

SOME IMPACTS OF SOUTH AFRICAN FDI FLOWS ON THE CURRENT ACCOUNT BALANCE

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Abstract

There has been a significant surge in capital flows to emerging market economies over the last decade. This paper analyses South Africa's experience with FDI flows. The paper highlights the South African experience in an international comparative context. The results indicate that South Africa has performed below-par (on-par) with comparator countries in terms of FDI inflows (outflows). Since 2004, the South African economy has become increasingly dependent on capital inflows to finance the widening current account deficit. While FDI inflows have been much smaller than portfolio flows, net dividend payments on FDI flows (non-fdi flows) made up 36 per cent (15 per cent) of the current account deficit for the period 2004 to 2012. Unless there is a significant rise (decline) in the exports (imports) of goods and services, the South African economy will be dependent on foreign capital inflows to offset the investment income repayments and the current account deficit. The policy challenge is to promote FDI that enhances exports production and economic growth. In this regard, the nature of the FDI, the manner in which it is funded and the impact on the current account and economic growth are important characteristics that warrant special attention when devising policies to promote FDI inflows.

1 Introduction

There has been a significant surge of capital flows to emerging market economies over the last decade. While capital inflows give access to foreign savings and can have a positive impact on financial development and economic growth, it can also pose major challenges for policymakers. The consensus is that capital flows should be carefully managed to prevent the economy from overheating, losing competitiveness and increasing the vulnerability to swings in capital flows. The

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conventional wisdom is that foreign direct investment (FDI) inflows are preferable to other forms of investment given that these entail investments in “building” and “equipment” and hence are longer lasting and more productive given the increased potential for positive economic spill-over effects.

This paper analyses South Africa’s experience with FDI flows. The paper is structured as follows. The next section provides a brief and selected overview of the empirical research on FDI flows. Section 3 gives an overview of South Africa’s experience with capital flows while a comparative analysis of South Africa’s FDI flows is undertaken in Section 4. The penultimate section analyses the impact of FDI flows on the current account balance. Some implications and conclusions are drawn in the last section.

2 Brief review of the empirical research on FDI flows

Over the past decade there has been a significant increase in the empirical research on the nature of FDI flows and the impact of FDI flows on macroeconomic outcomes. Kurihara (2012) finds that some of the main determinants of FDI inflows for a group of ASEAN (Association of Southeast Asian Nations) countries are economic growth, domestic prices and foreign prices. While the impact of FDI on economic growth has attracted much attention in the empirical literature, the results are mixed. Some studies (Ashgar, Nasreem and Rehman, 2012) found a positive cointegrated relationship between FDI and economic growth for some Asian countries. However, another study on Pakistan (Marasco, 2008) found that it is not FDI as such, but economic integration with other countries in general, that determines domestic growth prospects.

The globalisation of value chains has resulted in MNE’s locating their stages of production across different countries and also increased the share of inputs being sourced globally. With the emergence of fragmented and increasingly more pervasive value chains, the competition between developing nations to attract FDI have also increased. While developing economies, as a result of their underlying fundamentals and resource endowments, have a high potential to attract FDI, many still attract “below par” FDI flows (UNCTAD, 2012). Competitiveness, political and economic stability, institutional development and tax regimes of host countries have, *inter alia*, been cited as some of the main factors having a bearing on FDI flows (Kayam, 2009). As far as tax incentives are concerned, an aggressive FDI orientated tax structure could also contribute to depressed tax revenues for host country governments (Gropp and Kostial, 2000).

Research has also shown that the type of FDI and the mode of entry can also have a bearing on macroeconomic outcomes in the host countries. It is generally accepted that greenfield investments are preferable to mergers and acquisitions (M&A’s) (Nocke & Yeaple, 2007: 336-365). However, the choice of entry mode is influenced by country, industry and firm-specific factors. Thus, policy should also give attention to institutional, legal and macroeconomic developments in order to

attract FDI inflows. In general, firms base their type of FDI on their capabilities and hence policy should be orientated toward the specific FDI that is desired (Wei, Lui & Lui, 2004 and Nocke et al, 2007: 336-365).

The effect of FDI flows on host country balance of payments has attracted attention in policy and academic circles in recent times. In this regard the increase in FDI inflows and its impact on the current account through income payments have been given particular attention. While FDI can have a positive impact on the balance of payments (Hossain, 2008), inflows could also put a strain on the balance of payments through increased dividend and interest payments (Mencinger, 2009: 5-7). However, there is also the likelihood that FDI could become a channel for capital flight from poor resourced developing countries without positive compensating spill-over effects occurring (Kapoor, 2009).

3. An overview of South Africa's experience with capital flows

Figure 1 depicts the net capital flows and the current account deficit expressed as a ratio of GDP for the period 1980 to 2012.¹ Following the debt crisis and the intensification of sanctions in the mid-1980s, there was a net outflow of capital from South Africa for much of the decade preceding the advent to democracy in 1994. In essence, this forced the country to maintain a surplus on the current account in order to limit the constraint on domestic growth. The transition to democracy in April 1994 and the liberalisation of the capital account in 1995 led to an increase in net capital inflows. These inflows provided adequate support for the current account deficit which began to increase quite significantly since 2003.

Per cent

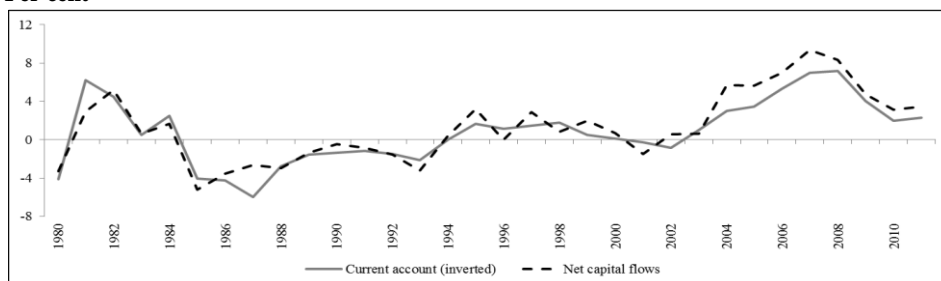


Figure 1: Net capital flows into SA (% of GDP)

Source: SARB

According to the national income accounting identity, the current account balance is equal to the difference between domestic saving and domestic investment. In

¹ The current account deficit ratio has been inverted such that a positive value represents a deficit while a negative value represents a surplus.

other words, the current account deficit reflects the shortfall in domestic savings to meet the investment needs of the economy. South Africa's low savings rate has in effect meant that domestic gross fixed capital investment has become increasingly reliant on international capital (see Figure 2). Between 2003 and 2010 South Africa's average savings rate as a percentage of GDP amounted to 15,2 per cent which was significantly below the global average of 21,2 per cent.

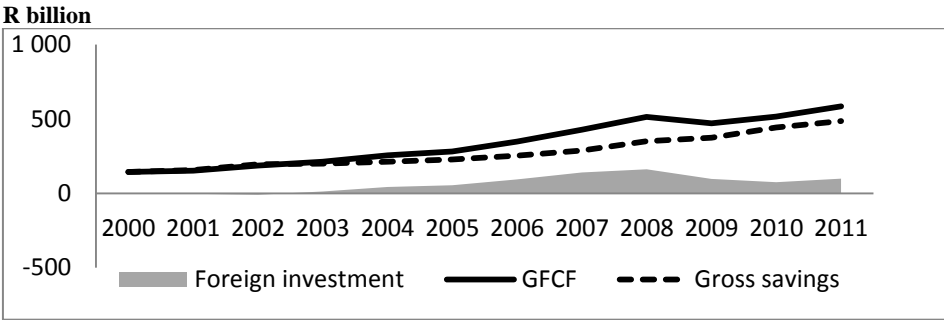
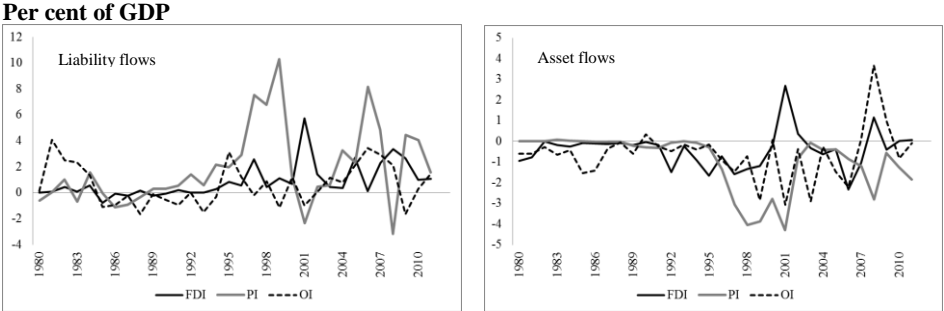


Figure 2: Financing South Africa's gross fixed capital formation

Source: SARB

Capital flows are classified under investment flows, portfolio flows and "other" investment flows. Investment flows refer to FDI including equity flows and capital flows covering at least a 10 per cent ownership of the enterprise. Portfolio investment entails investment in debt and equity securities while "other" investment includes trade finance, loans, currency and deposits at banks. Figure 3 depicts South Africa's gross capital flows by asset class. In general since 1994, gross flows have been dominated by portfolio inflows and portfolio outflows.²



Source: SARB

Figure 3: Liability and Asset Flows

² Inflows are depicted as liabilities and outflows as assets in the financial account of the balance of payments.

FDI inflows have increased since the mid-1990s but these flows have tended to be relatively smaller than portfolio inflows. For example, portfolio inflows (liabilities) as a ratio of GDP has averaged 3,1 per cent as compared to 1,5 per cent for FDI for the period 1994 to 2012. On the asset side, for the same period, portfolio outflows (1,65 per cent) were approximately three times higher than FDI (0,5 per cent).

The situation is somewhat different if one considers stock positions. While gross flows have increased significantly portfolio liability stock (R1,5 trillion) was very similar to FDI stock (R1,4 trillion) at the end of 2012. On the asset side however, the significant rise in portfolio acquisitions since 2004 has meant that portfolio asset stock (R1,4 trillion) was almost 50 per cent higher than FDI asset stock (R950 billion) at the end of 2012. Assets exceed liabilities for “other investment” with liabilities totalling approximately R775 billion and liabilities R414 billion.

R billions

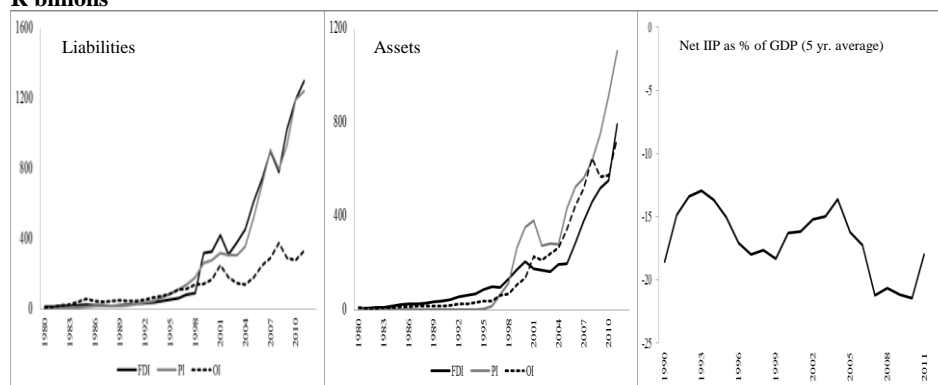


Figure 4: South Africa’s asset and liability stock position and net international investment position

Source: SARB

It is important to bear in mind that these stock positions have a direct bearing on the developments in the current account. There has been a deterioration in the country’s net international investment position since the mid-2000s (Figure 4 right-hand panel). This has meant that net dividend and interest payments have been an important contributor to the current account deficit through its impact on the income account of the balance of payments. This is an issue that is addressed more fully in Section 5.

4. South African FDI flows in an international comparative context

How has South Africa’s experience of FDI flows compared with those of other countries? A “peer” group of countries are identified on the basis of their long-term

credit ratings.³ Ratings indicate a relative credit risk and have become an important metric by which international investors allocate investment funds. Throughout the period under review South Africa had a BBB investment grade rating.⁴ Sixteen comparator countries were identified for the years 2000, 2005 and 2010.⁵

Figure 5 depicts the DI flows for the group during the period 2000 to 2011. South Africa has persistently recorded lower inflows of FDI as a percentage of GDP compared to the comparator countries (Figure 5, top panel). There were only two years within the review period that South Africa barely penetrated the inter-quartile range of the comparator group. In 2008, against the backdrop of global FDI inflows recording their second largest annual level of US\$1,7 trillion, South Africa experienced record FDI inflows of approximately US\$12 billion.⁶ However, despite the record inflows, South Africa's inward FDI flows as a ratio of GDP of 3,3 per cent was still considerably lower than the average of 5,9 per cent for the comparator group. In 2009, a similar situation prevailed with South Africa's FDI ratio of 1,9 per cent edging closer to the inter-quartile region but still significantly lower than the comparator group average of 3,1 per cent.

South Africa's poor record in attracting FDI inflows is particularly disappointing especially in light of the commodity price boom and South Africa's commodity endowment. Of interest however, is that South Africa's outward FDI as a percentage of GDP tended to move in sync with that of the comparator countries, particularly in the pre-crisis period (Figure 5, bottom panel). Between 2003 and 2007, South Africa's outward FDI remained within the interquartile range and even edged toward the top end of the range in 2006. This was mainly due to the concerted drive by South African multinational enterprises to increase their presence on the African continent.⁷

There were however, periods of large swings in South Africa's outward FDI flows with the outward FDI to GDP ratio ranging between 2,3 per cent and negative 1,1 per cent between 2006 and 2008.⁸ The general observation from the gross inward and outward FDI flow data is that South Africa's attraction of inward FDI trends

³ Fitch credit ratings were used in the identification of the comparator countries.

⁴ BBB is deemed a good credit quality rating with a low default risk. The capacity for payment of financial commitments is considered adequate but adverse economic conditions are more likely to impair this capacity.

⁵ Where necessary, countries with a credit rating of one level higher than that of South Africa were included in the group to ensure that there were 16 comparator countries in the sample for the entire period. In effect, what this meant was that while the sample was not fixed, the rolling cross-sectional panel meant that the countries in the group for every year had credit ratings similar to those of South Africa for the entire period. Credit ratings are fluid and reflective of changing economic outcomes and prospects. If the credit rating of a specific year was used to identify the comparator countries the group would not have been uniform since only five countries were in the group for the entire period (see Annex 1).

⁶ Global inflows in 2008 were marginally lower than US\$ 1,9 trillion recorded in 2007.

⁷ The 2006 spike was largely due to a South African MNE strategically focusing its outward drive into Africa and the Middle East.

⁸ The reversal of inflows in 2008 was mainly due to a significant unbundling transaction by a large South African MNE and coincided with the general downward trend of outward FDI in the comparator countries.

are lower than that of the comparator countries while its outward FDI flows are much more in line with that of the comparator countries.

R billions

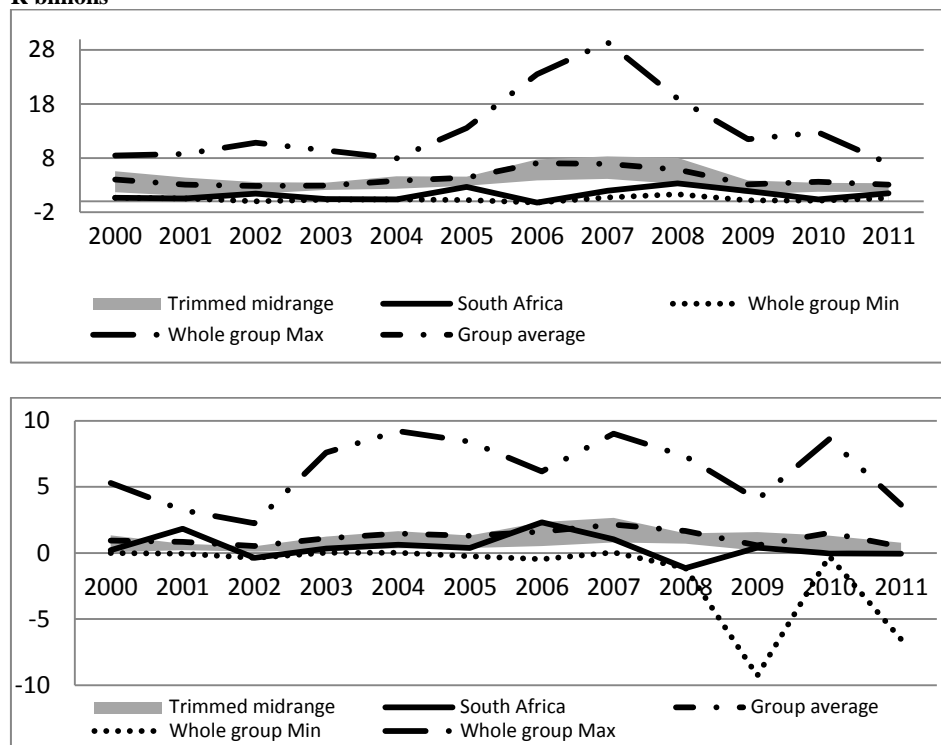


Figure 5: Inward (top) and outward (bottom) FDI flows as per cent of GDP

Source: UNCTAD

Has South Africa's experience of FDI inflows been in line with its potential? Credit ratings are a reflection of investor perceptions about a country's potential to attract FDI. Economic factors such as market potential, institutional constraints and other factors such as availability of natural resources have a bearing on a country's potential to attract FDI. Since 2002, UNCTAD has published a FDI potential index for a number of developed and emerging countries. The index captures four key economic determinants of inward FDI; namely, market attractiveness of the host country, availability of low cost labour and skills, infrastructure development and availability of natural resources.⁹ In addition, UNCTAD also publishes an inward FDI attraction index which measures a country's success in attracting FDI.

⁹ See UNCTAD (2012) for a more detailed description of the indices.

Figure 6 reflects the FDI attraction and potential index for a list of countries for the year 2011. Countries are grouped into four quartiles according to their level of attractiveness and potential. The comparator countries identified in Section 3 are reflected in bold italics. The matrix in Figure 6 reveals three broad sets of countries. Firstly there are those countries that are attracting FDI inflows in line with expectation (unshaded diagonal blocks). All countries to the left of the unshaded blocks are countries attracting more FDI than what has been expected. Finally, those countries that are attracting less FDI than their potential are reflected to the right of the unshaded blocks.

FDI attraction	High	4 th quartile	3 rd quartile	2 nd quartile	1 st quartile	Australia, Belarus, Belgium, <i>Brazil</i> , Chile, China, Colombia, Hong Kong (China), <i>Kazakhstan</i> , Malaysia, Peru, Poland, <i>Russian Federation</i> , Saudi Arabia, Singapore, Switzerland, Ukraine, United Kingdom, Viet Nam			
	1 st quartile					Albania, Bahamas, Congo, Congo (Democratic Republic), Equatorial Guinea, Jordan, Lebanon, Luxembourg, Mongolia, Mozambique, Zambia	<i>Bulgaria</i> , Ghana, <i>Ireland</i> , Israel, Nigeria, Norway, Panama, Turkmenistan, Uruguay	Chad, Liberia, Madagascar, Niger	
	2 nd quartile					Armenia, Cambodia, Guinea, Nicaragua, Saint Vincent and the Grenadines, Solomon Islands	Costa Rica, Georgia, Honduras, Kyrgyzstan, Libya, Maldives, Malta, <i>Namibia</i> , Seychelles, Sudan, United Republic of Tanzania	Brunei Darussalam, <i>Croatia</i> , Dominican Republic, Egypt, <i>Estonia</i> , Iraq, Portugal, Qatar, Serbia, <i>Tunisia</i> , Uzbekistan	Austria, Canada, Czech Republic, France, Germany, <i>Hungary</i> , <i>India</i> , Indonesia, <i>Mexico</i> , Netherlands, Romania, Spain, <i>Thailand</i> , Turkey, United Arab Emirates, United States
	3 rd quartile					Antigua and Barbuda, Belize, Cape Verde, Central African Republic, Djibouti, Dominica, Fiji, Grenada, Guyana, Mali, São Tomé and Príncipe, Vanuatu	Barbados, Botswana, Cameroon, Lao People's Democratic Republic, the former Yugoslav Republic of Macedonia, Mauritius, the Republic of Moldova, Myanmar, Uganda, Zimbabwe	Algeria, Azerbaijan, Bolivia (Plurinational State of), Denmark, Gabon, Guatemala, Iceland, Jamaica, Latvia, Morocco, Oman, Pakistan, Syrian Arab Republic, Trinidad and Tobago	Argentina, Finland, Iran, Italy, Japan, Korea (Republic of), <i>South Africa</i> , Sweden
4 th quartile	Afghanistan, Benin, Bhutan, Burkina Faso, Burundi, Comoros, Côte d'Ivoire, Eritrea, Gambia, Guinea-Bissau, Haiti, Kiribati, Lesotho, Malawi, Mauritania, Nepal, Rwanda, Samoa, Sierra Leone, Suriname, Swaziland, Togo, Tonga	Angola, Bangladesh, Bosnia and Herzegovina, El Salvador, Ethiopia, Kenya, Papua New Guinea, Paraguay, Senegal, Tajikistan, Yemen	Bahrain, Ecuador, <i>Greece</i> , Kuwait, <i>Lithuania</i> , New Zealand, Philippines, Slovakia, Slovenia, Sri Lanka	Venezuela (Bolivarian Republic of)					
Low	Low	4 th quartile	3 rd quartile	2 nd quartile	1 st quartile	High			

FDI potential

In line with expectation
 Slight variation from expectation
 Significant variation from expectation

Figure 6: FDI attraction versus FDI potential

Source: UNCTAD

According to this ranking, South Africa fares very poorly in attracting FDI (3rd quartile) despite having a high potential to attract FDI (1st quartile). This is in contrast to most of the comparator countries where their FDI inflows have been close to, or exceeded their potential.¹⁰ This result is in line with the earlier analysis which showed that SA, in a comparative perspective fared very poorly in attracting FDI inflows.

Providing a definitive reason for South Africa's poor performance in attracting FDI flows is beyond the scope of this paper. Multiple factors are important in attracting FDI. While size and growth potential of markets are positively correlated with FDI inflows, the investment climate (institutional and regulatory structure) and trade openness also matter (Hornberger, Battat & Kusek, 2011). The advantages of market size and growth potential could be negatively affected by market risks and the costs of doing business, which includes the level of taxes in the host economy, labour costs relative to productivity, and infrastructure. In addition, these factors hinge on an economy's institutional environment, where public efficiency can have a major bearing on inward FDI flows (Bénassy-Quéré, Coupet & Meyer, 2005: 764-782). In South Africa's case a lack of skills in the labour force, a low work ethic (Financial mail, 2013), stringent regulations and a relatively high tax burden (Schussler, 2012) have been cited as some of the main factors influencing FDI inflows.¹¹

5 The impact of FDI flows on the current account balance

There is a close link between capital inflows and the current account balance. The influence of capital flows on the current account occurs mainly through the trade and income accounts. Capital inflows can have an influence on exports and imports (trade account) as well as on dividend flows (income account).

We start off by undertaking a simple granger-causality test to ascertain the link between FDI inflows and the current account balance. We use the MWald granger no causality test of Toda and Yamamoto (1995) within a bivariate VAR framework to establish the relationship between FDI and the other variables of interest (namely, current account balance (CAB), exports and imports).¹²

¹⁰ The notable exceptions are Greece and Lithuania

¹¹ Over the period 2006 to 2013 the only region with a higher average corporate tax rate than South Africa was North America. From 1 April 2012 the secondary tax on companies at a rate of 10 per cent was abolished and replaced by a dividend withholding tax at a rate of 15 per cent, which moves the dividend tax to a shareholder tax. This means that the effective corporate tax rate is 28 per cent going forward. However, the sensitivity of FDI to taxation probably varies and should be seen in conjunction with several other host country conditions and policies.

¹² In this case, the Wald tests have asymptotic χ^2 distributions irrespective of the order of integration of the variables or the cointegration properties of the system (Dolado and Lütkepohl, 1996; Toda and Yamamoto, 1995).

$$X_t = \alpha + \sum_{i=1}^m \theta_i X_{t-i} + \sum_{i=m+1}^{m+dmax} \theta_i X_{t-i} + \sum_{i=1}^m \delta_i Y_{t-i} + \sum_{i=m+1}^{m+dmax} \delta_i Y_{t-i} + v_{1t}$$

$$Y_t = \psi + \sum_{i=1}^m \phi_i Y_{t-i} + \sum_{i=m+1}^{m+dmax} \phi_i Y_{t-i} + \sum_{i=1}^m \beta_i X_{t-i} + \sum_{i=m+1}^{m+dmax} \beta_i X_{t-i} + v_{2t}$$

where X_t is FDI inflows, Y_t represent the other variables of interest (current account balance (CAB), exports and imports). All the variables are expressed as a ratio of GDP. α , θ 's, δ 's, ψ , ϕ 's and β 's are parameters of the model. The maximum order of integration is given by $dmax$ and v_1 and v_2 are the residuals of the model. The Akaike Information Criterion (AIC) was used to determine the appropriate lag order of the VAR and the Augmented Dickey-Fuller (ADF) test to determine the maximum order of integration. Quarterly data were used in the estimations. The results are depicted in Table 1.

The results indicate that there is unidirectional causality from FDI to CAB. However, since FDI can exert an influence on both the trade and income accounts of the CAB, we proceed to test for the influence of FDI on the trade and income accounts separately.

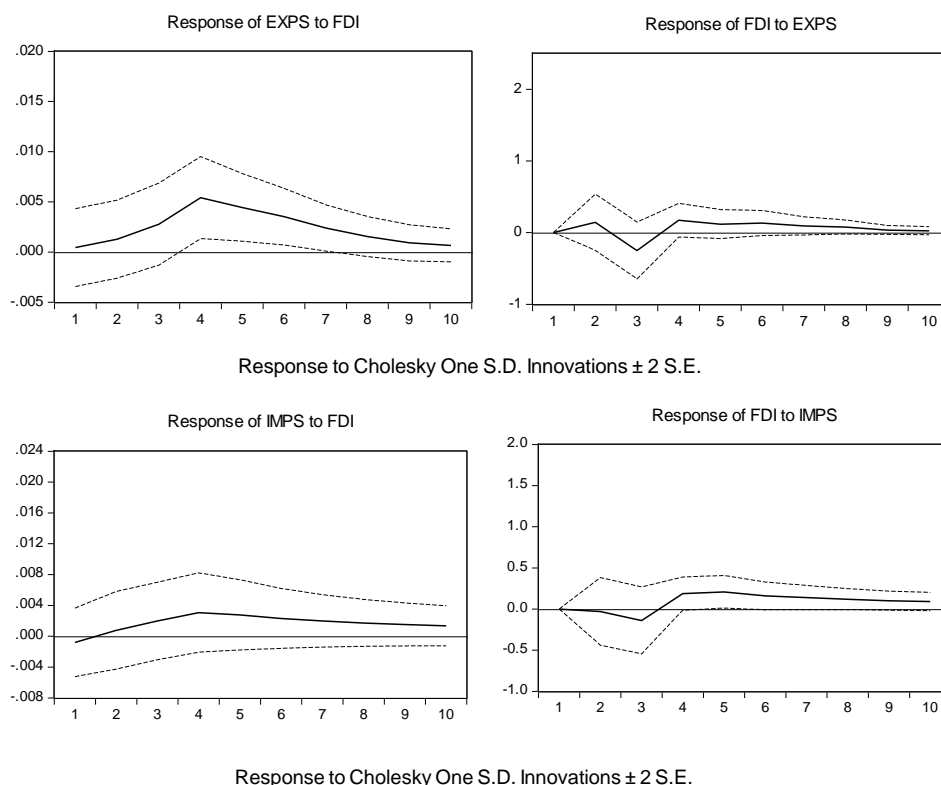
In order to ascertain the influence of FDI inflows on the trade account we test for causality between FDI and exports and imports separately. As far as exports are concerned there is bidirectional causality between FDI and exports. FDI contributes to export production while export production also attracts FDI inflows. On the other hand, while imports granger-cause FDI, there is no causality running from FDI to imports. This suggests that FDI inflows are driven by motives to capture domestic market share and do not lead to an increase in imports.

Table 1: Toda Yamamoto Granger no causality test for FDI and growth (1990-2012)

Null Hypothesis	Lags	Value (probability)	Decision
FDI does not granger cause CAB	8	16.24 (0.06)	Reject at 10% level of significance
CAB does not granger cause FDI	8	7.07 (0.25)	Do not reject
FDI does not granger cause imports	6	4.60 (0.60)	Do not reject
Imports does not granger cause FDI	6	17.68 (0.01)	Reject at 1% level of significance
FDI does not granger cause exports	7	15.84 (0.03)	Reject at 5% level of significance
Exports does not granger cause FDI	7	14.18 (0.05)	Reject at 5% level of significance

Source: own calculations

Figure 7 reflects the impulse responses of exports and imports to a shock in FDI and vice versa. The results indicate that FDI inflows have a positive impact on exports but no significant impact on imports. The impact occurs after 1 year and lasts for approximately 3 quarters. UNCTAD recently published the UNCTAD FDI contribution index that measures the development impact of FDI in the host economy.¹³ In terms of this index foreign affiliates (FDI) contribute around 20 per cent of South Africa's total exports.



Note: dashed lines represent confidence intervals

Figure 7: Impulse response of exports and imports to a shock in FDI

FDI responds marginally positively to rises in imports with the effects once again occurring after one year. The net effect of FDI inflows on the trade balance should be positive given its significant (insignificant) impact on exports (imports). If we assume that FDI accounts for 20 per cent of SA exports (as per the 2012 UNCTAD

¹³ This index measures the contribution of inward FDI (foreign affiliates) to GDP (value added), employment, wages and salaries, exports, R&D expenditures, capital formation and tax payments, as a share of the host-country total. Countries are categorized in homogeneous groups (quartiles) with similar levels of contribution for each type of impact. The ranking of an economy in the FDI contribution Index is calculated based on the simple average of the percentile rankings for each of the impact types, using equal weights (see UNCTAD (2012) for a more detailed description).

estimate) and zero impact on imports (granger-causality result from this study) then this implies that the contribution of FDI to net export production averaged approximately 5 per cent of GDP for the period 2004 to 2012.¹⁴

What is the impact of capital flows on the income account of the balance of payments? Capital flows in the financial account of the balance of payments are associated with dividend and loan payments and receipts in the income account (current account) of the balance of payments. Stated differently, capital inflows (outflows) in period t in the financial account are associated with capital outflows (inflows) in the income account (current account) in period $t+n$.

Figure 8 reflects the dividend and interest payments on FDI and non-FDI for the period 1982 to 2012.¹⁵ The left-hand panel of Figure 8 shows that, since the beginning of 2000, there has been a significant increase in dividend and interest payments on FDI. On the other hand, dividend and interest receipts have increased only marginally during the same period.

Net payments related to capital flows have been an important driver of developments on South Africa's current account balance (right-hand panel, Figure 10).¹⁶ Of interest is that payments related to non-FDI flows (portfolio and other investment) have been relatively flat while those related to FDI have increased significantly since 2004. For the period 2004 to 2012 net payments on FDI made up around 36 per cent of the current account deficit. The net payments on non-fdi related payments made up around 15 per cent of the current account deficit position for the period 2004 to 2012. Net payments on FDI flows were thus slightly more than double the payments on net non-fdi flows.¹⁷ The dividend and interest payments on FDI amounted to approximately 1,6 per cent of GDP for the period 2004 to 2012.

¹⁴ Exports accounted for approximately 25 per cent of GDP for the period 2001 to 2012.

¹⁵ Non-fdi flows refer to the sum of portfolio and other investment flows.

¹⁶ "Other" refers to the sum of the contribution of all the components of the current account excluding net FDI and non-FDI income payments.

¹⁷ Thus, just over half of the current account deficit position for the period 2004 to 2012 was due to interest and dividend payments on total capital flows (both FDI and non-FDI flows).

R billions

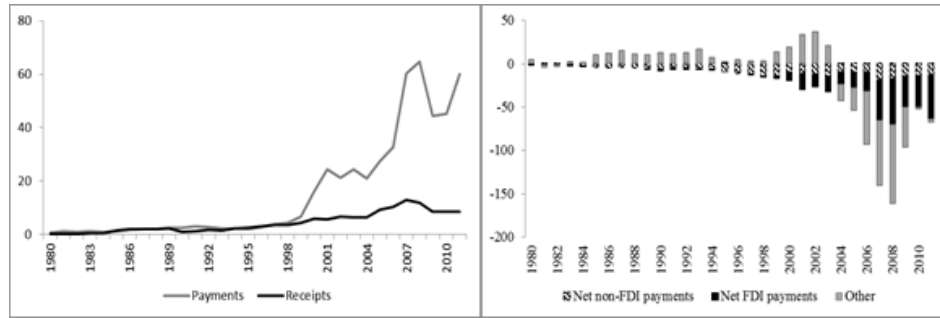


Figure 8: Dividend and interest payments and receipts related to FDI flows

Source: SARB

How does the dividend and interest payments for SA relate to those of the comparator countries identified earlier on? The impact of dividend and interest payments on the current account of the balance of payment can be estimated as follows:

$$CAB_t = \alpha_0 + \alpha_1 FDI_t + \alpha_2 NFDI_t + \alpha_3 RGDP_t + \varepsilon_t \quad (1)$$

where CAB_t = current account balance in period t

FDI_t = net dividend payment on FDI inflows in period t

$NFDI_t$ = net dividend and interest payment on non-FDI (i.e. portfolio + other investment) inflows

ε_t = error term in period t

$RGDP_t$ = economic growth in period t

Equation 1 captures the contribution of dividend and interest payments on the income account.¹⁸ The coefficients of interest are α_1 (dividend and interest payments on FDI) and α_2 (dividend and interest payments on non-fdi). Dividend and interest payments are captured with a negative sign in the estimations and hence an increase in FDI and NFDI results in an improvement in CAB (i.e. α_1 and α_2 are expected to have positive signs). The size of the coefficients gives an indication of the influence of these variables on the current account balance. $RGDP_t$ is included as a control variable. The estimations were done on annual data for the period 2000 to 2011. All the data were sourced from the IMF and are expressed as a ratio of GDP.

¹⁸ The panel included the following countries Brazil, Bulgaria, Chile, Croatia, Czech Republic, Estonia, Greece, Hungary, India, Ireland, Israel, Kazakhstan, Republic of Korea, Latvia, Lithuania, Malaysia, Mexico, Namibia, Poland, Russian Federation, South Africa and Uruguay. Due to data constraints Thailand was excluded from the estimations and the sample period was reduced to 2001 to 2011.

The panel least squares method was used to estimate equation 1. The presence of cross-section country-specific and period-specific effects were handled using a fixed effects model.

A one percentage point increase in economic growth results in a 0.4 percentage point decline in the CAB as a ratio of GDP.¹⁹ A one percentage point increase in dividend and interest payment on FDI as a ratio of GDP results in a 0.57 percentage point decrease in CAB. This is significantly lower than the contribution of NFDI where a one unit increase in payments results in an almost similar (0.99) increase in the CAB.

The econometric results indicate that for the panel as a whole, the impact of net payments on FDI on the current account balance is almost half the contribution of NFDI. This is virtually opposite to the experience of South Africa where the contribution of FDI has been twice that of NFDI, as pointed out above.²⁰ Net dividend payments on FDI for South Africa averaged around 36 per cent of the current account deficit for the period 2004 to 2011, approximately 80 per cent higher than the model prediction of 20 per cent.

Table 2: Panel regression of effect dividend and interest payments on CAB

Variable	coefficient
C	2.31* (1.32)
FDI	0.56** (0.24)
NFDI	0.99* (0.52)
RGDP	-0.41***
No of countries	(0.12)
R-squared	264
adj R-squared	0.75
No of countries	0.71
F-Statistic	22
Prob (F-statistic)	19.72 0.00

Notes: White cross-section standard errors in brackets

Source: own calculations

¹⁹ This effect could inter-alia work through the trade account (for example increase in imports).

²⁰ The returns on FDI were significantly higher than NFDI although the stock of FDI liability averaged 41 per cent of GDP as compared to 53 per cent for NFDI. The return on capital flows is an area worthy of further research.

6 Some implications and conclusions

The transition to a democratic dispensation in 1994 and the liberalisation of the capital account in 1995 stimulated an increase of capital inflows to South Africa. However, on a comparative basis, FDI inflows have been much lower than what was experienced by a peer group of countries. On the other hand, FDI outflows from South Africa have been much more in line with the experience of the peer group.

Since the mid-2000s, South Africa has become increasingly dependent on capital inflows as a result of the widening current account deficit. The deterioration in the country's net international investment position has also meant that the net income payments on capital inflows have exerted a significant negative influence on the current account.

Since 1994, gross flows have been dominated by portfolio investment. While FDI inflows have been much smaller than portfolio flows, net dividend payments on FDI flows (portfolio flows) made up 36 per cent (15 per cent) of the current account deficit for the period 2004 to 2012. While returns on FDI are usually higher (UNCTAD, 2013: 31-35), the significant rise in the returns is not strongly correlated with economic performance, particularly in the post-crisis period when economic growth has been very subdued. This is an important issue that warrants further research given that high rates of return on FDI have at times raised concerns about excessive rents for foreign firms (UNCTAD, 2013: 31-35). Where rent seeking behaviour is evident, fiscal tools should be used to ensure that the host country receives a fair share of profits (UNCTAD, 2012: 116-117).

The significant rise in dividend and interest payments – particularly on FDI – since 2004 is likely to remain at elevated levels given the current stock liability positions and the nature of the inflows to South Africa. Data collected by the South African Reserve Bank shows that since 2010, the bulk of FDI liability inflows were in the form of Mergers and Acquisitions (M&A's) and Existing Subsidiary Financing (ESF).²¹ This equity and debt financing places an obligation on a more structured repayment schedule. This will entail a more consistent drain on the current account through interest repayments in the income account. In contrast, most of the South African MNE's outward investment occurred via M&A's financed mainly by equity injection. South African MNE's were permitted, if they so desired, to retain their profits abroad for expansion purposes. This in effect has resulted in declining dividend receipts on FDI outflows. There is a need to ascertain how much of the profits retained abroad are used for expansion purposes and if so, when the

²¹ Mergers and acquisitions (M&A's) involve transactions where international MNE's either made a new investment into South Africa or increased their existing ownership of a South African interest (vice versa for assets). Existing Subsidiary Financing (ESF) refers to cross-border flows between parties that have an existing FDI relationship. To a large extent these flows represent funds supplied by international parent companies to South African subsidiaries to utilise as working capital or for the expansion of South African operations within an existing FDI relationship.

repatriation of profits back to South Africa is likely to occur. This is area that warrants policy attention.

South Africa's widening current account deficit has been cited as a major concern by rating agencies and other economic stakeholders. Unless there is a significant rise (decline) in the exports (imports) of goods and services, the South African economy will be dependent on foreign capital inflows to offset the investment income repayments and the current account deficit in general. As far as FDI is concerned, the policy challenge is to ensure that these result in "greenfield investment",²² that promotes technological spill-overs that positively impacts on South Africa's export production and growth prospects. In this regard, the nature of the FDI, the manner in which it is funded and the impact on the current account (i.e. trade account and income accounts) and economic growth are important characteristics that warrant special attention when devising policies to promote FDI inflows.

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²² Greenfield investment entails foreign investment in the creation of a completely new asset within the host economy.

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APPENDIX 1

Table A1: List of comparator countries

	<u>COUNTRY</u>	-	<u>2000</u>	-	<u>2005</u>	-	<u>2010</u>
1	Greece	1	BBB+	1	A	1	BBB-
2	Hungary	1	BBB+	1	BBB+	1	BBB-
3	South Africa	1	BBB-	1	BBB+	1	BBB+
4	Thailand	1	BBB-	1	BBB+	1	BBB
5	Tunisia	1	BBB-	1	BBB	1	BBB
6	Bahrain	1	BBB-	1	A-		A
7	Brazil		BB-		BB-	1	BBB-
8	Bulgaria		B+	1	BBB	1	BBB-
9	Czech Republic	1	BBB+		A		A+
10	Chile	1	A-		A		A
11	Croatia		BB+	1	BBB-	1	BBB-
12	Egypt	1	BBB-		BB+		BB+
13	Estonia	1	BBB+		A	1	BBB+
14	India		BB+		BB+	1	BBB-
15	Ireland		AAA		AAA	1	BBB+
16	Israel	1	A-		A-		A
17	Kazakstan		BB-	1	BBB	1	BBB-
18	Latvia	1	BBB	1	A-		BB+
19	Lithuania		BB+	1	A-	1	BBB
20	Malaysia	1	BBB	1	A-		A-
21	Mexico		BB+	1	BBB	1	BBB+
22	Namibia		NA	1	BBB-	1	BBB-
23	Poland	1	BBB+	1	BBB+		A-
24	Russia		B	1	BBB	1	BBB
25	South Korea	1	BBB+		A+		A+
26	Uruguay	1	BBB-		B+		BB
		16		16		16	

Notes: shaded blocks represent the countries in the comparator group

Source: Fitch Rating Agency