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This article unpacks the contribution of the investment income balance to South Africa’s current account deficit post-1994 and places it within the context of South Africa’s balance of payments and FDI history. It highlights the prominence of net investment income payments made to foreign direct investors in driving South Africa’s current account deficit (37% between 2004-2013). During the same period net payments to all other investors accounted for 14.5% of the deficit. The slow accumulation of direct investment assets by South African firms prior to 2006 coupled with the higher returns on South Africa’s direct investment liabilities further aggravates this imbalance. While FDI inflows currently present a challenge to South Africa’s balance of payments, over the long term they provide it with one of the best opportunities through which to alleviate its external imbalances, provided policy support is forthcoming.

1 | Introduction

In its balance of payments with other countries South Africa has a growing current account deficit (5.8% of GDP in 2013) since 2003. This reflects an excess of expenditure over income in relation to foreign trade and the transfer of earnings. 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 in nature and therefore volatile: they can just as easily flow out again. This much is well known. What is less well understood is what is causing the persistent current account deficit in the balance of payments. 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.

Ilan Strauss

1 Ilan Strauss is a PhD student at the New School for Social Research (Department of Economics) and was a consultant at the African Development Bank (AfDB), Development Research Department. An expanded version of this paper will be published by UNCTAD in Transnational Corporations. The author will like to thank Rob Petersen for his valuable comments on a basic first draft of this paper. The author is also grateful to Thomas Jost and Axel Schimmelpfennig; and to Piet Swart, Stefaans Walters and Zirk Jansen from the South African Reserve Bank for important clarifications and data. Author contact: Strai275@newschool.edu.
The focus of South Africa’s current account imbalances tends to be on the trade balance (Draper and Freytag, 2008). However, attention is now sometimes given to South Africa’s investment income account in driving its current account deficit (Samuel, 2013). Increasingly it is broadly true that South Africa’s current account deficit is caused by interest and dividend payments to foreign investors in its debt and equity markets, i.e. to non-resident holders of its bonds and other debt instruments, and to holders of its company shares. However, little attempt is made to distinguish between foreign direct investors and portfolio investors in this story (Samuel, 2013). The assumption is generally that the bulk of investment income payments made by South Africa go to portfolio (short-term) investors. Contrary to popular belief this is not the case. It is payments to foreign direct investors (i.e. long-term investors) that are, since 2005,² by a significant margin the dominant form of investment income payment South Africa makes abroad, and which are generally the immediate ‘cause’ of its current account deficit. On a net basis (i.e. taking into account investment income earned abroad) this situation is exaggerated by the dearth of direct investment income receipts earned by South African firms abroad. Together this has resulted in net foreign direct investment (FDI) income being the largest single burden on South Africa’s current account. This is not all bad news, since the counterpart to a deficit in net FDI income tends to be positive net inflows of FDI through the financial account which can help South Africa expand domestic output, employment, and industrial capabilities.

The topic of how foreign direct investment income payments are contributing towards developing economies’ current account deficits remains heavily under researched. This may be partly due to more recent patterns of global development favoring emerging markets as the primary destination for FDI: developing economies as a whole now receive more FDI than developed economies (UNCTAD, 2014). While in 2008 FDI received by Africa was double its Official Development Assistance (ODA) (UN, 2010). These inflows shape payment outflows and current account dynamics in developing economies to a greater extent than is often thought. Miguel Pérez Ludeña (2014) of the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), recently argued that after years of attracting FDI, FDI payments have:

now [become] the largest external liability in developing countries and also the largest contributor to debits in their income accounts. FDI income is now higher than portfolio or other investment income and one of the largest items in the balance of payments as a whole. Between 2008 and 2011, FDI income originating in Latin America was almost double the surplus in goods trade.

Mencinger (2008) finds a similar story for many new European Union (EU) member states. As countries receive growing amounts of FDI, net investment income has overtaken the trade balance in driving current account deficits. We show that the same is generally true for South Africa. Additional research is needed to ascertain if this is also the case for other developing economies, though a preliminary sweep of the data indicates that more often than not it is.

The rest of the paper proceeds as follows: Section 2 unpacks the key argument of this paper by focusing on the development of South Africa’s direct investment liabilities and assets and compares it to developments in its portfolio investment position. Section 3 concludes. All data used comes from the South African Reserve Bank (SARB), unless stated otherwise. FDI project data based on Greenfield FDI comes from the Financial Times’ fDi database.

2 | Disaggregating the role of investment income in South Africa’s current account deficit

The contributions of the main items to South Africa’s current account deficit from 2004-2013 are shown in Figure 1.

As Figure 1 illustrates, on average 37% of South Africa’s current account deficit between 2004-2013 was as a result of net payments to foreign direct investors. During the same period net payments to non-FDI investors – consisting of portfolio and other investors related to trade finance, inter-bank flows, and short and long term loans – accounted for only 14% of the current account deficit. While net FDI income was the single largest contributing item to the current account deficit during this period it was followed closely by the trade balance, which accounted for nearly 26% of the deficit – despite being in surplus during 2010 and 2011.³

Net investment income payments was the main contributors to the current account deficit, except in 2006 and 2013. Figure 2 shows South Africa’s growing current account deficit as a whole, along with the deteriorating net total investment income payments since 2005.

² In 2006 this situation was reversed before again reverting back to the new normal.
³ In order to make each year’s contribution add up to 100% the negative equivalent of the trade surplus in 2010 and 2011 is added to the current account deficit in those years.
Figure 1 Contributions of various current account items to the current account deficit (2004-2013, %)

Source: Data from SARB (2014c).

Figure 2 Net investment income payments are usually the main contributor to South Africa’s growing current account deficit (1994-2013, millions R)

Source: Data from SARB (2014c).

Note: Total trade balance equals the sum of the merchandise trade balance, services trade balance, and gold trade balance. Net investment income payments = FDI + non-FDI net income payments. Net current transfers are excluded from Figure 2.
Figure 2 graphically depicts what has been already noted several times: that net investment income has been the main contributor to South Africa’s current account deficit between 2004-2013.  

This is due to South Africa having more investment liabilities on which it makes income payments to non-residents, than investment assets from which it generates foreign income receipts. This imbalance is compounded by the returns it receives on its total foreign assets being lower (by more than 2%) than the yield it pays on its total foreign liabilities (SARB, 2013).  

Figure 2 shows that the balance on South Africa’s current account was positive until the economy started growing more quickly from 2004 (inclusive). Prior to this 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 be on a marked negative trend (notwithstanding the fluctuation around the financial crisis) – despite increasingly favorable (non-gold) terms of trade (SARB, 2014b). If this trend continues the trade balance may permanently become the largest drag on the current account.

When looking more closely at the balance on net direct investment income one should analyse three categories of variables: assets (which create receipts/inflows) and liabilities (which create payments/outflows); the frequency with which the holders of these claims receive (or repatriate) payments; and the relative profitability of these claims, as different types of assets will allow for the holder of the claim to receive a relatively larger or smaller payment. We begin by looking at the liabilities side, which represents payment obligations South Africa has to the rest of the world.

### 2.1 Liabilities

In 2013, 70% of the gap between the contribution of the net FDI income balance and that of the net non-FDI income balance to the current account deficit was due to differences in payments made on their respective domestic investment liabilities. The remaining shortfall (30%) was due to differences in investment income receipts received by each from their assets abroad. The liability side is, therefore, the primary reason why South Africa makes large net FDI payments abroad. In return it gets access to valuable foreign capital and business know-how.

Between 1994-2013 South Africa’s stock of inward FDI liabilities grew dramatically. Despite this FDI inflows have trailed behind portfolio inflows (a component of non-FDI inflows): amounting to 63% of portfolio inflows between 1994-2013 and 80% of portfolio inflows between 2001-2013. In relative terms the growth in South Africa’s stock of FDI has been relatively unexceptional: its ratio of inward FDI stock to GDP has grown moderately relative to other OECD countries (OECD, 2014). Relative to other African countries South Africa is receiving a shrinking share of official FDI inflows, as would be expected by the declining contribution of its GDP to the continent’s output.

Initially, South Africa attracted very low levels of FDI relative to portfolio flows (see Stals, 1998). From 1998-2004 this changed as confidence in South Africa returned and commodity prices picked up: South Africa’s FDI liabilities grew nearly 8 times quicker than its non-FDI liabilities during this period (albeit off a low base). This reflects the diversification of South Africa’s economy towards services, the upswing of the commodity cycle making mineral related investments more profitable, and modest though notable increases in FDI inflows from China and to a lesser extent Japan. Low global interest rates were also important: several of the most prominent investments into South Africa were Merger and Acquisitions, such as de Beers being taken over by Anglo American in 2001; Barclay’s Bank purchasing just over 50% of Absa Bank for R33 billion in 2005; and China’s largest bank, the Industrial and Commercial Bank of China (ICBC), purchasing a 20% stake in Standard Bank for R36.7 billion in 2007.

Part of the increase in South Africa’s FDI liabilities was probably due to the relisting of major South African companies abroad: between 1998 and 1999 the stock of South Africa’s FDI liabilities increased by almost two and a half times (247%). After the relisting of 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 impact was substantial on

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

5 Variables 5386K-5387K

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

7 Of this value, it was reported that Standard Bank would receive R15.9-billion in new core equity capital and existing shareholders R20.7-billion. The deal was also the largest investment by a Chinese bank outside of China at the time. The latter meant that by 2012, 10.5% of South Africa’s inward FDI stock was in the banking sector.
both the payments and the receipts side of FDI and portfolio flows. In 2000 these companies contributed roughly 7.5% of South Africa’s GDP (and 15.5% including their foreign activities). For that year SARB (Walters and Prinsloo, 2002:69) calculates that “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” to non-residents. This trend reversed again after 2004 when non-FDI liabilities grew more rapidly.

We now turn to the key fact which needs to be explained: Figure 3 shows that although South Africa’s inward FDI liabilities have grown at a reasonable pace, their stock remain smaller than the stock of non-FDI investment liabilities. 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?

Given the substantial (and increasing) difference between the size of the two respective liability stocks, we would expect gross non-FDI income payments made abroad to be larger than gross FDI income payments. In fact, the opposite has been the case (Figure 4). FDI income payments overtake non-FDI income payments in 2005 for the first time since 1972. By 2013 payments made by South Africa on its FDI liabilities were 1.6 times larger than the payments on its non-FDI liabilities (right hand axis).

Figure 3 Since 1999 South Africa’s stock of inward FDI liabilities broadly tracks, though is below, the stock of its non-FDI investment liabilities (Left hand axis: millions R, 1994-2012; Right hand axis: ratio of FDI to non-FDI liabilities)

Source: Data from SARB (2014c).

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

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8 Portfolio liabilities accounted for a little less than 80% of total non-FDI liabilities in 2012.
9 This situation is reversed in 2006 before continuing on its “new normal” from 2007.
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). Growth in the liabilities of ‘other’ investments have, since 2006, 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 importantly, non-resident portfolio investors have shifted out of South African equities and into lower yielding (government) bonds – with the latter accounting for 78% of all South African debt owned by non-resident investors in 2012. So, while at the end of 2007 the vast majority of portfolio investments into South Africa were in equities (82%), by the end of 2012 this was down to 62%, partly as a result of a strong shift out of equities and into government bonds during 2011 (SARB, 2014). An improved sovereign debt rating and lower domestic interest rates would have contributed to this trend.

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

2.2 Assets

Turning to the asset side, it is clear that a relative insufficiency of direct investment assets held abroad by South African firms is also a relevant contributor to the net direct investment deficit. In 2013 30% of the gap between the contribution of the net FDI income balance and that of the non-FDI net income balance to the current account deficit was due to differences in receipts received from their respective investment assets abroad.

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10 Foreign liabilities of South Africa. S-88.
11 This rating has now come under pressure.
Between 1994-2012 South Africa’s stock of outward FDI assets grew by less than half the rate of its liabilities. FDI assets only begin to ‘take-off’ in 2006, increasing over two and a half times more than FDI liabilities (231% vs. 86% respectively) since then. We describe the growth in South Africa’s outward FDI assets in more detail below before comparing it to the growth in its non-FDI investment assets.

After the relaxation of sanctions and the liberalization of outward FDI, South African firms expanded relatively heavily abroad, especially into Africa (UNCTAD, 2005). Until 1998 South Africa’s FDI assets matched, and even surpassed, its FDI liabilities.12 This was assisted by investments in the Common Monetary Area countries (Lesotho, Namibia, and Swaziland) being unrestricted (UNCTAD, 2005), and investments into SADC countries having far lower restrictions on investment amounts.13 During the period 1994-2004, roughly 22% of FDI flows received by the South African Development Community (SADC) were from South Africa (UNCTAD, 2005). As a result, the proportion of African countries in South Africa’s outward direct investment assets doubled between 1994 and 2004 from 5% to nearly 11%. The relisting of major South African companies abroad between 1999-2000 appears to also have significantly reoriented South Africa’s FDI assets towards the United Kingdom (UK).

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 to expand domestically: more productive firms tend to invest abroad and in turn receive the opportunity to further enhance their competitiveness through access to economics of scale and new complementary assets.15

Despite these benefits, the push to invest abroad appears to have slowed notably in the 2000s. Between 2000-2005 (inclusive) South Africa’s stock of FDI assets abroad shrunk by 5%. The seeming stability between 2000-2005 in its FDI assets hides significant restructuring of corporate holdings that was taking place during this period. Notably, the major dia-

12 Between 1994-1999 (inclusive) South Africa’s FDI financial outflows (through the financial account) exceeded its inflows for all but one year.
14 Underlying source is Business Map Foundation database of announced FDI (millions of dollars).
15 However, weak domestic growth prospects in South Africa (real or perceived) means that expansions abroad may occasionally substitute for domestic expansions.
Diamond producer De Beers went private in 2001, delisting from the Johannesburg Stock Exchange (JSE). This had a complex impact on South Africa’s net direct investment position (see South African Competition Tribunal, 2001).

Then beginning in 2006 we see a key shift: South African firms begin to engage in foreign direct investments at a significantly more rapid rate. Between 2005-2012 South Africa’s FDI assets increase nearly fourfold, the two most important destinations being China and Africa (Figure 6 and Figure 7), though Eastern Europe also plays a role accounting for roughly 2.5% of South Africa’s outward FDI stock in 2013. Concurrently, assets held in Western Europe more than halve from 78% in 2001 to 34% in 2013.

It is difficult to get accurate bilateral statistics for FDI between China and South Africa. Gelb (2010) argued that SARB data underestimated the inward Chinese FDI stock in South Africa but overestimated SA FDI into China.

FDI into China by South African firms shows little movements before 2004. After which it steadily increases from 8% of South Africa’s outward FDI stock in 2007 to 18% in 2012. It then jumps to 31.5% in 2013. This jump may be due to a large investment or due to omissions in the sampling frame used by SARB in its survey method (Gelb, 2010:6).16

The other major area of expansion for South African firms has been in Africa. Figure 7 shows that although the value of South Africa’s direct investment assets held in Africa increased by 280% between 1994 and 2000, all of the net relative increase in South Africa’s foreign direct investment assets held in Africa occur only after 2000.

The proportion of African countries in South Africa’s outward direct investment assets nearly double again between 2004 and 2012, from almost 11% to 21% (SARB, 2005, 2014), before declining to 17% in 2013. In particular, between 2005 and 2006 the proportion of South Africa’s FDI assets held in Africa double owing to a ten fold increase in assets held in Mauritius and a doubling of assets held in ‘other’. As an offshore financial center, investments into Mauritius can be motivated by a number of narrow tax and financial regulation considerations.

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16 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”.

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Figure 6 South Africa’s direct investment assets held in China expand dramatically after 2005
(Left hand axis: millions R, 1994-2012; Right hand axis: Chinese FDI assets as % of total)
A similar picture is shown when looking only at the proportion of Greenfield foreign direct investments into Africa by South African firms. Looking at project numbers and capital expenditure, Greenfield investments into Africa by South African firms almost double between 2003 and 2013 due to noticeable increases after 2005. 63% of South Africa’s Greenfield FDI projects and 85% of its capital expenditure went into Africa in 2013, compared to 38% of projects and 48% of capital in 2003 (Financial Times, 2014). 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 coincides with an uptick in intra-African FDI on the continent as a whole (Krüger and Strauss, 2015).

As a result of this push between 2005-2012 South Africa’s outward FDI assets increase nearly fourfold. Despite this, its FDI assets have not kept pace with its FDI liabilities. 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 8). As a result, income receipts from its outward direct investments have been unable to compensate for the outflow of income payments made on direct investments.

An imbalance between inward and outward FDI is not necessarily a bad thing. Developing economies generally tend to invest abroad only once they have already received FDI and developed more competitive domestic enterprises. However, in order to ensure that inward FDI enhances the production possibilities of an economy and relaxes the balance of payments constraint it needs to expand exports and improve the capabilities of domestic enterprises.

In contrast to FDI, South African residents have managed to consistently accumulate portfolio assets abroad (where a narrowing deficit exists) and ‘other’ investment assets (where a growing and sizable surplus exists). As a result the non-FDI assets accumulated by South African firms have broadly tracked the non-FDI liabilities accumulated by non-residents in South Africa (Figure 9). 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.

17 These figures will be exaggerated due to the Financial Times’ FDI database’s poor coverage of FDI investments between China and Africa, including South Africa.

18 Portfolio assets accounted for a little less than 63% of total non-FDI assets in 2012. ‘Other’ investment assets accounted for the remainder.

Figure 7 South Africa’s direct investment assets held in Africa expand dramatically after 2005 (Left hand axis: millions R, 1994-2012; Right hand axis: African FDI assets as % of total)

Source: Data from SARB (2014c).
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.

Again, what is peculiar is that the increase in FDI assets accumulated abroad by South African since 2006 has not yet decreased the net contribution of FDI income to the current account deficit. This is because at the same time as South African firms have undertaken new foreign direct investments abroad, the ‘payment ratio’ of investment receipts received by South African firms on their new direct investment assets have undergone a change downwards (Figure 10). Furthermore, in 2007 and 2008 direct investors into South Africa received a much larger portion of investment income related to debt or equity 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.
The implications of this is that South Africa’s balance of payments should improve in the future if its firms, who have now accumulated a fair amount of direct investments abroad, begin to return a greater portion of earnings on equity back home to the direct investor, or repay intra-company debt. Figure 11, in the next section, indicates that FDI income might contribute less to the current account deficit in the future if current trends continue.

2.3 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 FDI investment income. This situation is aggravated by the return on South Africa’s direct investment assets being in the order of 2% lower than the return on its direct investment liabilities. As a result investment income receipts from its outward FDI have been far lower than receipts from its non-FDI positions (Figure 11) – even though the gap has stabilized since 2006 and somewhat declined.

FDI income may contribute a reduced amount 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 12 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 in regard to the FDI income balance; net payments on non-FDI income have in fact steadily decreased since 2007.

Figure 10 Since 2005 South African direct investors have received fewer investment receipts relative to their assets (millions R, 1994-2012)

Source: Data from SARB (2014c).

Figure 12

Source: Data from SARB (2014c).

Table 1

<table>
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<th>Year</th>
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<tr>
<td>2011</td>
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<td>280</td>
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19 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 The gap between FDI and non-FDI income grew strongly until 2006 before stabilizing and declining (Left hand axis: millions R, 1994-2012; Right hand axis: ratio of non-FDI to FDI income receipts)

Source: SARB (2014c).

Figure 12 South Africa’s investment income payments mostly go to direct investors rather than portfolio investors (R millions, 1994-2013)

Source: Data from SARB (2014c) (Seasonally adjusted).

Total income balance includes balance on FDI and non-FDI investment income, as well as net compensation of employees.
Conclusion and some policy considerations

This article has highlighted the prominent role of investment income payments made to foreign direct investors in South Africa’s current account deficit. On average 37% of South Africa’s current account deficit between 2004-2013 was due to net payments made to foreign direct investors. During the same period net payments made to non-FDI investors accounted for only 14.5% of the deficit. The deficit in foreign direct investment income is due mostly to a large accumulation of direct investment liabilities by South Africa. Insufficient accumulation of direct investment assets abroad by South African firms has also played a role, as has the lower returns South Africa receives on its direct investment assets in the order of 2%. Recent trends, however, indicate that FDI may contribute less to the current account deficit in the future.

On the policy side much can be done to alleviate this imbalance. Inward FDI offers one of the primary means through which South Africa can upgrade and develop its comparative advantages, if utilized effectively. Strategies to encourage outward FDI need to be complemented by South Africa more effectively harnessing its inward FDI for developmental ends, but expenditures need to be used judiciously to avoid offering investment incentives that are unnecessarily costly and ineffective (CCSI, World Bank, & ICA, 2013). This requires a mixture of sticks and carrots, as well as holistic sector, cluster, and geographical strategies. These strategies are important in ensuring that any specific domestic linkages and industrial upgrading policies can be sustained in a competitive market.

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 (the scope for which has now, as a result, already been expanded), and for investments abroad – which in turn produces FDI income inflows. If the rate of local development in South Africa is faster than elsewhere, there will be an overall rebalancing tendency as far as the country and the world are concerned (although the distributional outcomes within the process can remain grossly skewed).

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, is likely to aggravate the present balance of payments constraints. So while FDI inflows currently present a challenge to South Africa’s balance of payments, over the long term they provide it with perhaps the best opportunity through which to alleviate its external imbalances. That they have the potential to do so does not mean that, left to their own devices, they will.

References


