable increase in foreign direct investment with regard to the local content programme. The localization of CKD imports becomes economically viable through increased volumes (economies of scale production). Marais (3 Nov 2005) argues that the increase in production volume, due to the fact that the company has expanded its business into foreign markets, resulted in higher returns on investment to the company. Marais (3 Nov 2005) further concludes that the increased level of investments in local content has resulted in a healthier local supply industry and the attraction of new technology to South Africa.

It also needs to be questioned whether the MIDP contributed towards foreign direct investments in the company? It is interesting to note that the export incentive programme in Turkey has resulted in positive export growth. (See heading 2.4.4). Marais (3 Nov 2005) claims that the MIDP has achieved its objective of promoting higher levels of exports as well as attracting significantly higher levels of foreign direct investment, compared to the period prior to the MIDP. The structuralists argue that government interventions are necessary to transform industries over time and believe that foreign assistance policies will determine the pace of change. (See heading 2.3.2). Marais (3 Nov 2005) believes that the Productive Asset Allowance (PAA) that runs until 2007 should be extended, especially given the fact that Eastern European countries offer tax incentives, such as tax holidays, to attract foreign direct investment.

It is thus an imperative that the benefits to the local automotive industry be extended in order to be competitive. It should also be noted that the Productive Asset Allowance only applies to vehicle manufacturers involved with exports. This benefit, Marais (3 Nov 2005) believes, should be extended to the supplier industry that is also involved with the exporting of components. This initiative should yield further investments and growth opportunities.

Fourie (3 Oct 2005) maintains that South African manufacturers will have to be niche players, and not volume players, if they want to fully "exploit" the benefits of the MIDP programme. He argues that the researched company does not have the production capacity to supply about two million vehicles to the world market. In fact, the company's production capacity is about 510 units per day, which equates to about 120,000 units per annum.

Fourie (3 Oct 2005) further argues that the best proposition would be to be the sole supplier of a specific niche model to world markets. He cited Toyota South Africa as meeting this challenge, with the production of about 150,000 units per annum of the Hilux commercial vehicle. Toyota has thus achieved very high levels of local content, and suppliers are able to create a return on investment due to the significant production volumes. As previously noted, there is no or little incentives for the supplier industry to invest in technology; thus volume plays a significant role in the decision to invest.

6.3.2 Employment

More jobs have been created since the researched company started exporting vehicles and components to foreign markets. However, Fourie (3 Oct 2005) argues that the increase in

the level of employment over the last two years was mainly as a result of the expanded domestic market. He maintains that exports have contributed very little to job creation over the last two years due to a stagnant world economy that has resulted in excess production capacity. He further argues that the MIDP is a value based programme, and manufacturers have thus moved away from investing in labour intensive products, such as sheet metal. Marais (3 Nov 2005) maintains that the focus is to increase productivity, which is more important. As noted in heading 2.4.2; it would thus be safe to assume that the researched company is pursuing a cost leadership strategy that also focuses on productivity improvement.

6.3.3 Productivity

The most obvious method to improve productivity would be to increase automation, which minimizes the task that employees must perform (Unknown 1, 2005). Tain-Jy and De-piao (1990) argue that more efficient operations, which can be achieved by concentrating on a narrower range of products, could lead to higher levels of productivity. Porter (in Wright, 1987) argues that higher levels of standardization would lead to economies of scale and thus improved productivity.

Marais (3 Nov 2005) asserts that the decrease in number of vehicle platforms and the increase in volume have certainly contributed to increased levels of productivity. He maintains that the cost disadvantage has been reduced due to a decrease in production cost per unit. He believes that the company has also improved its game with regard to quality as it competes against other group companies around the world, that also have the capacity, capability and technology to supply units for the export market. He maintains

that the company invests significant amounts of time and money to secure a qualitative manufacturing process.

It is thus not surprising that so much time and effort is spent on people and quality when one looks at the vision of the company of world class people, producing world class quality products for satisfied customers around the world.

6.3.4 Financial Performance

Marais (3 Nov 2005) concludes that the MIDP has contributed enormously to the financial performance of the company, even though not directly. He asserts that the benefits are a result of increased volumes, increased local content and increased productivity. The researched company has doubled its vehicle sales over the past ten years, from about 64,000 in 1998 to 134,000 in 2005. The credits earned on the exportation of vehicles allow the company to import fully built up (FBU) vehicles duty free. The contribution earned on imported FBUs has been quite significant as a result of increased volumes sold in the domestic market (see Figure 5.6, on page 78, for the development of imported FBUs) as well as a result of a strong currency. The company has shown significant improvements in profitability since 1998; the year it started its vehicle export journey. The export business contributes about 30% to the total company contribution; i.e. profits before the allocation of fixed costs. (Management Accounting Reports)

In summary, both Marais (3 Nov 2005) and Fourie (3 Oct 2005) agree that vehicle assembly/manufacturing in South Africa would not be possible without the MIDP

programme. They believe that the government has to put in place a programme that continues beyond 2012 to further stimulate the local automotive industry.

Marais (3 Nov 2005) believes that with the current growing domestic market, which is expected to be about 500,000 units this year, with some economists believing that it could grow to about 1,000,000 vehicles per annum in the near future; that the volumes should be sufficient to justify the existence of the domestic manufacturers. He has however expressed concern that if the market remains at 500,000 units per annum or reduces, which it has been doing for the last 20 years, then it would be very difficult for the motor industry to sustain itself.

The current excess production capacity internationally as well as a strong rate of exchange and an expanded domestic market have resulted in an increase in the level of fully built up (FBU) imported vehicles into South Africa. The increasing number of FBU imported vehicles, i.e. Kia, Tata, Renault, etc. pose a huge challenge to the local OEMs. Fourie (3 Oct 2005) believes that under the current circumstances, protection for the OEMs is non-existent as importers of fully built-up (FBU) vehicles can import cars into South Africa very profitably, even after paying the duties. The strong currency has negated any protection there was for the local OEMs.

It is however important to keep in mind that if the currency does weaken, that CKD production (local production) would be beneficial for the local OEMs, both from an export promotion perspective as well as selling it domestically, if it achieves at least a 40% local value added. Chenery and Srinivasen (1989) argue that a devalued currency for developing economies would be preferred, especially if the aim is to expand on exports.

Todaro (1997) further asserts that an overvalued exchange rate results in imports becoming cheaper while exports become more costly. Fourie (3 Oct 2005) believes that a significantly weak currency could mean the end of business for importers such as Kia, Renault, etc., as they will not be able to recover the cost increase through additional pricing. The fundamental strengthening of the exchange rate has therefore negated the protection local OEMs enjoyed as the duty payment on fully built-up imported vehicles under a strong currency serves as no deterrent (Fourie, 3 Oct 2005).

6.4 Summary and Conclusion

Both Marais (3 Nov 2005) and Fourie (3 Oct 2005) agree that the MIDP has indeed revolutionized the automotive industry. Exports have grown; investments in new technology have increased and the local supplier industry has shown promising growth. There has been significant economic growth in the overall automotive industry as well as an ongoing drive to increase vehicle affordability.

The effect of the MIDP on the researched company would thus be best summarized by reflecting on the positives and negatives over the past decade:

Positives:

- ✓ The company has achieved a 40% rationalization of production platforms/models;
- ✓ The company has secured export volumes of about 30,000 units annually, with an increase to 40,000 units in 2005;
- ✓ Employment levels have increased since the start of the export programme in 1998;
- ✓ Productivity has increased by an average of 6.9% per annum over the past decade;

- ✓ Investments in plant and equipment have increased substantially, especially since 2001 (this development is expected to continue, with a projected spend over the next five years of R2.6 billion);
- ✓ Increased level of investments in training and skill development;
- ✓ Motor vehicle prices have remained constant for the past two years;
- ✓ Increased profitability as a result of increased volumes and increased efficiencies.

Negatives:

- ❖ Lower than expected levels of local content;
- ❖ Increased number of fully built up (FBU) imports.

Logistic costs remain a huge cost disadvantage for the researched company as well as for all other South African OEMs. The strengthening of the Rand is adding more pressure on export business, and would thus require of the local OEMs a further improvement on efficiencies.

It would thus be safe to conclude that the overall positive performance of the company over the past decade could not have been possible if it was not for the MIDP.

Chapter 7

Recommendations

7.1 Introduction

Almost all successful cases of development over the last 50 years have been based on creative policy innovations. The most successful East Asian economies have used infant industry protection, export subsidies and local content rules to build their industrial capabilities, disciplining the process by strong export orientation. It is interesting to note that when developing countries grow their economies, they also expand their trade volumes.

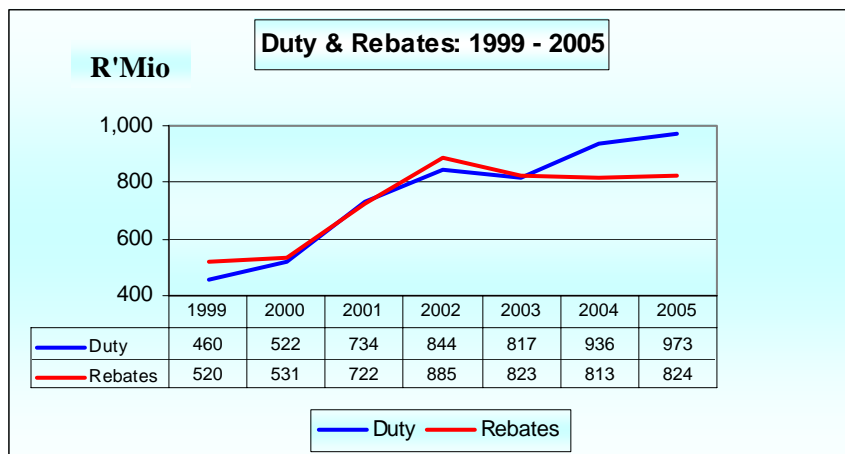
The MIDP, as a carefully selected trade policy, has been very instrumental in reviving the South African automotive industry. To successfully take the South African OEMs into the next decade of trade liberalization; it is critical that the following issues be addressed:

7.2 Import-Export Complementation

The MIDP was implemented to give local OEMs an opportunity to improve production efficiencies, in order to compete internationally. It has always been the understanding that the benefits derived from the MIDP were going to be scaled down in line with acceptable world trade requirements, as set by the World Trade Organization (WTO). The export complementation scheme was implemented to achieve this objective. Vehicle manufacturers receive 4% less rebates for every vehicle exported every year, since 2003, until it reaches a level of 70% by 2009. (See Table 3.2 on page 51 for this development).

It is interesting to note that the researched company has paid duty of R123 million in 2004 and will be paying R149 million in 2005. (See Figure 7.1 for the duty and rebate development at the researched company).

Figure 7.1: Duty & Rebate Development



Source: Management Accounting Reports

The reason for paying the duties was due to: (i) the increased number of imported vehicles; (ii) a less aggressive localization programme **and** (iii) the export complementation scheme. The company will also be paying R2.8 billion in duties over the next five years. The export complementation effect will be R600 million out of the R2.8 billion duty liability. This equates to almost the same level of investment in a new paint shop or a new vehicle model range (Fourie, 3 Oct 2005).

It is significant that the export complementation scheme was also implemented on the back of a flat South African vehicle market with no growth possibilities in the near future as well as a depreciating currency. These two fundamentals have changed completely and the outcome of this scheme is thus not aligned with the intended purpose. The intention

of the export complementation scheme was, except for the WTO requirements, that even without increasing export volumes, but with a depreciating currency, OEMs would still be on the same income level. This however has not happened; in fact the total opposite has occurred. (Fourie, 2005)

It must however be pointed out that if higher levels of investments in the local content programme at the researched company had been achieved, as well as an increase in export volume, then this negative effect on the company's profitability would have been less severe.

The government must thus guard against phasing down the import-export complementation scheme too aggressively and rapidly. Lessons learned from the textile industry should be invaluable in determining the pace of phasing down the scheme. It is a necessary process, as it would require of the South African OEMs to further improve on efficiencies and to increase export volume and thus become internationally more competitive. The flat world market, with an excess production capacity of 24 million vehicles, would however make it extremely difficult for the local OEMs to further increase export volumes. (Fourie, 2005)

It should also be noted that the South African manufacturers, with specific emphasis on the textile industry, competes against countries like China, which deliberately devalued its rate of exchange by 40% (Kipling, 2005). These kind of efforts by other countries, in pursuit of economic growth, present huge challenges for the South African manufacturers with regard to cost competitiveness.

7.3 Ad Valorem Duty

An anomaly OEMs have faced over the last three to four years was a change in the ad valorem duty calculation/formula. It has become cheaper to import a FBU vehicle compared to importing CKD for local production when a company is in a duty payable position, i.e. duty is paid in cash and not by way of a rebate credit certificate.

For example: Ad valorem duty payable on an imported vehicle, with an FOB (free on board) value of about R260,000 would be about R12,500 when paying cash, compared to R6,850 when using a rebate credit certificate. The ad valorem duty payable on CKD, to produce a similar vehicle locally, is about R7,500. Importers thus purchase excess rebate credit certificates from exporters at 100% or even at a premium to import FBUs. A fully built-up vehicle therefore becomes cheaper to import compared to producing it locally, which is in contrast with government's intention of promoting local production (Fourie, 3 Oct 2005).

It is thus recommended that the ad valorem duty calculation be revisited to align it with the objectives of the MIDP of promoting local production.

7.4 Productive Asset Allowance (PAA)

Fourie (3 Oct 2005) observes that the effectiveness of the PAA had been questioned. OEMs that invest in property, plant and equipment, with the intention of producing units for the export market, qualify for an investment incentive. However, OEMs are experiencing negative cash flows as the benefit of the incentives only start flowing to the manufacturer once the product is launched into the market.

OEMs usually start investing in a new product/model two to three years before the product is launched into the market. The 20% investment incentive of total foreign direct investment is spread over five years after the vehicle has been launched into the export market. This in essence means that you invest in year one and only receive the last portion of the 20% incentive in year seven or eight. If the investment is therefore discounted over this period and compared to the incentive payout over the five years; the benefit from the PAA is immaterial (Fourie, 3 Oct 2005).

Another drawback with the PAA is that it only applies to investments in new and unused equipment. It often happens that used machinery is purchased from other group companies to secure business locally in order to be competitive when quoting on export business. The used machinery or equipment however does not qualify for a rebate under the criteria of the MIDP; only new equipment qualifies for a rebate.

The researcher recommends that the investment incentive programme (the Productive Asset Allowance) for OEMs and component manufacturers be revisited. The productive asset allowance (PAA) should be extended beyond 2007 and a provision for accelerated depreciation on plant and machinery be granted. This would reduce the effective corporate tax rate and should appeal to current and potential future foreign investors. This proposed incentive programme could negate the logistical cost disadvantage the local OEMs are facing.

7.5 Further Rationalization

Porter (in Wright, 1987) stresses the importance of standardization, as it would lead to an increase in economies of scale production, which in turn would lead to a lower cost per unit. A study by Kwon (in Tain-Jy and De-piao, 1990) on Korean manufacturing industries has also found that economies of scale, is the main factor contributing to total factor productivity growth. Domestic production at the researched company has been rationalized by 40% since the inception of the MIDP programme in 1995, with the focus on economies of scale production for both the domestic market and international markets. The researcher however believes that further rationalization of vehicle platforms is necessary. A maximum of two platforms at the researched company is advisable to fully exploit the benefits offered by the MIDP programme.

South African OEMs need to be niche players, as indicated by Fourie (3 Oct 2005), when he cited the export business proposition of Toyota with the production of about 150,000 Hilux commercial vehicles annually. OEMs can further optimize the benefits offered by the MIDP programme by reducing the number of platforms/models, thus increasing production volumes through economies of scale. The reduction of platforms will also put less strain on capital investment requirements.

With an increasingly competitive world market, characterized by excessive production capacity; local manufacturers need to pursue further substantial improvements in operational efficiencies and world class manufacturing standards. The industry must continue to pursue options of restructuring and rationalization.

7.6 Other Challenges

7.6.1 Exchange Rate Developments and Local Inflation

The effects of a strengthening rate of exchange should also not be underestimated as imports become cheaper, which would have a negative affect on the desired increased local value added. The current level of the Rand, being relatively strong against the Euro and Dollar, has resulted in exports becoming less competitive as exporters receive less income when the currency strengthens. Local inflation has also pushed up the cost of production and the South African OEMs are unable to recover these costs through increased pricing, because of the over supply of vehicles in the international market. As mentioned in chapter 5.2.4, there has been no increase in vehicle prices over the last two years. This development has resulted in decreased contribution margins for the local manufacturers (Fourie, 3 Oct 2005).

Fourie (3 Oct 2005) asserts that the key fundamentals of a weak currency and a stagnant domestic market, which was one of the key driving forces behind the MIDP, have changed quite significantly. He maintains that local manufacturers involved with exports were assisted quite significantly in generating higher income due to a sliding/collapsing currency towards the end of the 1990s and the early 2000s. He believes that OEMs face a huge challenge to continue with the export drive, in an environment characterized by excess production capacity and a strengthening currency. It is thus critical that these variables of the programme be considered when finalizing the potential future programme.

7.6.2 Uncertainty about the Programme

Both Fourie (3 Oct 2005) and Marais (3 Nov 2005) have raised concerns about the uncertainty of the programme. The drawback of the MIDP programme is that it only gives certainty for a period of about five years. However, multinationals need certainty for a longer period (about 10-15 years) in order to make substantial strategic investment decisions. It is thus critical that certainty and clarity about the current programme and the potential future programme be reached as soon as possible. Lessons learned from the clothing and textile industry must be incorporated in the current programme and in a potential succession programme to the MIDP.

It is also important that the OEMs be represented on the board of the Department of Trade and Industry to give input and recommendations with regard to the MIDP going forward.

7.7 Recommendations for Further Research

An important field of research would be to conduct an investigation into how the OEMs can reduce the logistical cost disadvantage. Because of the geographical dislocation of the South African OEMs; an average cost disadvantage of about R7,200 per unit is incurred by the researched company, which equates to about R290 million annually if 40,000 units are to be exported. Added to the R290 million would be the duty payable on the packing cost element of the logistic costs, which is about R55 million (R290 million times 70% for packing costs times the duty rate of 27%). This shows that research into cost reduction, and specifically logistical costs reduction, would be extremely useful.

Improvements in logistical cost efficiencies would result in increased economic performance and a more internationally competitive automotive industry.

This leads to the following question: When can the industry be expected to grow up and lose its infant status? Most industry representatives argued that the “infant” industry subsidies for this sector will be required in perpetuity, as supported by Marais (3rd Nov 2005) and Fourie (3rd Oct 2005). It would thus be interesting to know what the net effect of the MIDP programme is on the South African economy, in terms of economic value added, for both government and the automotive industry.

Appendix A

Semi Structured Interview Sheet

Two separate interviews were conducted with the Strategic Finance Planning executive, with the supervisor of the MIDP department present, and the other interview was with the Financial Controller of the company. The interviews were confirmed telephonically and/or by e-mail. A clear indication of the purpose of the interviews was given to the interviewees well in advance. This has contributed to a well organized, well prepared and credible process of collecting data as it has given the interviewees sufficient time to prepare.

The researcher also made it clear that the interviews would be transcribed in order to analyze the data. Any objections hereto would however have been respected.

The following type of generic questions was sent to the interviewees. The interviews were semi-structured; i.e. fluid rather than rigid.

- ◆ Give an overview of the business operations with specific emphasis to the application of the MIDP.
- ◆ Why was it necessary for the company to embrace the MIDP?
- ◆ When did the company fully embrace the MIDP?
- ◆ How did it all start?
- ◆ How did the company respond to the MIDP?
- ◆ Has the MIDP brought about any changes?
- ◆ How did they go about making the MIDP part of their business?

- ◆ Do you believe that standards have improved as a result of this economic policy?
- ◆ What was it like before the MIDP?
- ◆ How important is the MIDP for the company?
- ◆ Has the MIDP contributed to the financial performance of the company?
- ◆ Do you think that the company could have achieved this without the MIDP?
- ◆ If so, why not?
- ◆ With the possibility of the MIDP being phased out in 2012; can the company survive/operate without it?

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