

Understanding South Africa's current account deficit: The role of foreign direct investment income*

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This article highlights the prominence of net investment income payments made to foreign direct investors in South Africa's current account deficit. After a brief history of South Africa's balance of payments, we describe several factors driving the growth of South Africa's direct investment assets and liabilities, including the roles of China and Africa as investment destinations and the relisting of major South African companies abroad. The slow accumulation of direct investment assets by South African firms before 2006, coupled with the higher returns on South Africa's direct investment liabilities, has contributed to an imbalance in the country's net FDI income, while a compositional shift in the stock of non-FDI liabilities has helped to decrease its payments to non-direct investors. If South African firms continue to invest productively abroad, net FDI income may contribute less to South Africa's current account deficit in the future. The trade deficit remains a major area of concern.

Keywords: FDI; balance of payments; investment income; current account; South Africa

1. Introduction

Since 2003 South Africa has had a growing current account deficit (–5.4 per cent of GDP in 2013) in its balance of payments (BOP) with other countries. A current account deficit is not necessarily a bad thing, especially if it is not caused by a persistent inability to compete in international markets.

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The gap in South Africa's current account is financed by a surplus on its financial account, which relies on investment inflows from abroad. A large part of these inflows consists of portfolio investments, which are short-term and therefore volatile. This much is well known. What is less well understood is what is causing the persistent current account deficit in the balance of payments.

The trade balance tends to receive the most attention in attempts to explain South Africa's current account imbalances (e.g. Draper and Freytag, 2008). Attention is also given occasionally to South Africa's investment income account (Samuel, 2013). Increasingly South Africa's current account deficit is caused by interest and dividend payments to foreign investors. However, little attempt is made to distinguish between foreign direct investors and portfolio investors in this story (Samuel, 2013). The assumption is generally made that the bulk of investment income payments made by South Africa go to portfolio investors; however, contrary to popular belief, this is not the case. Instead, since 2005,¹ payments to foreign direct investors (i.e. long-term investors) have been, by a significant margin the dominant form of investment income payment South Africa makes abroad. This form of payment has often been the immediate cause of the country's current account deficit. On a net basis, this situation is exacerbated by a dearth of direct investment income receipts earned by South African firms abroad (though this is changing). Together this has resulted in *net* foreign direct investment (FDI) income tending to be the largest single burden on South Africa's current account.

This paper shows that post-1994 net investment income payments are the main contributor to South Africa's current account deficit, at 51 per cent of the current account debits. Of this, payments on FDI dominate: on average, 40 per cent of South Africa's annual current account deficit between 2004 and 2013 was a result of net payments to foreign direct investors. During the same period, net investment income payments to non-FDI investors – consisting of portfolio investors and “other” investors (related to trade finance, interbank flows, and short- and long-term loans) – accounted for only

¹ In 2006, this situation was reversed before again reverting to the new normal.

20 of the current account deficit. It is important to highlight that the persistent decline in South Africa's net investment income position is almost entirely attributable to the growing deficit in regard to the FDI income balance. Net payments on non-FDI investment income have in fact steadily decreased (improved) since 2007. Although net FDI income payments were the single largest contributor to South Africa's current account deficit during this period, they were followed by the trade balance, which accounted for almost 16 per cent of the deficit. Current trends indicate that the net FDI income balance should improve as South Africa reaps the returns from its rapidly increasing outward FDI.

The extent to which FDI income payments are contributing to developing economies' current account deficits remains poorly understood, despite the fact that developing economies now receive more FDI than developed economies (UNCTAD, 2014). FDI income in Latin America is now the largest external liability for many economies (Ludeña, 2014). Mencinger (2008) finds similar results for new European Union (EU) member states. We show that the same is generally true for South Africa. Not much academic evidence exists on the situation in other African countries despite FDI into Africa amounting to twice its official development assistance (ODA) in 2008 (UN, 2010).

The rest of this paper proceeds as follows: Section 2 provides a brief historical overview of South Africa's balance of payments; section 3 unpacks the key argument of this paper, focusing on the development of South Africa's direct investment liabilities and assets and comparing it to developments in the country's portfolio investment position. A historical and comparative perspective on South Africa's outward and inward FDI is provided to supplement balance-of-payments figures. I highlight the role of China and Africa as investment destinations for South African firms, as well as the impact of the relisting of major South African companies abroad, especially on South Africa's direct investment liabilities. Section 4 concludes. All data used come from the South African Reserve Bank (SARB), unless stated otherwise. FDI project data based on greenfield FDI comes from the fDi Markets database of the Financial Times.

2. A brief history of South Africa's balance of payments up to the present

South Africa's BOP has three primary accounts: the current account, the financial account and the foreign exchange reserves account. We are concerned only with the first two. For our purposes, we can consider the current account as consisting of two main items: a trade balance which records all the trade that South Africa does with the rest of the world; and an investment income balance which records all investment income payments and receipts between South Africa and the rest of the world.² Current transfers³ and net compensation of employees are also listed in the current account. As this paper will show, when trying to understand a country's economic situation, treating the current account as being synonymous with the trade account leads to serious oversights.

The investment income balance ("net investment income payments") records the balance of investment income earned on various types of capital. Our focus is on direct investment income, which can be distributed as dividends, reinvested,⁴ or remain undistributed as branch profits. Hence, investment income in the BOP can be further divided into dividends, interest and branch profits (reported for FDI only).

The investment income balance is linked to the financial account, which records all investment *flows* into and out of a country by three types of foreign investors: direct (foreign direct investors), portfolio and "other". We group the latter two types of investors into a "non-FDI" category. "Other" is a residual category for recording transactions between residents and non-residents, related mainly to loans and

² In practice, one usually looks at the broader category called the 'income balance', which consists of the investment income balance + net compensation of employees, defined as compensation paid to non-resident workers or received from non-resident employers.

³ "Current transfers" refers to unilateral receipts and payments between residents and non-residents that are not related to fixed capital formation.

⁴ In practice this can simply be undistributed profits. This is why reinvested earnings can be calculated as the net operating surplus of the direct investment enterprise, plus any income or current transfers receivable, minus any income or current transfers payable.

deposits (banks).⁵ The investment income payments made and received by South Africa through its current account are the counterpart to the investment flows going into and out of its financial account.

South Africa's BOP has historically been coloured by three key trends:⁶ (i) A trade surplus supported by commodity exports: South Africa's trade balance was in deficit only eight times during the 1960–2003 period as a result of voluminous gold receipts. (ii) Substantial net investment income payments made to non-resident investors: For all but four years between 1960 and 2013, net investment income payments were the largest drag on South Africa's BOP. (iii) Political instability leading to chronic outflows (and hence shortfalls) in the financial account. Other historical studies of South Africa's BOP pay far less attention to the *net* investment income balance, despite its ongoing significance.⁷

On the basis of these three trends, we can identify two key shifts in South Africa's BOP dynamics. The first is a shift in who receives the majority of payments that South Africa makes on its investment liabilities: initially it was non-FDI investors, and now it is foreign direct investors. The year 2005 ushered in a period when, for the first time since 1972, gross investment income payments made to foreign direct investors into South Africa were larger than those made to all other foreign investors. The second major shift is a movement in South Africa's trade balance since 2004 from surplus to almost persistent deficit. The first shift is a sign of the country's return to economic health, as investors see the potential of the South African economy to provide sustained returns over the long-term. In contrast, the growing trade deficit is cause for concern.

Historically, South Africa has been subject to recurring BOP crises (Stals, 1993). Political instability has motivated investors to take their

⁵ The BoP manual of the International Monetary Fund (IMF) notes that this includes trade credits, loans (including the use of IMF credit and loans from the IMF), currency and deposits (both transferable and other), and other assets and liabilities (<https://www.imf.org/external/pubs/ft/bopman/bopman.pdf>).

⁶ The analysis that follows is based on data available in SARB (2014c).

⁷ For a somewhat different take on South Africa's BoP history, see Mohr, Botha and Inggs (1989) and Mohr (2003). Within the current account, these authors do not clearly disaggregate the trade balance and net investment income payments. They also generally see the current account as the passive (or accommodating) item in the BOP.

money out of the country and eventually divest altogether, leading to large reversals in the financial account. This also drew attention to the large payments that South Africa needed to make on its borrowing from abroad.

Using SARB data (SARB, 2014c), we can identify three distinct periods in South Africa's more recent BOP history (1960–2013).

In the first period, between 1960 and 1976, the current account was in deficit largely because of the net investment income balance, with the financial account and the trade balance taking turns in compensating for this deficit with a surplus. In the second period, 1977–1994, the key dynamic was a trade surplus driven by a boom in the gold price initially (peaking in January 1980). The trade surplus was also driven by constraints placed on the trade balance by net outflows of capital through the financial account: the trade surplus generally compensated for the substantial outflows of capital, as well as for the negative net income payments (with the debt crisis of August 1985 a notable event) (Mohr, Botha and Inggs, 1989; Mohr, 2003). Despite the political unrest, net investment income payments (driven by non-FDI payments) were the largest drag on the BOP, and not net capital flight through the financial account (which was negative between 1985 and 1993). In the third period, 2004–2013, a growing surplus on the financial account both compensated for, and facilitated, South Africa's growing current account deficit. The current account deficit was now driven foremost by a growing deficit in FDI investment income (rather than non-FDI income) and greatly aggravated by a growing trade deficit starting in 2004. The period 1994–2003 might be seen as a bridge between the second and third periods. In 1994, South Africa's first democratic election ushered in a period of positive net capital inflows into the financial account (barring in 2001 and 2003), as well as a consistent trade surplus.⁸

Looking at this narrative in more detail, we see that historically a surplus in South Africa's trade balance relied on commodity exports, in particular gold (all calculations are based on SARB, 2014c). In 1960, net gold earnings accounted for one-third of all foreign exchange earned

⁸ The net investment income balance remained persistently negative and significant during this period.

through the trade balance (including service receipts). This peaked in 1980 at 46 per cent before falling gradually to 6 per cent in 2013, as gold was replaced by platinum as the major foreign exchange earner.

Exports diversified substantially into manufacturing in the 1980s and early 1990s, but apart from motor vehicles and parts, this was largely confined to resource-based production, such as production of chemicals, paper, and iron and steel (Bell, Farrell and Cassim, 1997). Subsequently exports diversified into machinery and foodstuffs. More generally, the dependence on commodities appears to have stifled the diversification of South Africa's exports (and hence the achievement of a healthier trade balance) through "Dutch disease" type effects, such as notable appreciation of the exchange rate during the 1970s (Bell, Farrell and Cassim, 1997).

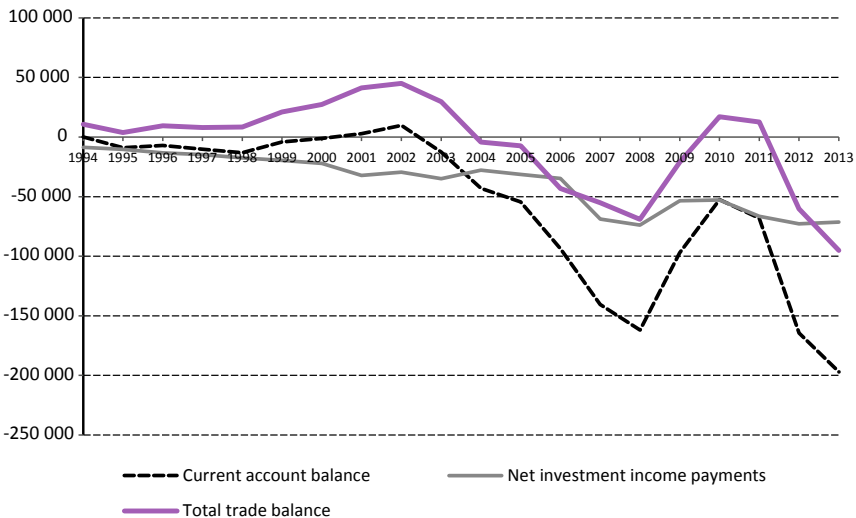
Although historically a trade surplus has been almost guaranteed for South Africa, this is no longer true. In the periods 1960–2003 and 2004–2013, the same number of annual trade deficits were recorded: eight. Historically, trade surpluses balanced the persistent deficit in the financial account arising from political instability. Between 1977 and 1993, the financial account was in permanent deficit, except for the period 1981–1984. The balance on investment income in the current account was also negative – and in fact a larger contributor to imbalances in the country's external payments than capital outflows through the financial account. This negative balance was due mostly to substantial net non-FDI income payments abroad. Net FDI flows and net "other" investment flows were, when aggregated throughout this period, strongly negative, while net portfolio flows remained positive. Net "other" flows played a particularly important role, both in providing capital and then in seeing it flee, as it records the foreign interbank lending that ballooned during this period, as well as the IMF loans to the South African government.

In fact, South Africa ran a constant deficit in its net investment income between 1960 and 2013. In the first four decades, this was caused by payments on non-FDI liabilities. But since 2000 it has been due to net payments on FDI liabilities, as South Africa has attracted greater amounts of valuable FDI while engaging in relatively less FDI abroad. This brings us to the present day.

The contributions of the main items to South Africa's current account deficit during the period 2004–2013 highlight the role of direct investment income. On average, 40 per cent of South Africa's annual current account deficit between 2004 and 2013 was a result of net payments to foreign direct investors. During the same period, net payments to non-FDI investors accounted for only 20 per cent of the current account deficit. Although net FDI income was the single largest contributor to the current account deficit during this period, it was followed by the trade balance, which accounted for nearly 16 per cent of the deficit – despite being in surplus during 2010 and 2011.

When combining all investment payments made abroad, net investment income payments were the main contributors to the current account deficit, except in 2006 and 2013. Figure 1 shows South Africa's growing current account deficit as a whole, along with the deteriorating net *total* investment income payments since 2005.

Figure 1. The balances of the current account, trade and investment income, 1994–2013
(R millions)



Source: SARB (2014c).

Note: The total trade balance equals the sum of the merchandise trade balance, the services trade balance, and the gold trade balance. Net investment income payments = FDI + non-FDI net income payments. Net current transfers are excluded.

Figure 1 graphically depicts what has been already noted several times: that net investment income was the main contributor to South Africa's current account deficit between 2004 and 2013.⁹ This is due to South Africa having more investment liabilities than investment assets. This imbalance is compounded by the fact that the returns South Africa receives on its total foreign assets are lower (by more than 2 per cent) than the yield it pays on its total foreign liabilities (SARB, 2013).¹⁰

Figure 1 shows that the balance on South Africa's current account was positive until the economy started growing more quickly in 2004.¹¹ Before 2004, the current account was buoyed by South Africa's trade surplus, which helped finance repayments on capital inflows. When the trade balance moved into deficit in 2004, such a luxury was no longer available. The trade balance appears to have been on a marked negative trend (notwithstanding the fluctuation during the financial crisis), despite increasingly favourable (non-gold) terms of trade (SARB, 2014b). If this trend continues, the trade balance may permanently become the largest drag on the current account.

3. Disaggregating the role of investment income in South Africa's current account deficit

When looking more closely at the balance on net direct investment income, one should analyse three sets of variables: assets and liabilities, the frequency with which the holders of these claims receive (or repatriate) payments; and the relative profitability of these claims. We begin by looking at the liabilities side, which represents payment obligations that South Africa has to the rest of the world.

3.1 Liabilities

In 2013, 70 per cent of the gap between the contributions to the current account deficit of the net FDI income balance and the net non-

⁹ The contribution of income payments (the largest component of which is investment income) is even greater when compensation and payments of employees is included.

¹⁰ Variables 5386K-5387K

¹¹ However, the current account begins to deteriorate from 2003 when growth was still relatively low (2.95 per cent), indicating a larger issue at play related to a change in the structure of South Africa's trade.

FDI income balance was due to differences in payments made on their respective domestic investment liabilities. The remaining shortfall (30 per cent) was due to differences in investment income receipts. The liability side is, therefore, the primary reason why South Africa makes large *net* negative FDI payments.

Between 1994 and 2013, South Africa's stock of inward FDI grew dramatically, expanding by more than 3000 per cent. Looking at its growth since 2001, after several major South African conglomerates listed abroad, its inward FDI stock still grew by a respectable 336 per cent. Nevertheless, FDI inflows trailed portfolio inflows, amounting to 63 per cent of those inflows between 1994 and 2013.

In relative terms, the growth in South Africa's stock of inward FDI has been unexceptional: its ratio of inward FDI stock to GDP has grown moderately relative to other countries of the Organization for Economic Cooperation and Development (OECD, 2014). Relative to other African countries, South Africa is receiving a shrinking share of official FDI inflows, as would be expected from the declining contribution of its GDP to the continent's output. In terms of greenfield FDI project numbers, South Africa's relative decline is not as visible: it received by far the largest number of projects destined for Africa in 2013, more than double the number for Kenya and triple that for Nigeria (Financial Times, 2014). South Africa's inward FDI stock relative to GDP is still large but not an outlier: it is higher than the 2012 OECD average and below the median (OECD, 2014).

By way of preliminaries, we now describe several key features of South Africa's growing stock of FDI liabilities, before addressing the puzzling question of why South Africa is making greater payments on its stock of FDI liabilities if its stock of non-FDI investment liabilities is larger in value.

Post-apartheid, South Africa initially attracted very low levels of FDI relative to portfolio flows (see Stals, 1998). In the 1998–2004 period this changed: South Africa's FDI liabilities grew nearly eight times more quickly than its non-FDI liabilities (albeit off a low base). This reflected the diversification of South Africa's economy towards services; the upswing of the commodity cycle, making mineral-related investments relatively more profitable; modest though notable increases in FDI inflows from China (and to a lesser extent Japan); and the relisting of

major South African companies abroad. Low global interest rates were also important: several of the most prominent investments into South Africa were mergers and acquisitions, such as de Beers being taken over by Anglo American in 2001, Barclay's Bank purchasing just over 50 per cent of Absa Bank for R33 billion in 2005, and China's largest bank, the Industrial and Commercial Bank of China (ICBC), purchasing a 20 per cent stake in Standard Bank for R36.7 billion in 2007. We look at these factors in more detail below.

Post-apartheid South Africa has been able to attract FDI into a more diverse range of sectors only in the past decade or so. In 1994, most of the country's FDI liabilities were in services. However, the inward FDI stock held in manufacturing was still larger than that held in finance, insurance and real estate (FIRE) (SARB, 1995). Few FDI liabilities were held in mining at this time. During the commodity boom in the 2000s, FDI appears to have swarmed into mining, peaking at 37 per cent of the total inward FDI stock in 2007 before falling to 25 per cent the following year as prices and equity values fell. During the boom, there was also a strong increase in the retained and reinvested earnings held by the mining sector. The largest impetus to this sector, however, would have been the relisting of Anglo American Corporation abroad. Concurrently, significant FDI was made into South Africa's banking sector, as well as into other services such as call centres, mining and business consulting, and engineering services. As a result, by 2013, FIRE and business services accounted for 40 per cent of South Africa's FDI liabilities. When other service sectors such as transport and retail are included, services accounted for 54 per cent, mining 28 per cent, and manufacturing 16.8 per cent of total inward FDI in South Africa in 2013.

An important subtheme is the slow revival of manufacturing FDI since 2001, after shrinking in absolute terms between 1995 and 2001. Between 2001 and 2013, manufacturing was in fact the largest growth sector (33 per cent), followed closely by FIRE and business services (28 per cent) and mining (27 per cent).

Another factor in the strong growth of South Africa's FDI liabilities was increased interest from Chinese investors. China held a negligible amount of direct investment assets in South Africa in 2001. By 2013, that amount had increased to 3.7 per cent of South Africa's FDI liabilities: more than the whole of Africa's investments into South Africa (3.1 per

cent), more than Japan's investments (2.2 per cent) and half of North America's (7 per cent), but still insignificant compared with Western Europe (78 per cent).¹² China plays a much more prominent role as a destination for South African FDI. However, the South African data on this relationship may not be entirely reliable (Gelb, 2010). Notable investments include those by the Industrial and Commercial Bank of China, Huawei Technologies, Sinosteel and Powerway Renewable Energy. In addition, Chinese firms have established a sizable presence in South Africa's cement and construction sector, and have made several investments in the automotive cluster.

A large part of the increase in South Africa's FDI liabilities was due to the relisting of major South African companies abroad: between 1998 and 1999, the stock of South Africa's FDI liabilities increased almost two and a half times (247 per cent).¹³ In 2000, these companies contributed roughly 7.5 per cent of South Africa's GDP (and 15.5 per cent, counting their foreign activities) (Walters and Prinsloo, 2002). After the relisting of the five major South African companies on the London Stock Exchange, the domestic subsidiaries of these (now non-resident) companies became their wholly or partly owned foreign subsidiaries. The relisting also significantly increased South Africa's foreign assets (portfolio and direct) as the holdings in these companies by South African individuals and entities were now holdings in foreign assets. In fact, as a result of the listings, South Africa's *total* foreign asset position increased by more than its total foreign liabilities position between 1997 and 2000 (Walters and Prinsloo, 2002:65).

The impact of the relistings on net *investments* flows is far more complex to disentangle, for reasons we now discuss. At the time of the relistings, corresponding capital movements in South Africa's international financial account were not recorded because the relisting represented only a reclassification of existing assets (Walters and Prinsloo, 2002:65). In the period immediately following the relisting, complex mechanisms were put in place that limited the actual flow of investment income.

¹² The United Kingdom, followed by the Netherlands, accounted for the bulk. Removing Luxembourg from the calculation does not change the shares much.

¹³ Billiton plc relisted in London earlier in 1997.

Take the case of Old Mutual, for example: It was demutualized in 1998; a new ultimate parent company (Old Mutual plc) was created and listed on the London Stock Exchange on 12 July 1999. Its shares were also traded on the Johannesburg Stock Exchange (as well as on the miniscule Malawian, Namibian and Zimbabwean stock exchanges). The South African Mutual Life Assurance Society was converted to a public company, namely Old Mutual Life Assurance Company (South Africa) Limited (OMLACSA). The latter became a wholly owned subsidiary of Old Mutual plc. Those who had been policyholders in the Society remained policyholders on the same terms in OMLACSA. They were also issued shares pro rata in the ultimate parent company, Old Mutual. The main asset of the now London-listed Old Mutual, and thus its main source of dividend income, was its wholly owned South African subsidiary, OMLACSA. But at the same time, the majority of the shareholders in Old Mutual (being the policyholders in OMLACSA) were still resident in South Africa. This means that, at least initially, when Old Mutual declared dividends to its shareholders, it would be paying those same dividends received back out to South African residents. Thus, massive flows of money would have to take place out of South Africa and then back into South Africa at particular times of the year, with potentially serious implications for currency volatility. To address these and other implications of the circular flow of dividends, the demutualization scheme incorporated a device called a dividend access trust. Portions of the locally declared dividend would be paid to and retained in this local trust, pending the declaration by Old Mutual of its own dividend to shareholders. Local shareholders in Old Mutual plc would then be paid their dividend out of the funds retained in the trust without the money never leaving the country.

The impact of these and subsequent relistings on South Africa's net capital flows (let alone its net direct investment flows) is nearly impossible to disentangle. International investors' interest in these companies grew in the period following the relisting, which saw an increase in non-resident holdings in these companies and a concomitant inflow of capital into the South African economy. As ownership of the parent company became increasingly dispersed internationally, so too did its dividend payments. As a result, the dividends received and the dividends paid by South African entities from offshore equity investments both increased between 1998 and 2001, but the gap between the two widened, increasing the deficit in the net flow of dividends. The net

position related to the London companies specifically was negative (Walters and Prinsloo, 2002:69), such that “in 2000 the net outflow of dividends related to the London listed companies amounted to R4.9 billion or 21.3 per cent of the total net payment of investment income (i.e. mostly dividend and interest payments) to non-residents”.

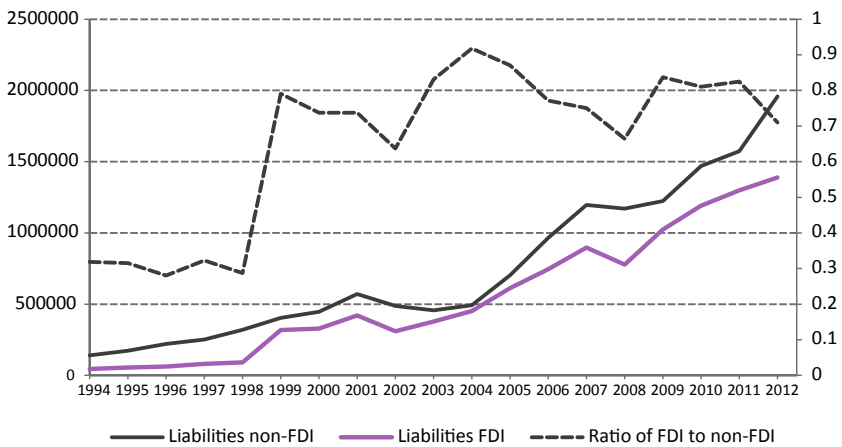
The ownership of some subsidiaries would also have changed hands over time.¹⁴ For example, Anglo America’s gold mining operations were spun off into a separate corporation, AngloGold, which merged with Ashanti Goldfields Corporation in 2004 to form AngloGold Ashanti. Anglo American reduced its stake in AngloGold Ashanti to 16.6 per cent in 2008 and then exited the company completely in 2009, selling its remaining 11.3 per cent holdings to investment funds managed by Paulson & Co Inc. The asset base of almost all the relisted companies has also expanded subsequently, making them less reliant on South African subsidiaries for income and the disbursement of profits. As a whole, control in the South African economy has become more dispersed and more international over the past decade (Makhaya and Roberts, 2014), and most major South African companies have pursued a primary or secondary listing abroad. Whereas the South African subsidiaries controlled by SABMiller, Anglo American and Old Mutual represented 36.2 per cent of the market capitalization of the Johannesburg Stock Exchange in 2002, this figure had declined to 21.4 per cent in 2012. Institutional and unallocated ownership doubled to 19.5 per cent by 2012, from 9.1 per cent in 2002. During this period, foreign control in the South African economy, even excluding a dozen major foreign companies such as Anglo American, SABMiller and Old Mutual, tripled, – to 30 per cent in 2012, up from 10.1 per cent in 2002 (Makhaya and Roberts, 2014).¹⁵ A final point is that the relistings brought South African corporate behaviour under the influence of global finance. This led to changes in how profits were distributed to shareholders (Walters and Prinsloo, 2002). The relisted firms became compelled to use their assets to reduce their cost of capital and show a return on capital in line with international norms.

¹⁴ OMLACSA is a life insurer and needs to be systemically sound. Regulatory control of who owns it would be a big factor in any change in ownership.

¹⁵ Control is assessed by McGregor’s, taking into account the various cross-holdings of shares and may be associated with a relatively small direct shareholding in any given company.

We now turn to the key fact that needs to be explained: although South Africa's FDI liabilities have grown at a reasonable pace, their total value remain smaller than the stock of non-FDI¹⁶ investment liabilities (figure 2). Moreover, the gap between the two stocks is growing. This poses a conundrum: why would South Africa be making bigger payments on its stock of FDI liabilities if its non-FDI investment liabilities are larger in value?

Figure 2. South Africa's FDI and non-FDI liabilities, 1994–2012
(Left axis: R millions; right axis: ratio of FDI to non-FDI liabilities)



Source: SARB (2014c).

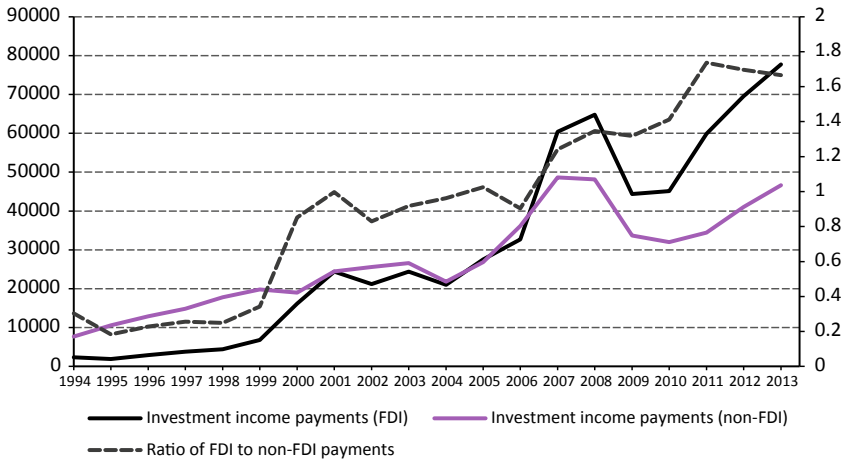
Note: Non-FDI liabilities = portfolio liabilities + other investment liabilities.

Given the substantial (and increasing) difference between the size of the two respective liability stocks, we would expect gross non-FDI income payments to be larger than gross FDI income payments. In fact, the opposite has been the case (Figure 3). In 2005, FDI income payments overtook non-FDI income payments for the first time since 1972.¹⁷ By 2013, payments made by South Africa on its FDI liabilities were 60 per cent more than the payments on its non-FDI liabilities.

¹⁶ Portfolio liabilities accounted for a little less than 80 per cent of total non-FDI liabilities in 2012.

¹⁷ This situation reversed in 2006 before continuing on its “new normal” from 2007.

Figure 3. Payments on South Africa’s FDI and non-FDI liabilities, 1994–2012
 (Left axis: R millions; right axis: ratio of FDI to non-FDI income payments)



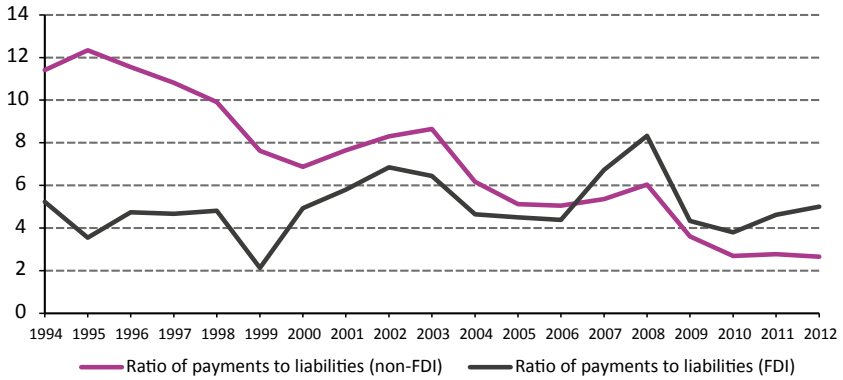
Source: SARB (2014c).

The difference between the two payments may be partly explained by a compositional shift in the stock of non-FDI liabilities (which consists of portfolio plus “other” investments). Since 2006, growth in the liabilities of “other” investments has come from long-term loans taken by the public sector as well as an expansion in the liabilities of the banking sector (SARB, 2014), including low-yielding deposits. More important, relatively speaking, non-resident portfolio investors have shifted out of South African equities and into lower-yielding (government) bonds – with the latter accounting for 78 per cent of all South African debt owned by non-resident investors in 2012. So, although at the end of 2007 the vast majority of portfolio investments into South Africa (82 per cent) were in equities, by the end of 2012, this share was down to 62 per cent (SARB, 2014).

This compositional shift is reflected in changing “payment ratios”. Figure 4 shows that there is a tendency for non-FDI payments made abroad relative to its stock to decline. An improved sovereign debt rating¹⁸ and lower domestic interest rates would have contributed to this trend.

18 This rating has now come under pressure.

Figure 4. Ratios of investment payments to FDI and non-FDI stocks, 1994–2012 (R millions)



Source: SARB (2014c).

By contrast, the proportion of FDI payments made abroad relative to the stock of liabilities has been roughly stable, with an increasing trend from 1999 to 2008. As a result, although South Africa’s stock of inward FDI has grown more slowly than the stock of its non-FDI investment liabilities, payments on the former are larger than the latter and growing.

3.2 Assets

A relative insufficiency of direct investment assets held abroad by South African firms is also a contributor to the net direct investment deficit. In 2013, 30 per cent of the gap between the contributions to the current account deficit of the net FDI income balance and the non-FDI net income balance was due to differences in receipts received from their respective investment assets abroad. This implies that greater outward FDI by South African firms and greater repatriation of profits by those firms have roles to play in improving the net FDI income balance.

Between 1994 and 2012, South Africa’s stock of outward FDI grew by less than half the rate of inward FDI. However, after 2001 its outward FDI stock grew more quickly than its inward FDI stock (440 per cent compared with 336 per cent) and even quicker than non-FDI investment assets accumulated abroad (252 per cent). This is all the more remarkable as FDI assets only began to take off in 2006, increasing

over two and a half times more than FDI liabilities (231 per cent versus 86 per cent) since then.

Despite the significant expansion in outward FDI since 2006, South Africa's FDI assets are not particularly large. Relative to the 2012 OECD average and median, South Africa has a lower level of outward FDI stock to GDP (OECD, 2014). This trend is still noteworthy given that overseas investments by South African firms were limited for many years before 1994, and even after 1994 considerable exchange control restrictions were in place on outward FDI, especially until 2004 (SARB, 2014a: C5). Before 2007, more relaxed regulations applied only to outward FDI projects that had a controlling stake (50 per cent + 1) in the foreign entity (for investments outside the Common Monetary Area). The requirement was lowered to 25 per cent in 2007. Only after 2008 was the minimum investment share requirement dropped to 10 per cent.

I now describe the growth in South Africa's outward FDI assets in more detail before comparing it with the growth in its non-FDI investment assets.

After the relaxation of sanctions and the liberalization of outward FDI, South African firms expanded abroad, especially into Africa (UNCTAD, 2005). Until 1998, South Africa's FDI assets matched, and even surpassed, its FDI liabilities.¹⁹ This achievement was assisted by the lack of restrictions on investments in the Common Monetary Area countries (Lesotho, Namibia and Swaziland) (UNCTAD, 2005), and by the far lower restrictions on the size of investments into the South African Development Community (SADC) countries (SARB, 2014a). During the period 1994–2004, roughly 22 per cent of FDI flows received by the SADC came from South Africa (UNCTAD, 2005).²⁰ As a result, the proportion of African countries in South Africa's outward direct investment assets doubled between 1994 and 2004, from 5 per cent to nearly 11 per cent. The relisting of major South African companies abroad between 1999 and 2000 appears to also have significantly reoriented South Africa's FDI assets towards the United Kingdom.

¹⁹ Between 1994 and 1999 (inclusive), South Africa's FDI financial outflows (through the financial account) exceeded its inflows for all but one year.

²⁰ Underlying source is the Business Map Foundation database of announced FDI (millions of dollars).

The limited size of South Africa's domestic market means that outward FDI was always going to be a necessary part of the expansion strategies of its larger firms. The burst in outward FDI should have assisted these firms in expanding domestically and elsewhere: more productive firms tended to invest abroad and in turn received the opportunity to further enhance their competitiveness through economies of scale and new complementary assets.²¹

Despite these benefits, the push to invest abroad appears to have slowed notably in the 2000s. Between 2000 and 2005 (inclusive) South Africa's stock of FDI assets abroad shrank by 5 per cent. Significant restructuring of corporate holdings took place during this period. For example, the major diamond producer De Beers went private in 2001, delisting from the Johannesburg Stock Exchange. This had a complex impact on South Africa's net direct investment position (see South African Competition Tribunal, 2001).

Beginning in 2006, we see a key shift: South African firms engaged in outward FDI at a significantly more rapid rate. Between 2005 and 2012, South Africa's FDI assets increase nearly fourfold, the two most important destinations being China and Africa (figures 5 and 6), though Eastern Europe also played a growing role, accounting for roughly 2.5 per cent of South Africa's outward FDI stock in 2013. The share of assets held in Western Europe dropped by more than half, from 78 per cent in 2001 to 34 per cent in 2013.

It is, however, difficult to obtain accurate bilateral statistics on FDI between China and South Africa. Gelb (2010) argues that SARB data underestimates the Chinese FDI stock in South Africa but overestimates South African FDI in China.

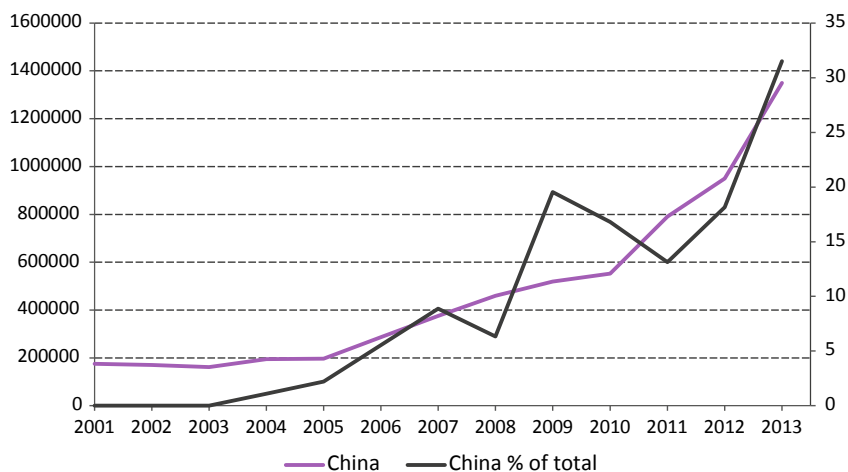
FDI into China by South African firms showed little movement before 2004, after which it steadily increased, from 8 per cent of outward FDI stock in 2007 to 18 per cent in 2012. It then jumped to 31.5 per cent in 2013. This jump may be due to a large investment or omissions in the sampling frame used by SARB in its survey method (Gelb, 2010:6).²²

²¹ However, weak domestic growth prospects in South Africa (real or perceived) mean that expansions abroad may occasionally substitute for domestic expansions.

²² As Gelb (2010:6) notes, "this is likely to be a particular problem for source countries with a relatively large number of new entrants each year relative to firms already present, such as China in South Africa".

Figure 5. South Africa's FDI assets in China, 1994–2012

(Left axis: R millions; right axis: FDI assets in China as per cent of total)

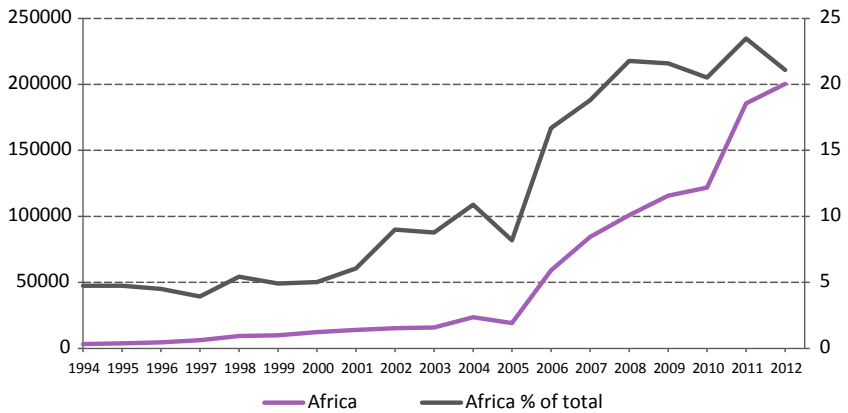


Source: SARB (2014c).

The fDi Markets database of the *Financial Times* indicates that South African firms are mainly, but not exclusively, investing in the mineral sector in China, though the database's coverage is very uneven. Sasol has undertaken half a dozen or more investment projects in China, while De Beers and SRK Consulting (mining) all have made more than one. Two major non-mining firms of South African origin, Naspers and SABMiller, also have a considerable presence in China. SABMiller, then South African Breweries, entered China in 1994 through a partnership with China Resources Enterprise. It is now the largest brewer in China, according to its website. Richemont was another major South African investor in China from early on, acquiring a controlling stake in Shanghai Tang in 1998 (headquartered in Hong Kong, China). Exxaro entered in 1994 to establish port facilities, in order to upload iron ore from its South African activities (Gelb, 2010).

The other major area of expansion for South African firms has been in Africa. Figure 6 shows that although the value of South Africa's direct investment assets held in Africa increased by 280 per cent between 1994 and 2000, all of the net relative increase occurs only after 2000.

Figure 6. South Africa's FDI assets in Africa, 1994–2012
 (Left axis: R millions; right axis: African FDI assets as per cent of total)



Source: SARB (2014c).

The proportion of African countries in South Africa's outward direct investment assets nearly doubled again between 2004 and 2012, from almost 11 per cent to 21 per cent (SARB, 2005, 2014), before declining to 17 per cent in 2013. In particular, between 2005 and 2006, the proportion of South Africa's FDI assets held in Africa doubled, owing to a 10-fold increase in assets held in Mauritius and a doubling of assets held in "other".²³ These investments into Mauritius were concentrated in the information technology and business process outsourcing (IT/BPO) services sector (Draper et al., 2010). They appear not to be used by the companies to route FDI back into South Africa.²⁴ However, in other instances this may be the case, motivated by Mauritius's favourable tax treaties and regulations. As of 2008, the largest South African affiliate in Mauritius was in fact a subsidiary of the European multinational, Munich Re, called Munich Mauritius Reinsurance Company (Draper et al., 2010). A recent review of South Africa's tax system notes that South African investors have clearly used Mauritius as a vehicle for

²³ All African countries apart from Botswana, Lesotho, Mauritius, Mozambique, Namibia, Nigeria, Swaziland and Zimbabwe.

²⁴ By 2014, 23 per cent of South Africa's "African" FDI liabilities (R10.510 billion) were held by "Mauritian" firms (SARB, 2015). South Africa was the third largest (cumulative) foreign direct investor in Mauritius as of 2012, surpassed in 2013 by France and China. Online: <http://www.investmauritius.com/newsletter/2014/march/article4.html>.

investing in other countries with which Mauritius has favourable tax treaties, including in Africa (Davis Tax Committee, 2015:41–52). By 2012, four of 17 global funds listed on the Stock Exchange of Mauritius had been established to finance projects developed in Africa (Board of Investment Mauritius, 2012).

Returning to the issue of South Africa’s surge in FDI into Africa, greenfield FDI data confirm this trend, despite distortions arising from the country’s FDI into Mauritius. Looking at project numbers and capital expenditure, greenfield investments into Africa by South African firms almost doubled between 2003 and 2013 with noticeable increases after 2005: 63 per cent of South Africa’s greenfield FDI projects and 85 per cent of its capital expenditure went into Africa in 2013, compared with 38 per cent of projects and 48 per cent of capital in 2003 (Financial Times, 2014).²⁵ By 2013, South Africa was the second largest investor in Africa by greenfield project numbers when one removes investments from abroad into South Africa itself. This coincided with an uptick in intra-African FDI on the continent as a whole (Krüger and Strauss, 2015).

South African direct investors have been accumulating far fewer direct investment assets abroad than non-resident direct investors have been accumulating in South Africa (Figure 7). Income receipts from the country’s outward direct investments have been unable to compensate for the outflow of income payments.

An imbalance between inward and outward FDI is not necessarily a bad thing for a developing economy. However, in order to ensure that inward FDI can over time relax the BOP constraint it needs to assist in expanding exports and improving the capabilities of domestic enterprises.

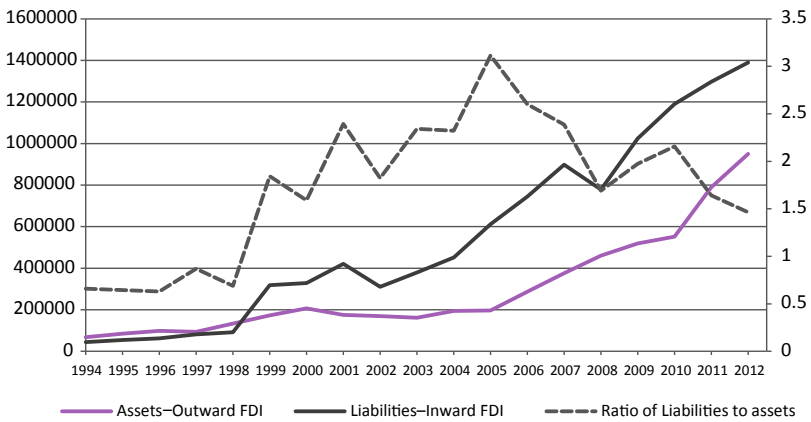
In contrast to the situation with outward FDI flows, South African residents have managed to consistently accumulate both *portfolio* assets (where a narrowing deficit exists) and “other” investment assets (where a growing and sizable surplus exists).²⁶ As a result, the non-FDI assets accumulated abroad have broadly tracked the non-

²⁵ These figures are exaggerated because of the fDi Markets database’s poor coverage of FDI investments between China and Africa, including South Africa.

²⁶ Portfolio assets accounted for a little less than 63 per cent of total non-FDI assets in 2012. “Other” investment assets accounted for the remainder.

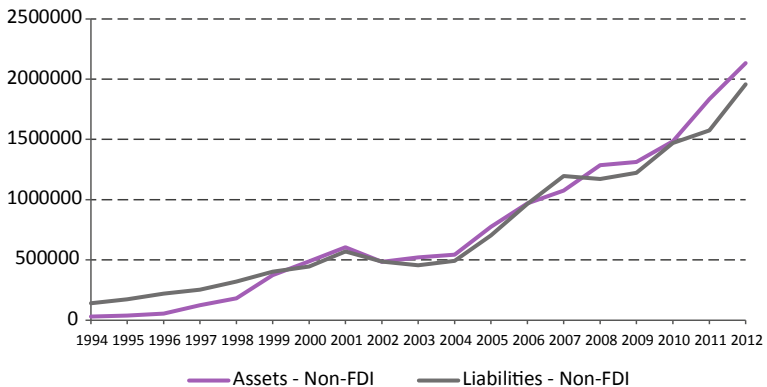
FDI liabilities accumulated by non-residents in South Africa (Figure 8). This has guaranteed a steady inflow of non-FDI income receipts for South Africa and has been crucial in helping to balance net non-FDI investment income in the current account. The gradual (and then sudden) depreciation of the rand meant that external portfolio assets (and income) increased considerably in rand terms during much of this period.

Figure 7. South Africa's FDI assets and liabilities, 1994–2012
(Left axis: R millions; right axis: ratio of FDI liabilities to assets)



Source: SARB (2014c).

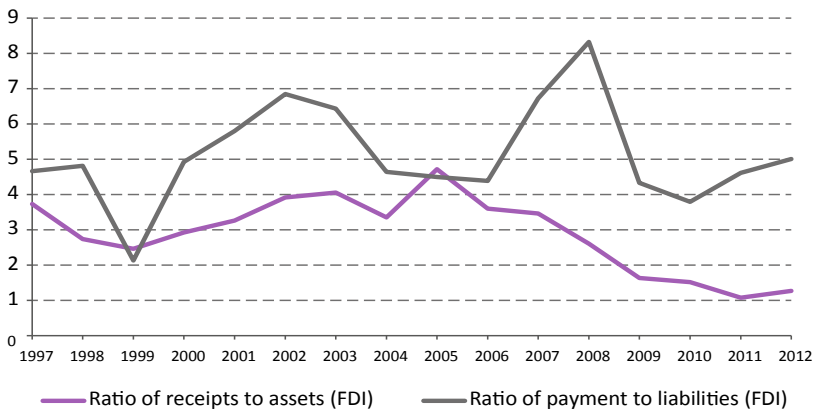
Figure 8. South Africans' non-FDI assets and liabilities, 1994–2012
(R millions)



Source: SARB (2014c).

Again, what is peculiar is that the increase in FDI assets abroad since 2006 has not yet decreased the net contribution of FDI income to the current account deficit. This is because the payment ratio of investment receipts received by South African firms on their direct investment assets has undergone a change downwards (Figure 9). Furthermore, in 2007 and 2008, direct investors into South Africa received a much larger portion of investment income than usual. The sudden depreciation of the rand in the second half of 2008 (or its expectation) may have played a part in these movements.

Figure 9. Returns on investment for South Africa’s FDI assets and liabilities, 1994–2012
(R millions)



Source: SARB (2014c).

The implication of this situation is that South Africa’s BOP should improve in the future if its firms, which have now accumulated a fair amount of direct investments abroad, begin to return a greater portion of earnings on equity back home.

3.3 Combining the liabilities and asset sides

The continued imbalance between South Africa’s FDI assets and its much greater FDI liabilities has created a deficit in net investment income on FDI. This situation is aggravated by the return on South Africa’s direct investment assets being on the order of 2 per cent

lower than the return on its direct investment liabilities.²⁷ As a result, investment income receipts from the country's outward FDI have been far lower than receipts from its non-FDI positions (Figure 10) – even though the gap has stabilized since 2006 and even declined somewhat.

Figure 10. The gap between FDI and non-FDI income, 1994–2012
(Left axis: R millions; right axis: ratio of non-FDI to FDI income receipts)



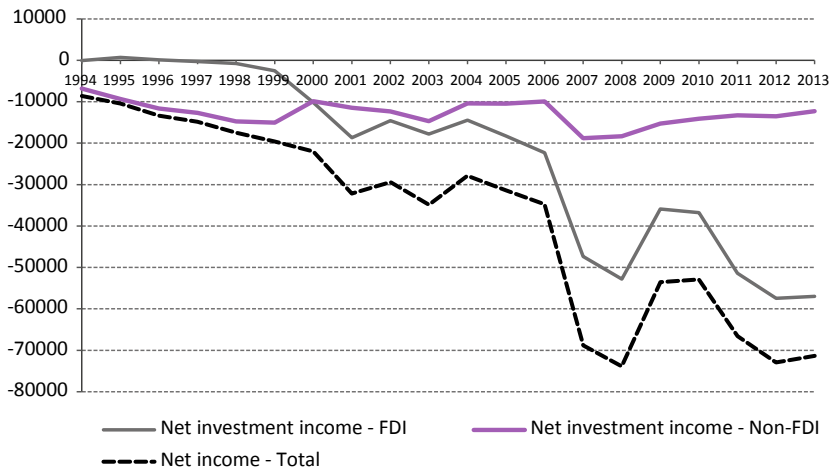
Source: SARB (2014c).

FDI income may contribute less to the current account deficit in the future if current trends continue. The rate of growth of FDI liabilities has been on a noted downward trend since 2009, while the growth in FDI assets has picked up again after falling to a low in 2010.

Combining the asset and liability sides, Figure 11 shows that South Africa's *net* investment income payments position is negative when it comes to both non-FDI and FDI payments. However, the deficit on net FDI income payments is by far the larger of the two. Furthermore, the persistent deterioration in the total net investment income position is almost entirely attributable to the growing deficit with regard to the FDI income balance; net payments on non-FDI income have in fact steadily decreased since 2007.

²⁷ Calculated as annual FDI income for year t divided by the average of the final FDI positions for years t and $t - 1$.

Figure 11. South Africa's net investment income, 1994–2013
(R millions)



Source: SARB (2014c), seasonally adjusted. Total income balance includes balance on FDI and non-FDI investment income, as well as net compensation of employees.

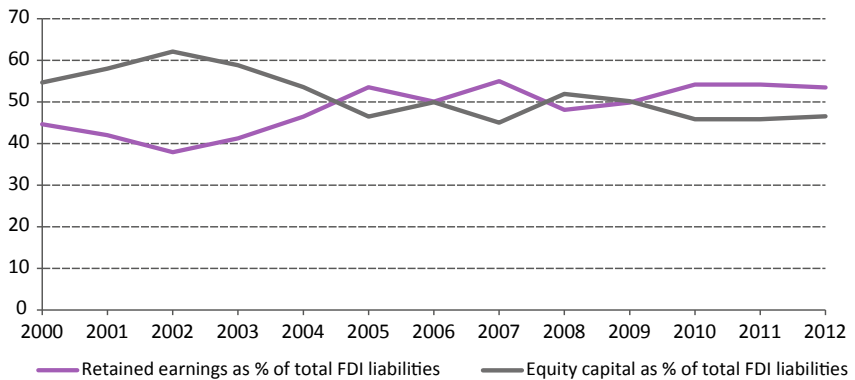
3.4 Should policymakers be concerned?

First, when retained earnings are recorded in the BOP, FDI income outflows through the current account will, by definition, be covered by corresponding imputed FDI capital inflows into the financial account and so pose no immediate threat to the sustainability of any current account deficit. Nevertheless, this may still artificially inflate the size of a country's current account deficit. But this is not the case for South Africa. SARB does not include reinvested earnings in the current or financial accounts of the BOP. Reinvested earnings are included only in the stock levels of South Africa's International Investment Position (IIP).²⁸

In general, retained earnings constitute an important part of FDI in developing-economy hosts (UNCTAD, 2013:34). This is also true for South Africa. Figure 12 shows that about 50 per cent or more of South Africa's inward FDI liabilities consist of retained earnings, but this is not entirely relevant for the deficit in South Africa's investment income discussed in this paper.

²⁸ For emerging markets that do record reinvested earnings in line with IMF recommendations, this may be a significant issue and the primary contributor to the perceived lack of sustainability of their current account deficits.

Figure 12. The shares of equity and retained earnings in South African FDI liabilities, 2000–2012
(Per cent of total FDI liabilities)



Source: SARB (2002, 2007, 2014).

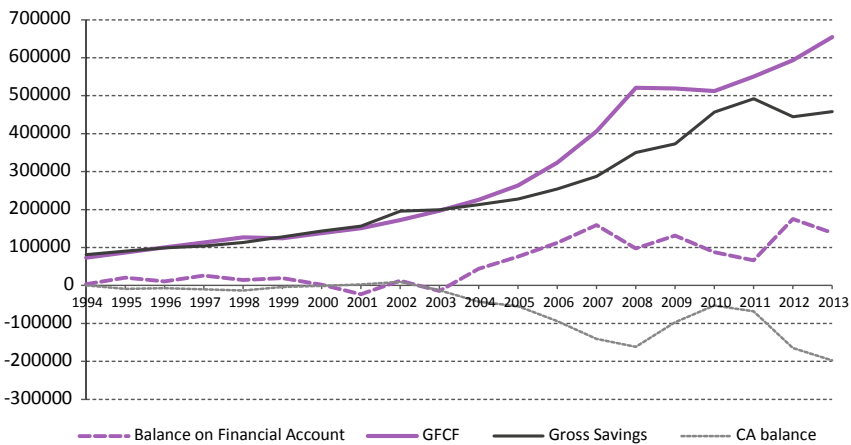
Note: In retained (“reinvested”) earnings I include short- and long-term FDI capital.

Second, FDI has a number of additional benefits for an economy, which need to be taken into account when evaluating its cost to the current account. FDI can enhance a country’s ability to export competitively and thus achieve a sustainable balance in foreign trade. Whether the so-called negative “direct effects” of FDI on the income account outweigh the positive “indirect effects” on the trade balance in any specific instance remains a matter for further exploration (Mencinger, n.d.). Inward FDI flows could positively affect South Africa’s trade balance, through both direct means (setting up entities that are net exporters), and indirect means such as technology and knowledge spillovers to local firms and workers, increased demand for domestic inputs, and reductions in input costs through competition. These benefits often need to be drawn out from investments, given their propensity to procure inputs and technology from abroad.

Third, in an intertemporal framework (often associated with “consumption smoothing”) financial inflows provide access to funds not only to meet present demand but to alleviate savings imbalances in the future by raising the rate of investment. Therefore, a current account deficit, reflecting an imbalance between savings and investments, may not be a bad thing if it assists a country in raising its investment rate over the long term above what it would have been absent the deficit.

In South Africa's case, gross fixed capital formation (GFCF) has, since 2004, overtaken savings (Figure 13). This shift was enabled or driven by the growing current account deficit, and more specifically the surplus on the financial account. As a percentage of GDP, GFCF rose from 16 per cent in 2004 to a peak of 23 per cent in 2008, before falling to 19 per cent in 2013 (SARB, 2014c). We cannot, however, easily isolate the effect of the FDI inflows from the other flows into South Africa's financial account.

Figure 13. South Africa's saving-investment gap, 1994–2012
(R millions)



Source: SARB (2014c).

If the increase in investment leads to sustained increases in domestic output and productivity growth, then it will reduce the burden on the financial account over time. We know that part of the investment boom was in construction, a chunk of which was related to South Africa's hosting of the Soccer World Cup. Construction as a percentage of investment increased from 16 per cent in 2006 to 28 per cent in 2013 (down from 31 per cent in 2009). Part of these investments would have improved output and economy-wide efficiency (public infrastructure) while other investments may not have (soccer stadiums).

The underlying question remains how to improve the effect of inward FDI on South Africa's current account. Doing so requires creating a greater scope for the productive reinvestment of FDI (and other) earnings domestically. The less the scope for reinvestment of earnings

domestically, the greater the tendency for earnings to flow out and for investments by domestic and foreign direct investors to favour foreign markets.

4. Conclusion

The alternative to encouraging FDI inflows offers no way out of South Africa's growing current account deficit. In principle, local economic development through FDI inflows adds to locally generated surpluses, which are then available both for domestic investment and for investments abroad – which in turn produces additional FDI income inflows. If the rate of local development in South Africa is faster than elsewhere, there will be an overall rebalancing tendency.

Taking advantage of foreign capital to transform how South Africa grows is vital, as without a different pattern of growth, simply more of it – while necessary – may be insufficient to alleviate the present BOP constraints. So although FDI inflows currently present a challenge to South Africa's BOP, over the long term they provide the country with perhaps the best opportunity through which to alleviate its external imbalances. That they have the potential to do so does not mean that, if left to their own devices, they will.

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