Commentary: Capital flows, current-account adjustment and monetary policy in South Africa

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1. Introduction

Smit's paper addresses one of the most important and topical issues in international economics. It starts by providing a brief overview of the balance-of-payments developments in South Africa. The general observation is that the current-account deficit in South Africa is rather large by historical standards, but it is comfortably financed by increases in capital inflows. These capital inflows, however, are predominantly portfolio capital. The paper then digresses and looks at international experiences covering issues such as sudden stops and current-account reversals. Then the issue of current-account sustainability is discussed, which is quite important, given the current global financial crisis. Section four of the paper is devoted to a consideration of appropriate macroeconomic (especially monetary) policy responses. Finally, the macroeconomic impact of a sudden stop of foreign capital flows to South Africa under alternative macroeconomic policy assumptions is modelled and analysed.

2. Sustainability

Several issues raised in Smit's paper merit some comments. First, the issue of sustainability needs further interrogation. The author cites at least two studies as proof of the non-sustainability of the South African current-account deficit, that is, Smit (2007) and Frankel et al. (2007). The conclusions reached from both these studies are not very tractable. The criteria used in Smit (2007) of choosing net foreign liabilities are ad hoc and thus can generate any result that the author desires. Similarly, Frankel et al. (2007) draw a probability conclusion without providing the magnitude of the probability. Of course, these are standard tools for evaluating current-account sustainability and have been used by a number of authors as pointed out in the paper. However, this points to an important area of future research, that is, there is a need for more rigorous interrogation of current-account sustainability in South Africa. Edwards (2006) provides a good starting point in this regard.

3. Policy

The other issue raised in the paper relates to policy options available to deal with current-account deficits. The paper focuses more on monetary policy and, to a lesser extent, on fiscal policy. The questions then are (1) is there a role for other policies such as fiscal and trade policies and (2) is there a role for confidence-building initiatives, given that, to a large extent, the current financial crises are basically crises of confidence? The issue here is that there is a need to be more comprehensive when one searches for an appropriate policy response.

4. Macro-model simulation

Smit's paper also provides some interesting macro-model simulation exercises. Unfortunately, the author provides no model on which the simulation is based. Understandably, often these models, given their size, can be difficult to present in the text, but authors typically include a model or, at a minimum, a subset of critical equations in an appendix for readers to appreciate what they have done. In the absence of a model, the paper is basically a "black box" and it is therefore difficult to make an informed evaluation. However, suffice to mention that authors need to be extra careful when using non-micro-founded "large-scale econometric models" (assuming that they are of the type used in the paper) for policy simulation (see, for example, Favero, 2007).

5. Scenarios

The scenarios provided in the paper need to be reconsidered. As they are, they seem incomplete and not systematically "question-driven". Take, for example, a sudden-stop scenario, version I. With adverse assumption on both the performance of the world economy and capital flows, how does one separate the impacts? Moreover, with a floating exchange rate system in South Africa, how does one justify the exchange rate as a policy instrument? Thus, there is a need to rethink the policy scenarios analysed here. The first scenario, in my view, should be the one that answers the following question: how does a one-off shock to capital flows impact on the other variables? This question is important because policy responses often come at a price and, as such, researchers need to demonstrate necessity for policy response(s).

6. Further research

Finally, there are other questions that the topic raises for further research. There is a need to model fully the early-warning signals of current-account reversals or sudden stops. There is also a need to disentangle the current account fully so that one may understand its components. One needs to understand, for example, (1) the extent to which the outflow is a result of normal dividends paid out to foreign shareholders, given the reasonable amount of foreign ownership in South Africa; and (2) whether this is an investment-driven current account or a consumption-driven one. In this way one will begin to have a better understanding of the current-account deficit and its implications. This paper, nonetheless, is interesting since it begins to address an important question that South Africa faces in the current financial turmoil.

References

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