NEDBANK

# Economic Research

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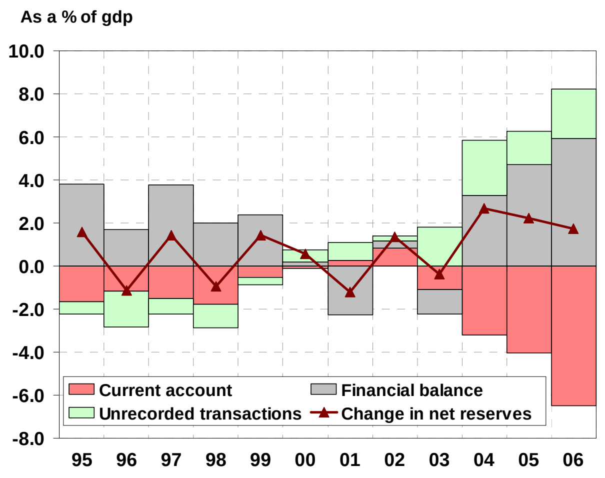
## BALANCE OF PAYMENT DRIVERS

***In the May 2006* Guide to the Economy *we asked whether the widening current account deficit was a problem. In subsequent months the currency market reflected these concerns as the rand came under increasing pressure. Interest rates were hiked in response to the increased vulnerability. However, one year further down the line and the current account has worsened, but markets are relatively calm. Is this because the reasons for the widening are better understood and accepted, or because the phenomenon is seen as temporary? This article examines recent balance of payment trends for clues.***

Graph 1: *Capital inflows continue to fund current account*

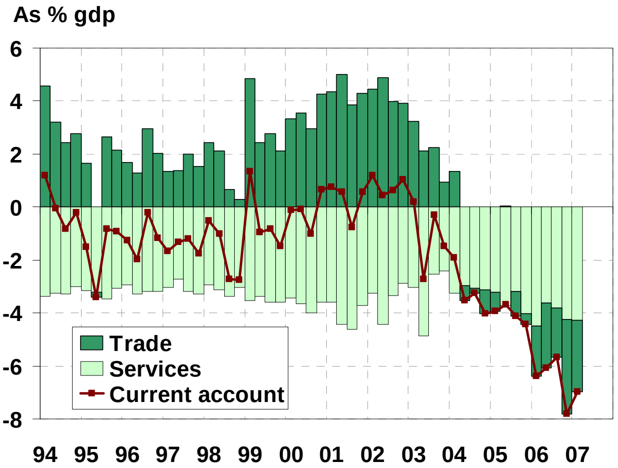



*Source: SA Reserve Bank*

Current account deficits are often viewed as a bad thing - evidence that export performance is lagging import growth and that a country is living beyond its means. However, a deficit implies that investment is exceeding domestic savings and, therefore, that foreign investors are happy to fund a country's plans to build capacity and raise potential economic growth and employment to higher levels. In '*Is the widening current account deficit becoming a problem?*' (*Guide to the Economy*, May 2006) we examined the reasons for the rise in imports and questioned whether the deficit was sustainable. The conclusions, broadly, were that imports had largely risen as a result of burgeoning consumer spending, that exports were dependent on the commodity cycle, but that South Africa's very low foreign debt meant that successive current account deficits could easily be sustained. We suggested that tighter fiscal policy was appropriate (to boost domestic savings), that trade protectionism was not (the longer-term effects are increased inefficiencies not production) and that tougher monetary policy could help, but only if the authorities built up official reserves to counter rand appreciation.

### Recent trends

Graph 2: *Worsening trade balance to blame*

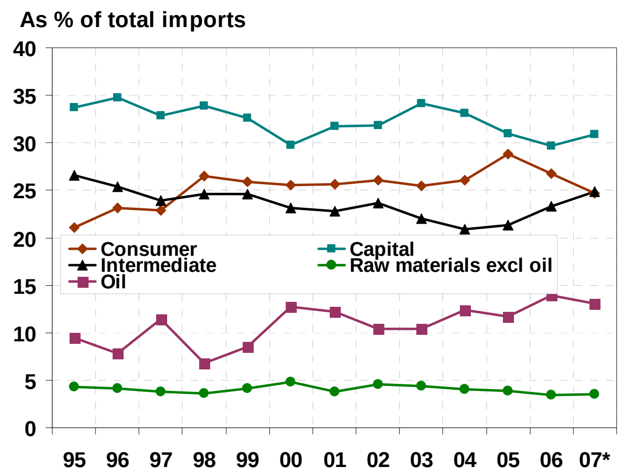



*Source: SA Reserve Bank*

In just a year the current account deficit widened from 4,4% of gdp (fourth quarter 2005) to a peak of 7,8% of gdp (in the fourth quarter of 2006). It then narrowed slightly to 7% in the first quarter of this year. The deficit in 2006 was 6,5% of gdp compared with 4,0% in 2005. The current account can be broken down into the trade balance (exports minus imports), and the 'services' balance (receipts of income and services minus payments, together with current and capital transfers). As graph 2 shows, most of the deterioration has been due to a worsening in the trade deficit, with imports rising at a quicker pace and off a higher base than exports. During 2006 imports rose by 32,4% and by a further 36,9% in the first five months of 2007 compared with the same period in 2005. In comparison, exports increased by 23,3% and 43,7% over the same periods, a significant improvement over the two previous years, but only recently starting to offset import trends.

The major culprits behind the rise in ***imports*** were again oil and refined fuel (contributing around 30% of the increase in 2006), partly the result of high internationally determined prices and partly because of the higher volumes needed to drive the economy outstripping local capacity. However, graph 3 shows that the overall mix has improved since our analysis last year. While the contribution of capital goods was again smaller in 2006, early indications (based on the first four months of the year) suggest that this has started to reverse. The relative share of consumer goods is also falling quicker, confirming that the expected move towards more capacity-enhancing imports has started. Imports of capital goods rose by 38,6% year-on-year in early 2007 compared with 27,3% for consumer goods and an overall increase of 36,3%. The moderation in the growth of consumer-related imports has not been uniform, however. Growth remains high in key areas such as motor vehicles, furniture and appliances, while growth in clothing imports has eased after rising very strongly towards the end of last year. These trends are likely to become more entrenched as fixed-investment growth remains buoyant and consumer spending growth settles at more sustainable levels.

Graph 3: *Capital goods imports are rising*

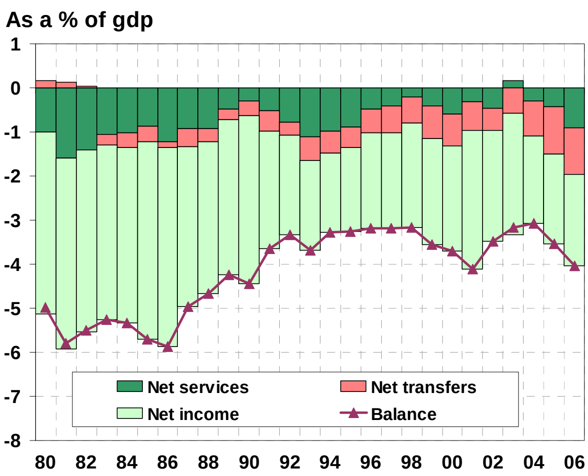



** Based on first four months of the year*
*Source: SARS, Group Economic Unit*

***Export performance*** has improved after a disappointing period that lasted from late 2001 to early 2006. Initially this was due to a weak global economy and depressed commodity prices, but the climate quickly changed once the reflationary policies pursued in the US started to impact and as China emerged as a major economic force and an intensive raw-materials consumer. Poor performance was then linked to rand strength and volatility. Exporters – particularly those not benefiting from commodity price rises – were uncertain how to respond to the dramatic pullback in the rand following the sell-off in 2006. Although dollar weakness was a major contributing factor, the move in the currency from close to R14 to the dollar to under R6 made investment in the export industry unattractive.

More recently the rand has traded in a more acceptable range (with authorities no longer espousing the virtues of an appreciating currency). The correction in 2006 brought the currency closer to its long-term purchasing power parity value and has helped exporter competitiveness. However, performance has still been hampered by a lack of capacity and transport infrastructure. Capital formation in the mining industry was also surprisingly weak despite the massive rise in commodity prices and significant investment taking place in other commodity-rich countries. Some have attributed this to regulatory uncertainties and delays following the 2002 Mining Charter and the 2004 Minerals and Petroleum Resources Development Act. The latter required so-called old-order mineral rights to be converted into new-order rights. The government has denied this, blaming rand appreciation and increasing opportunities for mining companies elsewhere in Africa. Either way, export prospects are now on a sounder footing as infrastructure and regulatory concerns are being addressed and the rand continues to trade at more competitive levels.

Graph 4: *The services deficit has widened fractionally*



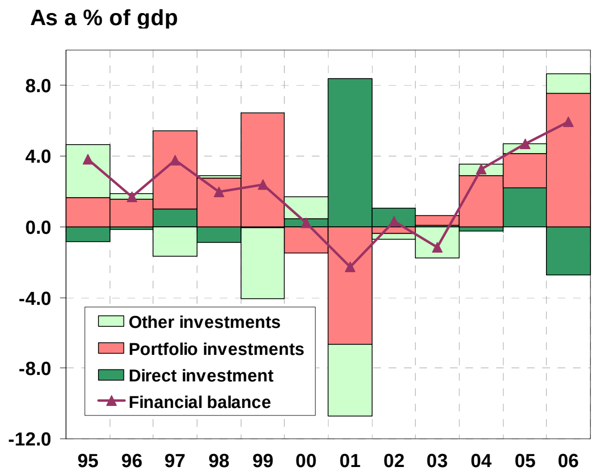

*Source: SA Reserve Bank*

Graph 2 shows that the ***'services' deficit*** has been considerably less erratic than the trade balance, but also that it has consistently experienced shortfalls and that the deficit has widened over the past three years. The payments balance is made up of receipts and payments for services (such as transport and travel), income (employee compensation and investment income such as dividends and interest) and current and capital transfers (mainly intergovernment payments). Within these categories the largest net shortfall is in the ***investment income*** category. However, graph 4 shows that this is still relatively small compared with earlier decades, when foreign investors had more dominant interests. Interestingly, it is not the component that is growing the quickest, despite foreign investors having increased their interests in South Africa considerably. This is probably because South African residents have also been buying foreign assets and that returns flowing from these investments have compensated to some extent.

Within ***net services*** the largest net-payments component is for transport, but South Africa receives considerable net payments for travel, an area that could improve further as the country improves its tourism infrastructure and profile in the run-up to the FIFA World Cup in 2010. The sharp rise in ***transfers*** in recent years is due to Southern African Custom Union payments, whereby South Africa transfers a disproportionate share of customs and excise receipts to its Custom Union partners. The sharp rise in imports and consumer spending has increased this figure considerably over the past three years.

Net inflows on the ***financial account*** have generally matched net outflows on the current account (see graph 1). Added to this have been large positive unrecorded transactions, which could be either underestimated inflows on the current or on the financial accounts. What is known is the overall change in net reserves. So this figure is simply the difference between the overall balance of payments figure and identifiable transactions.

Graph 5: *Financial surplus widens further*




*Source: SA Reserve Bank*

Much has been made of the increasing reliance on ***net portfolio flows*** to fund the current account deficit. However, graph 5 shows that such investment flows have been very reliable even during periods of emerging market turmoil (1998) or moderate rand weakness (1996). The exception was the 2000 to 2002 period, but even then the large outflow in 2001 was largely due to a technical switch resulting from the De Beers delisting.

## Conclusion and outlook

The current account deficit remains persistently wide, but the mix is improving, with imports more related to capital goods and exports starting to rise more strongly in volume and value terms. These trends are expected to intensify. Given low domestic savings and the expected capital formation boom, the country will remain dependent on foreign investment over the next few years. As long as positive global liquidity continues and the South African economy remains attractive, this is unlikely to pose any serious problems and will help to boost economic growth potential.

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