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### **Current Account Situation in South Africa: Issues to Consider**

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# **Current Account Situation in South Africa: Issues to Consider**

**Tonia Kandiero**\*

## **Abstract**

The current account deficit in South Africa deteriorated from 0.1 percent of GDP in 2000 to 6.4 percent in 2006 and averaging 6.7 percent in the first half of 2007. Recently, there has been a growing concern of the ballooning deficit which warrants some discussion on its causes and sustainability to avoid any current account reversal. The general message of this paper is that the current account situation in South Africa does not seem to be a major concern because it is more than financed by capital inflows at the back of strong macroeconomic fundamentals. However, the paper underscores that it is important to remain conscious of its magnitude and to monitor the risks associated with running a current account deficit of this nature.

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## **1. Introduction**

The purpose of this paper is to raise some issues associated with relatively high current account deficit in South Africa and to draw lessons from other country experiences. In particular, the paper investigates whether high current account deficits lead to a crisis and/or what type of adjustment measures may be implemented to avoid a crisis.

The current account deficit in South Africa stood at 6.5 per cent of Gross Domestic Product (GDP) in the second quarter of 2007 from 6.9 per cent in the first quarter; averaging 6.7 per cent in the first half of 2007<sup>1</sup>. This deterioration of the current account deficit since 2000 should not be ignored although there is no need for panic. Following the introduction, the next sections attempt to address four key questions: (i) Is the current deficit unusually or even abnormally large? (ii) How long can it be sustained? (iii) Are current account reversals harmful? And (iv) What are the risks to South Africa? The tone of these questions may seem pessimistic but they are warranted and they deserve some attention. The final section provides some key points on the way forward.

## **2. Is South Africa's current account deficit "abnormal"?**

The economics profession has no consensus model to tell us, for a given economy, what the appropriate level of the current account balance should be. At best, economists can agree on some general principles. Two guiding principles are as follows: first, current account imbalances allow countries to smooth consumption over time, for example, in response to the "ups and downs" of the world price of a major export; and second, current account imbalances - which represent the difference between domestic savings and domestic investment - allow savings to be allocated to those parts of the world where they can be invested most productively. In the case where the current account reflects new investment opportunities, Edwards (2001) and Sachs (1981) argue that there is no need to be concerned about the current account deficit. South Korea is a good example. From 1960 to 1985 the country consistently

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<sup>1</sup> See Table 1 in Appendix 1

experienced a significant current account deficit of around 7 per cent of GDP, small surplus only in two years during this period. Although the deficit increased, the new investments were used productively. Fixed investment increased from 11 per cent of GDP in 1960 to 30 per cent in 1970. Economic growth reached an average of 8 per cent during the 25 year period. In the 1990s, however, South Korea experienced a current account reversal. This was mainly due to weak fundamentals such as a weak banking sector.

The current account deficit in South Africa stems largely from strong domestic demand. With terms of trade unchanged, the current account imbalance reflects the volume growth in imports outpacing exports and current accounts transfers such as dividend payment to foreigners. The deficit on the trade balance averaged 2.2 per cent of GDP in the first half of 2007, while the net income receipts deficit stood at 2.5 per cent of GDP in the same period (see Table 1 in Appendix).<sup>2</sup> This strong increase in imports has coincided with a strong domestic expenditure as lower interest rates in previous years and broader participation in the economy boosted strong consumer spending. Mineral products, in particular oil, put the most pressure on imports. Crude and refined oil accounted for 16.1 per cent of total imports in 2006. Crude oil grew by about 28.0 per cent between 2005 and 2006 and accelerated to 35 per cent in the first half of 2007 (Figure 1 in Appendix presents the trade balance and trade balance excluding oil).

The strong crude oil import growth has been sustained by buoyant growth in non-oil imports such as vehicles and vehicle parts, transport equipment, televisions and other electronic equipment (see capital goods and vehicle data in Appendix Figure 2). The main concern is that consumer related goods are starting to rival capital goods, which have been the major component of the import mix. However, the lower borrowing cost due to lower interest rate and strong domestic demand also encouraged stronger capital formation.

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<sup>2</sup> A large portion of current transfers reflect payments to the South African Customs Union Member States (1.1 per cent of GDP in the first half of 2007).

The challenge, however, is to get accurate estimates of capital goods from consumer goods. According to the Reserve Bank imported goods are classified according to the "harmonised system" which makes it very difficult to identify capital goods from consumer goods. Based on rough estimates, capital goods as a ratio of total imported goods accounted for 67.9 per cent in 2005 and 68.8 per cent in the third quarter of 2006. Likewise, final consumption expenditure by households and gross capital formation to GDP amounted 62.6 per cent of final consumption expenditure by households for both 2005 and third quarter of 2006 and 17.0 per cent in 2005 and 18.7 per cent in third quarter 2006 for gross capital formation.

The surge in investment associated imports will continue to rise as spending increases to meet demand for the 2010 Soccer World Cup and Accelerated and Shared Growth Initiative for South Africa (ASIGSA) activities. One way to reduce imports is to increase local capacity to produce investments goods and/or to increase the local content in the production of final products. Another way to improve the trade balance would be to increase reduce import duties on inputs to boost exports, as export expansion often requires imported inputs.

So far the discussion has painted a less alarming picture. Smit (2006) and the 2006 and 2007 IMF Article IV reports on South Africa also highlight the point that current account deficits of a magnitude around 6 or 7 per cent of GDP are not uncommon and some countries have maintained large deficits for more than 5 years. However, the studies caution that the current account deficit in South Africa is fairly large for an emerging market making the country vulnerable to changes in the global environment.

### **3. How long can the current account deficit be sustained?**

Edwards (2005a, 2005b) show examples of high or persistent current account deficits in 157 countries between 1971 and 2001. Fifty per cent of these countries had a current account deficit to GDP of greater than 3.1 per cent, and 26 countries experienced high current account deficits for a period of 5 years at least once. During this period some of the developed countries that experienced high deficits include Australia, Austria, Greece, Portugal and New Zealand. In recent years the most interesting case is the United States. The country has set an unprecedented record of

sustaining a high current account deficit for a decade. In the second quarter of 2006 the current account deficit stood at 6.6 per cent of GDP.

According to Edwards (2005a), one of the reasons for the high current account deficits in developed countries is that global investors have confidence in countries such as the United States. They can safely seek the highest possible return for their funds in these countries. This has led to a substantial increase in the international demand for United States assets. Some of the factors that lie behind such confidence are political stability; a legal system that effectively protects property rights and enforces commercial contracts; economic policies that promote and strengthen the role of markets; a financial system that efficiently channels resources to their most productive uses; an educational system that produces highly skilled workers; and supports rapid technological development.

The studies by Edwards, however, stress that even though the United States is able to attract large investments, at some point the current account deficit will have to go through a significant adjustment or reversal. The recent dollar depreciation of 20 per cent since 2002 could be part of the adjustment process.

South Africa's current account level is not a major concern as it has been easily financed by capital inflows, which stood at 8.12 per cent of GDP in 2006 (see Figure 3 in Appendix). Given the sound and improving macroeconomic fundamentals, South Africa should continue to attract foreign investment and the current account deficit should be easily financed. However, if for some reason there was a slow down in the inflows of capital, the deficit will have to be financed by running down reserves.

Linking the current account situation to the fiscal balance, one could make an argument along *Lawson's Doctrine*<sup>3</sup>, which states that a current account deficit should not be a cause of concern if the fiscal accounts are balanced or in a surplus. Currently South Africa's budget deficit is about 0.3 per cent and it is expected to improve to a surplus of 0.5 per cent in 2007/08. This *Doctrine*, however, should be taken with a grain of salt as it has not held in instances like the financial crisis in East Asia. Most

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<sup>3</sup> Based on the argument by the former Chancellor of Exchequer Nigel Lawson.

of the countries in East Asia had a surplus before the crisis. Nonetheless, during the reform process after the crisis, fiscal contraction was one of the policy options. The importance of a fiscal surplus or contraction is to support tight monetary policy.

Milesi-Ferreti and Razan (1996) developed a framework of current account sustainability. They point out that persistent current account deficits of 5 per cent of GDP for 3 – 4 years do not necessarily mean that the deficit is sustainable. Their main argument is that the “sustainable” level of a current account deficit is the level consistent with solvency. This is the level at which the external debt to GDP level stabilise. In the case of South Africa foreign debt to GDP was only 4.3 per cent in the period 2005/2006 compared with average figures for developing Asia of around 20 per cent (National Treasury, 2006; International Monetary Fund, 2006).

According to National Treasury estimates the foreign debt level is expected to remain low over the next three years. Milesi-Ferreti and Razan also argue that the size of the current account imbalance can be tackled by looking at exchange rate policy and structural factors including the degree of openness and composition of trade as well as the level of savings and investment. In the case of South Africa, however, it is important to caution that exchange rate interventions have been largely unsuccessful and that the policy may not fit with Inflation Targeting. One of the major conclusions of the study by Milesi-Ferreti and Razan is that the current account deficit should “flash a red light” if the export sector is very small, external debt and debt service costs are too high, savings are low and the financial sector is poorly regulated.

#### **4. Are Current Account Reversals Harmful?**

With the net external debt of a country growing more rapidly than GDP, some narrowing of the deficit is inevitable and a current account reversal could occur. Major reversals are defined as a reduction in the current account deficit by at least 6 per cent of GDP in a three year period.<sup>4</sup> The outcome may be a decline in domestic consumption and output. Edwards (2005a) argues that most of the developed countries that had persistent current account deficits of over 5 per cent of GDP

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<sup>4</sup> This definition, however, may differ from study to study.

experienced a current account reversal. Some of these countries include Greece, New Zealand, Norway, Portugal, Malta and Italy. More familiar cases of current account reversals which led to financial crisis occurred in Chile (1982-83), Mexico (1994-95) and East Asia (1997-98).<sup>5</sup>

So when are reversals bad? Edwards (2001) analyses the current account situation in developing countries and concludes that reversals have a negative impact on economic performance through the decline in investment. Edwards (2005a) also shows that large countries that experienced current account reversals experienced reduced GDP growth in the range of 3.5 to 5.0 per cent. This, however, does not necessarily mean that every large current account deficit will result in a crisis.

To be able to answer this question suitably, it is important to understand the origin of the current account deficit. The reversal situation can be analysed in three scenarios. First, a country may have a large current account deficit as a result of increased investment opportunities. If suddenly the investment opportunities decline, domestic investment and output would fall. Normally, if the current account deficit occurs due to productive investments, reversals are less severe or may not occur at all. In this case, the current account deficit reflects welfare enhancing behaviour because the capital flows enable productive investment to take place that would have not occurred otherwise. In countries like Turkey, for example, the current account deficit of 6 plus per cent of GDP has been driven mainly by high levels of investment. Using this type of thinking, it would mean that any reversal would not be severe or may not occur at all. Nonetheless, the deficit in Turkey is still relatively large for an emerging economy and it should be watched closely.

In the case where the reversal does not only cause a reduction in output, but also a sharp decline in consumption, then there is a cause for concern. In this case the fall in consumption shows a welfare loss. This type of result occurs when the current account is mainly driven by consumption. The United States is a good example where a high current account is sustained for a decade to fund excessive consumer demand

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<sup>5</sup> One ironic similarity between the Mexican (1995) and Korean (1997) crises is that both countries joined the OECD on the eve of their respective financial catastrophes.

and government spending. As one of the major global economic powers any “disorderly adjustments” would not only have negative consequences in the United States, but the slowdown could also drag the global economy down with it.

The third type of example relates to the situation in East Asia in 1997-98, where the reversal was affected by a weak financial sector which revealed the power of external vulnerability. In Asia, banks had incentives to borrow abroad and then the proceeds were used to grant risky domestic loans. Unpaid debt was settled by using tax payer’s money. Commercial banks in East Asia accumulated bad loans, which eventually led to the collapse of the banking industry. This moral hazard type of behaviour led to a financial panic, with short-term investors suddenly withdrawing their loans. Investment collapsed and a current account reversal occurred. The East Asian case was severe because the sharp output decline dipped the countries into a recession. In this example the state of the financial sector and bank balance sheets would be an indicator of a potential reversal. Macroeconomic fundamentals also played a role in the East Asian crisis. These countries also had fixed exchange rate regimes, which could not freely adjust in the light of a massive outflow of capital. Nor did these countries have sufficient levels of reserves to deal with the capital outflows.

The situation in East Asia presents a classic case of the Krugman (1979) model of *Macroeconomic policy-induced crisis*. In this model of balance of payments crisis (currency depreciation; loss of foreign exchange reserves; collapse of a pegged exchange rate) domestic credit expansion by the Central Bank is inconsistent with the pegged exchange rate. Foreign exchange reserves fall gradually until the Central Bank is vulnerable to a sudden run, which exhausts the remaining reserves, and pushes the economy to a (substantially lower) floating rate. This comes with (at least initial) severe adjustment costs to the economy.

South Africa’s current account deficit is driven mainly by investment goods and strong consumer related products. The importation of capital goods is expected to increase in order to meet national priorities such as Accelerated and Shared Growth Initiative for South Africa (ASGISA). However, the rapid growth in consumer related goods is a concern and it should be monitored very closely. Any current account reversal in South Africa should, however, be cushioned at least to some extent by the

flexible exchange rate, level of reserves (although more accumulation is needed) and other key macroeconomic factors such as low external debt.

## **5. What are the Risks to South Africa?**

The paper has stated that the current account deficit in South Africa has been more than financed by sufficient capital account inflows, mainly driven by portfolio flows and to a lesser extent by foreign direct investment (FDI). The risk, however, is that these inflows are highly speculative and determined by global activities. The Asian Crisis in 1997-98 was an important lesson to developing countries of how “sensitive” these flows are and how investors can pull out their capital overnight. So what are risks in the case of South Africa? The major external vulnerabilities include the recent turmoil in the United States housing market, global imbalances and oil price volatility.

### *5.1 The Recent Turmoil in the United States Housing Market*

The global liquidity crisis that developed as a result of the United States sub-prime mortgage market was due to the United States housing boom between 2001 and 2006. The housing boom encouraged excessive risk-taking by lenders who sharply extended loans to marginal borrowers allowing people to purchase property who could not afford it. As broad portions of the credit market started experiencing low levels of liquidity, it was necessary for central banks in the United States, Europe and other developed markets to inject huge sums of capital into the overnight money markets.

Financial systems in South Africa and emerging markets so far have negligible exposure to the sub-prime market. Liquidity conditions domestically have remained healthy, and there has not been any need for Central Banks to provide extra liquidity to markets. However, it is important to note that the South African economy is closely linked to the global financial markets and the sustainability of capital inflows depend in part on global liquidity conditions. In this regard, capital flows are important for the financing of the current account. This means that South Africa should accumulate more reserves to manage any sudden stop of capital inflows.

Another risk regarding the sub-prime market will depend on the impact of the developments on the United States growth performance. The slowdown in the United States growth rate is bound to spill over to the South Africa as the economy demand conditions depend on the United States growth for exports and supply of capital. Consequently, any incorrect adjustment to the sub-prime problem could translate into lower supply of capital abroad and growth in South African economy.

## 5.2 *Global Imbalances*

Another concern relates to the phenomena of global imbalances, in particular the large current account deficit in the United States. As argued by Edwards (2005a), the high current account deficit cannot persist for ever; it will have to decline sooner or later. Any “disorderly” adjustment in the United States could cause a sharp depreciation of the dollar and eventually lead to a substantial decline in United States and world output, a fate that South Africa may not be able to escape. This will not only lower demand for South African exports, but may also result in a decline in commodity prices. As a consequence the current account situation in South Africa could deteriorate even further.

According to the International Monetary Fund, coordination to reduce global imbalances includes the following global policy responses:

- a) Monetary policies in developed countries should remain supportive of growth.
- b) A cooperative approach is essential to underpin an orderly global adjustment process, including orderly currency adjustments, China in particular, and other imbalances.
- c) Fiscal frameworks that aim to restore fiscal balance.
- d) Both developed and emerging market economies should make sustained progress in vigorously implementing ongoing structural reforms to strengthen economic growth, support domestic demand and reduce vulnerabilities.
- e) A timely and successful conclusion of multilateral trade under the Doha Round is critical to help curb protectionist pressures and achieving further

trade liberalisation, as this will help strengthen confidence in the global economic recovery. Progress with agricultural trade reforms—especially among the largest developed economies—will be critical for boosting the growth prospects for developing economies and making progress with further poverty reduction.

### *5.3 Commodity Volatility*

Another major source of external vulnerability is a decline in commodity prices, as most of the investments from abroad are tied to commodities in one way or another. In May and June 2006 a slight decline in commodity prices put some pressure on the rand, which required interest rate hikes to counter possible inflationary pressures. If a massive outflow were to have occurred due to the risk caused by further depression in commodity prices, the demand for the rand would have dropped leading to further depreciation. As the outlook for commodities and hence South Africa's financial assets deteriorate, capital could start flowing out on a massive scale.

The severity of the reversal on the economy would depend on how much the reversal affected both domestic and foreign consumer and business confidence and hence investment, consumption and output. Even though a weaker rand may trigger some positive net trade developments, this will ultimately depend on domestic price responses (i.e. how much of the depreciation will come through as competitive gains versus just increases in general price levels). However, international experience indicates that these adjustments can be very costly to the domestic economy in terms of output loss (at least over the short-term).

## **6. Going Forward**

The current account situation in South Africa does not seem to be a major concern because it is more than financed by capital inflows at the back of strong macroeconomic fundamentals. However, it is important to remain conscious and to monitor the risks (i.e. a decline in short-term inflows) associated with running a current account deficit of this nature. The paper has pointed out that South Africa has increased its vulnerability due to a relatively high current account deficit. Triggers

could be a sudden stop in capital inflows, slow global growth and/or a decline in commodity prices. The consequence of these triggers would be a sudden decline in the investment opportunities, which would result in a fall in domestic investment and output plunging the country into a recession.

It must also be underscored that South Africa's strong macroeconomic fundamentals should at least to some extent help it weather these storms if they had to occur. These fundamentals include among others (i) flexible exchange rate; (ii) relatively small external debt (iii) sufficient reserve position; and (iv) a strong banking system. Therefore, policy makers should continue to build reserves, stem credit growth, slow demand and increase investment proportion of demand. This would make sure that any current account reversal would not result in any undesirable economic effects. In this regard the right fiscal and monetary policy mix is important. Effective trade policy will also play an important role in improving trade performance and narrowing the current account deficit.

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APPENDIX

Summary of South Africa's current account, 1990 - 2007Q2

Percentage of GDP*	1990	2000	2006	2007Q1	2007Q2
Exports (excluding gold)	15,4	21,1	23,1	24,8	25,8
Gold exports	5,8	3,0	2,1	2,0	1,9
Exports	21,2	24,1	25,1	26,8	27,7
Imports	15,4	20,5	27,6	29,5	29,3
<b>Trade balance</b>	<b>5,8</b>	<b>3,5</b>	<b>-2,5</b>	<b>-2,7</b>	<b>-1,6</b>
Net service receipts	-0,3	-0,6	-0,9	-1,0	-0,9
Net income receipts	-3,8	-2,4	-2,1	-2,2	-2,9
Current account balance excl. SACU and other transfer payments	1,7	0,6	-5,4	-5,9	-5,4
SACU payments and other current transfers	-0,3	-0,7	-1,0	-1,0	-1,2
<b>Current account balance incl. transfer payments</b>	<b>1,4</b>	<b>-0,1</b>	<b>-6,4</b>	<b>-6,9</b>	<b>-6,5</b>

\* GDP seasonally adjusted annualised rates

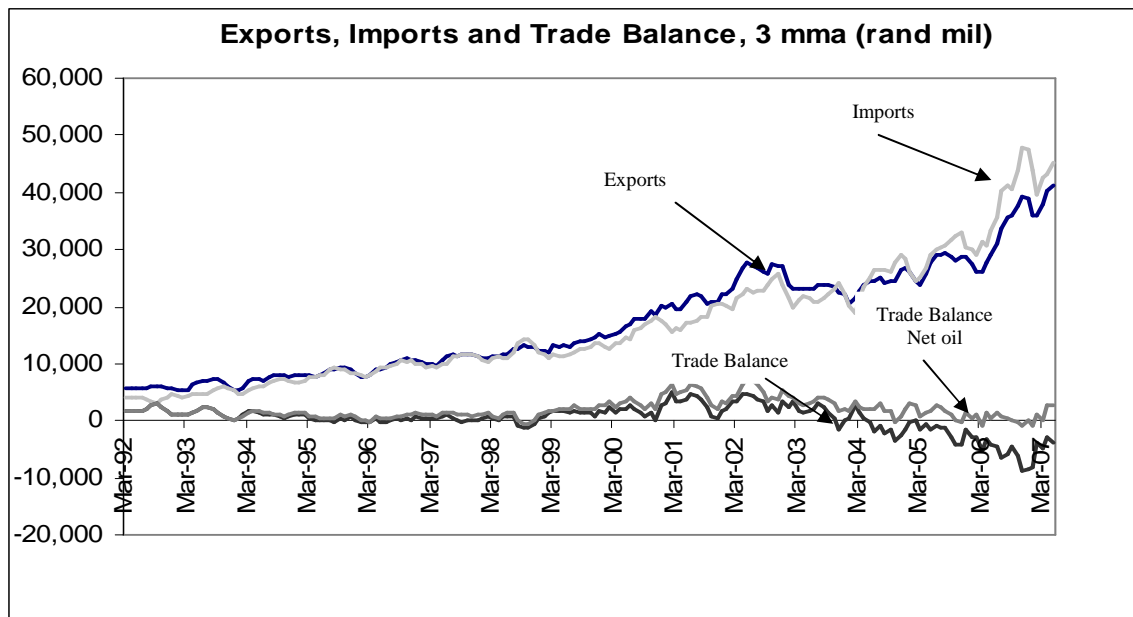


Figure 1

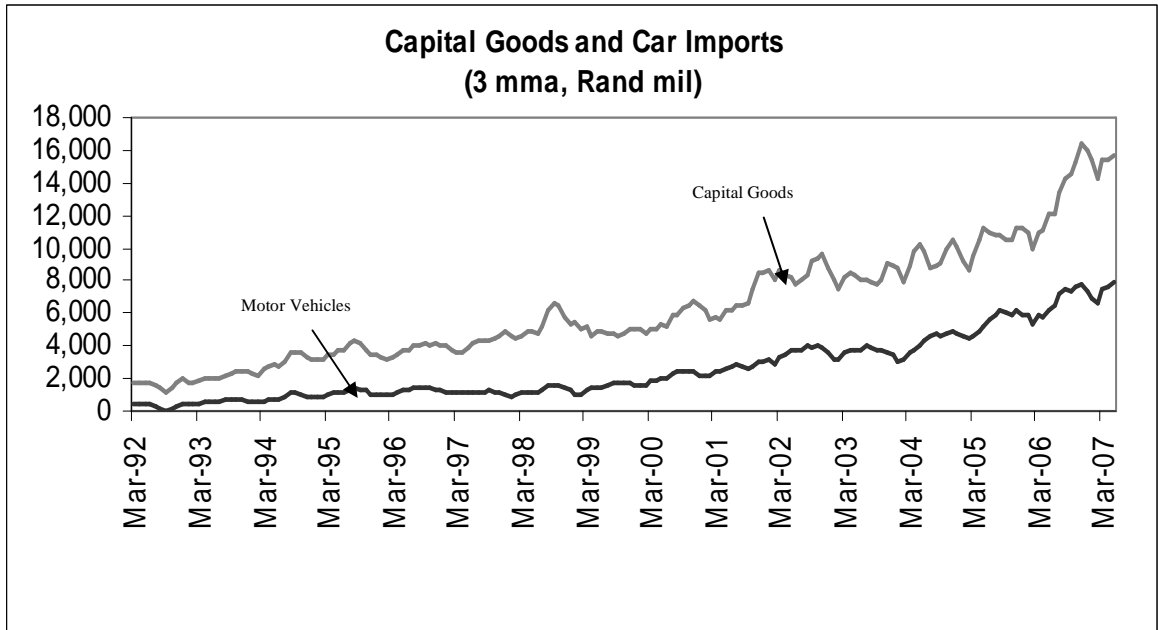


Figure 2

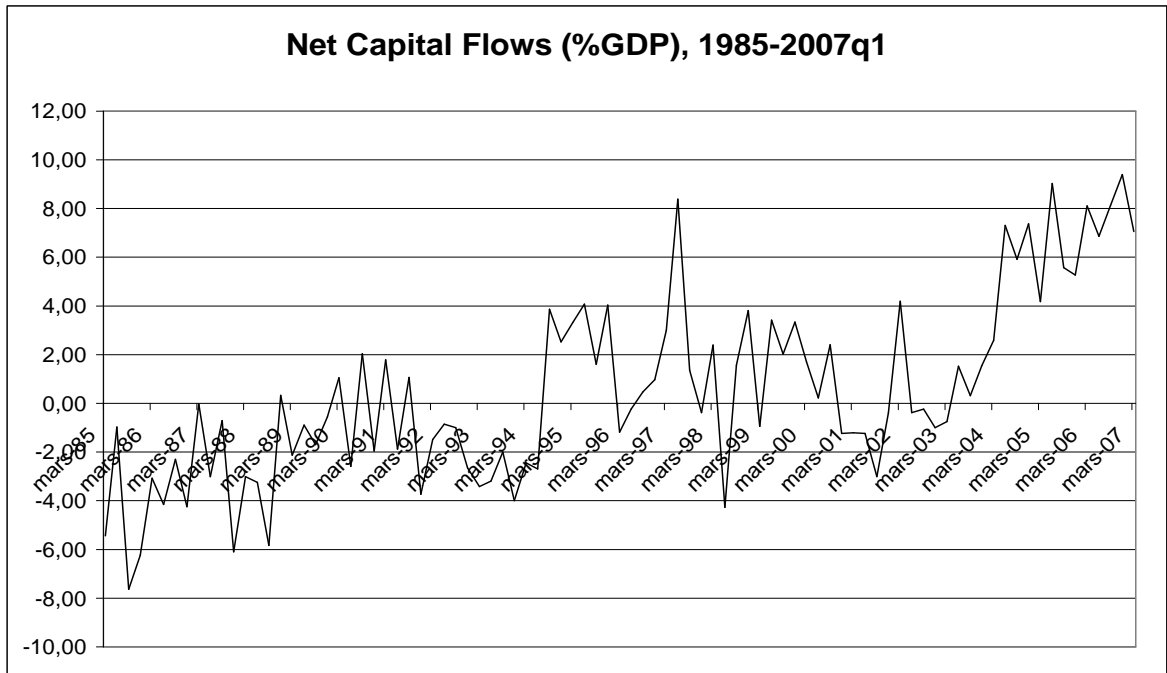


Figure 3