

Living with structural current account deficits: Foreign lessons for SA?

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Abstract

South Africa's persistent and often large current account is generally seen as one of the country's major structural weaknesses. Yet there are several advanced economies (Australia, New Zealand and to some extent Canada) which have run large deficits for decades, without obvious negative consequences for growth, monetary policy effectiveness and financial stability. This note looks at parallels and differences between these three economies and South Africa, and concludes that the external deficit may not prove (over time) as innocuous in the latter as in the other three countries. More fragile public finances, signs that capital is not used as efficiently, higher economic and policy risks are reasons why foreign investors may be less willing to finance lasting deficits on favourable terms in South Africa.

Introduction¹

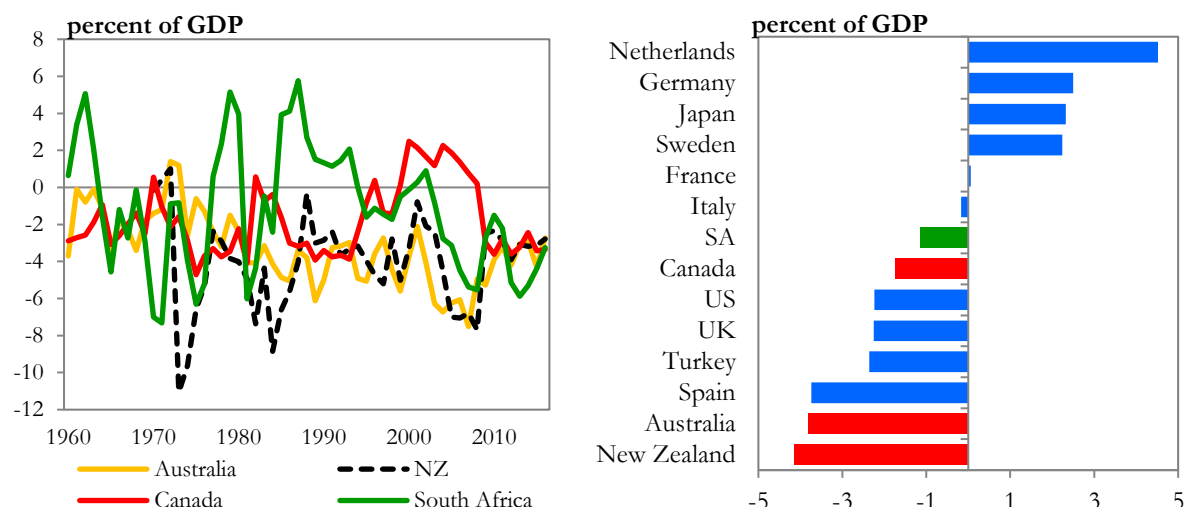
The persistence of a relatively large current account deficit in South Africa – even at times when the terms of trade improved significantly – is generally seen as one of the country's weak fundamentals. Economists and investors view it as a sign of poor competitiveness, which reduces the attractiveness of SA as an investment location. They feel it perpetuates expectations of further real (as well as nominal) depreciation of the rand, adding to the domestic cost of capital and thus penalizing growth. Finally, they believe it increases the risks of shocks to the economy from “sudden stops” in the non-resident capital flows needed to finance these deficits. Last year, the IMF noted “large gross external financing needs” as one of South Africa's vulnerabilities;² and rating agencies have regularly cited external deficits as one of South Africa's weak fundamentals in the past.

South Africa is not unique in running large current account deficits. Other emerging countries (Brazil, Mexico, Colombia, Turkey for example) fall into that pattern; in past decades, they have at some stage experienced severe financial stress. Nonetheless, there are some advanced economies – Australia, New Zealand and to some extent Canada – that have run regular, often large current account deficits for most of the past decades; and do not appear to have suffered negative consequences as far as economic growth, financial health and policy effectiveness are concerned. This note analyses the financing of current account deficits in these three countries, the implications for external balance-sheets and domestic economic and financial fundamentals. It then draws comparisons with South Africa's situation, and concludes that while large, structural deficits can at some point be relatively “risk-neutral” for a specific country, this requires several pre-conditions – not all of which are met in South Africa.

¹ Many thanks to Theo Janse van Rensburg, David Fowkes and Daan Steenkamp for their valuable comments.

² See IMF Article IV Consultation – Staff Report, July 2017

Figures 1 and 2: Current account deficits in selected countries since 1960 (left) and 1975-2017 historical averages (right)



A common history of lasting, relatively large current account deficits

Among advanced economies, Australia and New Zealand stand out as having experienced deficits for most of the past 50 years, and indeed, in the case of Australia, deficits were the norm since the mid-19th century.³ With the exception of a string of surpluses in the 2000s, Canada also tends to experience structural deficits (see Figure 1). Furthermore, the average long-term size of current account deficits (as a share of nominal GDP) is high relative to both advanced economies' norms and South Africa in Australia and New Zealand (see Figure 2). Canada's long-run deficit is moderately wider than that of South Africa. In the past decade, however, overall comparisons are increasingly less favourable to South Africa.

While South Africa, unlike the other three countries mentioned, is a developing economy (with significantly lower GDP per capita and higher sovereign risk), there is nonetheless merit in comparing these countries' external balances. In the late 19th and early 20th century, all four countries were "new" economies with strong capital flows from the United Kingdom that funded domestic investment, mostly in resource extraction, commercial farming and infrastructure. To this day, commodities dominate their export structure, while manufacturing is low as a share of GDP – implying that a large share of consumer and capital goods are imported. Sophisticated banking systems and financial markets were developed to fund productive investments, as well as housing for a growing population with net migratory inflows. In turn, easy access to credit (especially mortgage credit) resulted in all four countries traditionally experiencing low household savings rates by world standards, similar to the UK.

Debt portfolio flows are crucial for deficit financing

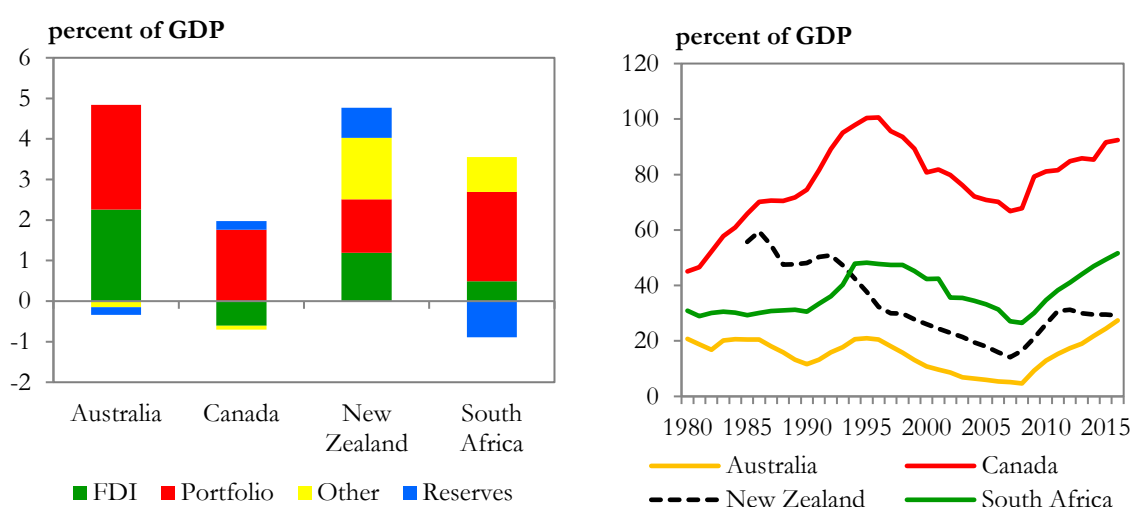
In today's world of (generally) free capital flows, the way a current account deficit is financed can prove crucial to its sustainability and the risk of "sudden stop" reversals. In this aspect as well, Australia, Canada and New Zealand display similarities to South Africa. Their deficits are privately-financed, with no significant pressure on official reserves (although these are low by global standards in all four countries). Furthermore, in all cases, non-resident portfolio flows are a key source of financing – and in Australia and

³ See "Current account deficits: The Australian debate", R. Belkar, L. Cockerell and C. Kent, Research Discussion Paper, Reserve Bank of Australia, March 2007

Canada, these consist mostly of bond purchases. By contrast, net “other investments” (mostly, bank financing) play a smaller role, with the exception of New Zealand (see Figure 3).

There are, however, significant differences in the structure of financing across all four countries. Noticeably, in Australia and New Zealand – where government deficits are historically small and public debt-to-GDP ratios relatively low (see Figure 4) – most portfolio flows finance purchases of *private*, rather than public bonds (of which a large part were bank bonds). To some extent, it appears that prudent fiscal policies have “crowded in” foreign-financed private-sector expansion. Equally, in both countries, net FDI inflows have been significant over time, in contrast to Canada (where elevated outflows roughly match inflows) and South Africa, where inflows are sporadic.

Figures 3 and 4: Split of current account deficit financing (2000-17 averages, left) and government debt to GDP ratios (right)



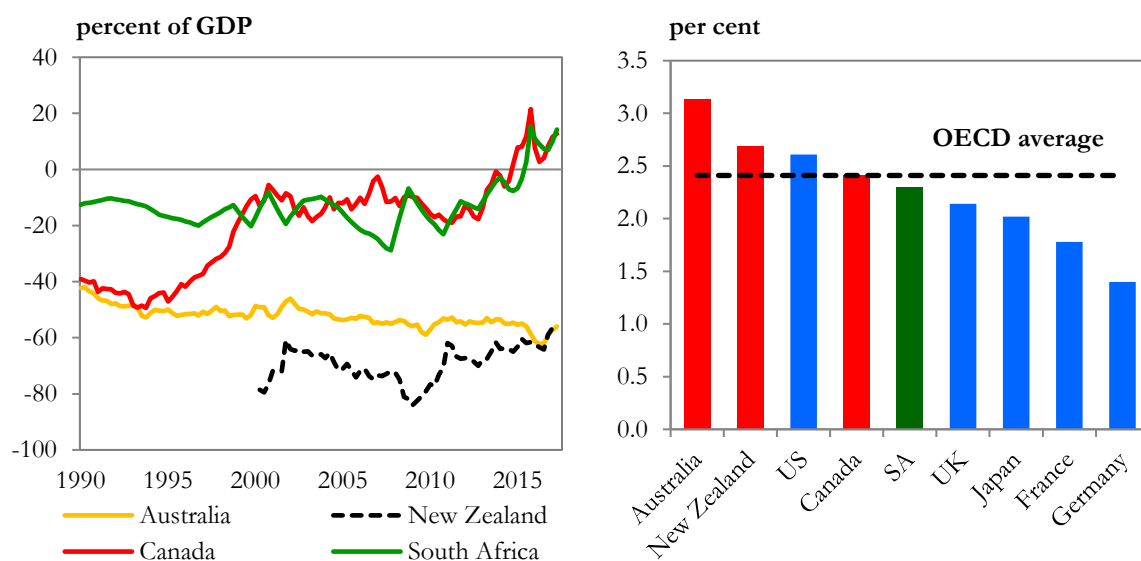
Divergent trends in net external positions

One concern raised by recurrent external deficits is that a country’s net external liabilities will build up over time, raising sustainability concerns and potentially prompting foreign investors to require a risk premium on their assets. In that respect, there is a key difference between Canada and South Africa – where the net international investment position (NIIP) recently moved into surplus – and Australia and New Zealand, where it has consistently been significantly negative (see Figure 5). Because, as mentioned above, government debt is relatively low in these latter two countries, most of these liabilities are the private sector’s, in particular the banking sector’s.

In fact, in both countries, the banking sector is large, with balance-sheets exceeding or close to 200% of GDP, and has effectively been the key vehicle for transforming foreign capital inflows into domestic lending. In Australia, for example, net international liabilities of the banking sector amounted to nearly 20% of GDP as of September 2017, though this was only 8% of total banks’ balance-sheets. A majority of these liabilities are denominated in foreign currency, though the existence of a sophisticated derivatives market allows banks and other corporate borrowers to hedge most of this currency exposure. In New Zealand too, offshore funding is relatively high (23% of total bank funding as of September 2017).⁴

⁴ A specific characteristic of the New Zealand banking system, however, is that subsidiaries of Australian banks account for a large majority (86%) of domestic banking assets.

Figures 5 and 6: Net international investment positions (left) and 1980-2016 average real GDP growth rates in selected economies (right)

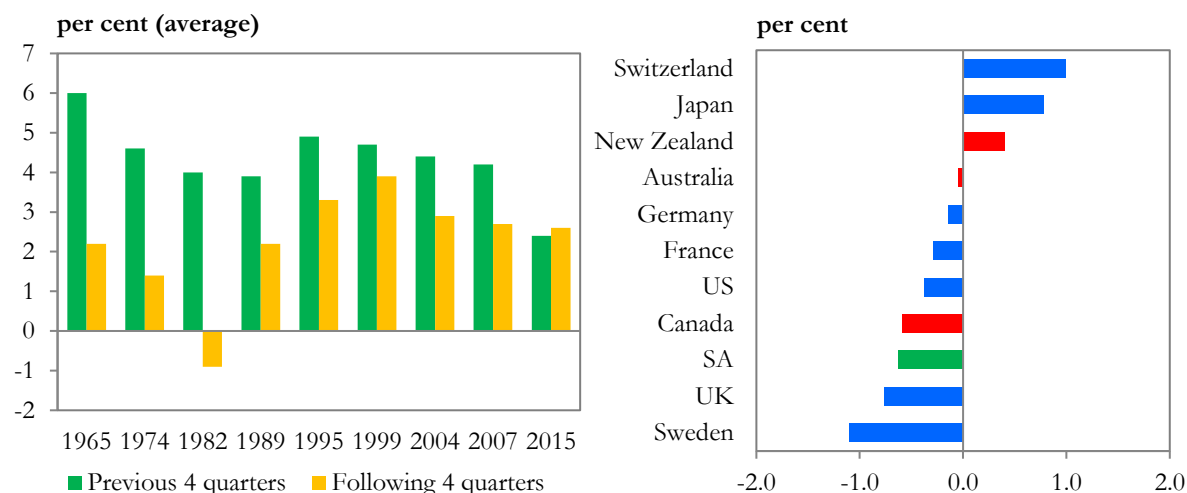


No obvious consequences for growth, policy or financial stability

But did these countries— especially Australia and New Zealand, with their large negative NIIPs – have to some extent to “pay a price” in terms of growth performance, policy effectiveness or financial stability? The answer, with some nuances, is generally negative. In all three countries (Canada, Australia and New Zealand), long-term real GDP growth averages matches or exceeds the OECD average (see Figure 6).⁵ Admittedly, real growth performance proves more volatile over time in Canada and New Zealand than in the OECD as a whole; however, it is not clear whether this is a consequence of “sudden stops” or of the importance of the commodity sectors in these economies, and hence, of the sensitivity of national income to volatile terms of trade. If one specifically looks at episodes of “unusually large” external deficits – defined as shortfalls of at least 1.5 standard deviations wider than an HP-filter trend for at least two quarters – they are generally followed by a downward adjustment in GDP growth rates, which can be a sign of “sudden stop” constraint. However, it is important to note that the magnitude of these adjustments has declined markedly in both Australia (see Figure 7) and New Zealand since these countries liberalized their capital accounts and allowed a free currency float in the early 1980s.

⁵ Even when looking at GDP per capita, long-term growth rates broadly match the OECD norm. The New Zealand growth rate falls somewhat short; however, its absolute GDP per capita level was relatively high to start with.

Figures 7 and 8: Average real Australian GDP growth before and after “peak deficits” periods (left) and average annual changes in REERs since 1970 for selective countries (right)



Equally interestingly, persistent current account deficits in these countries have not led to trend depreciation in their real effective exchange rates (REER). Since the end of the Bretton Woods system at the start of the 1970s, the Australian and New Zealand dollars have performed better on that specific metric than the Canadian dollar (where the deficit is smaller) or the Swedish krona, where the current account is structurally in surplus (see Figure 8).⁶ Some might argue that the mix of current account deficits and appreciating real exchange rates is a sign of structural REER overvaluation; if this is indeed the case, however, it is hard to understand why no durable adjustment has occurred over so many decades, as the open capital account allows for “price discovery” in the FX market. The Australian and New Zealand dollars did depreciate in the 1970s-1980s, but this later reversed as commodity prices recovered.⁷ Both currencies have been relatively volatile on a REER basis in the last two decades, though over a longer period (since the 1970s) their volatility is not much different from that of “anchor” currencies like the US dollar or the yen.

In turn, relatively “normal” currency behaviour seems to have helped keep inflation in check. Inflation was highly volatile in the 1970s and 1980s in Canada, Australia and New Zealand, but this was the norm across most countries, and these countries’ inflation rates subsequently followed the global downtrend. In fact, since these three countries implemented inflation targeting (IT) regimes in the early 1990s, the volatility of their headline inflation rates has declined significantly, and has not exceeded that of, for instance, Japan. Thus, having a large current account deficit need not result in high or volatile inflation. On balance, since IT was introduced, inflation in these three countries has been on average close to the midpoint of targets; and the number of quarters in which the target has been exceeded does not seem unusually high relative to, for instance, the US or the UK.

Equally, despite their large size and their net external liabilities, banking systems in these three countries do not appear structurally more vulnerable than those of other OECD countries. Long-term historical data from Carmen Reinhart⁸ do not show a higher incidence of banking crises, on average, than other developed economies; similarly, recent data on non-performing loans (expressed as a share of total bank assets) shows

⁶ The conclusion remains the same if we only consider the periods during which the currencies were allowed to float freely (beginning in the early 1980s for Australia and New Zealand, the mid-1990s for South Africa).

⁷ In the case of New Zealand, this is analysed in “New Zealand History of Monetary and Exchange Rate Regimes”, R. Sullivan, Reserve Bank of New Zealand, March 2013

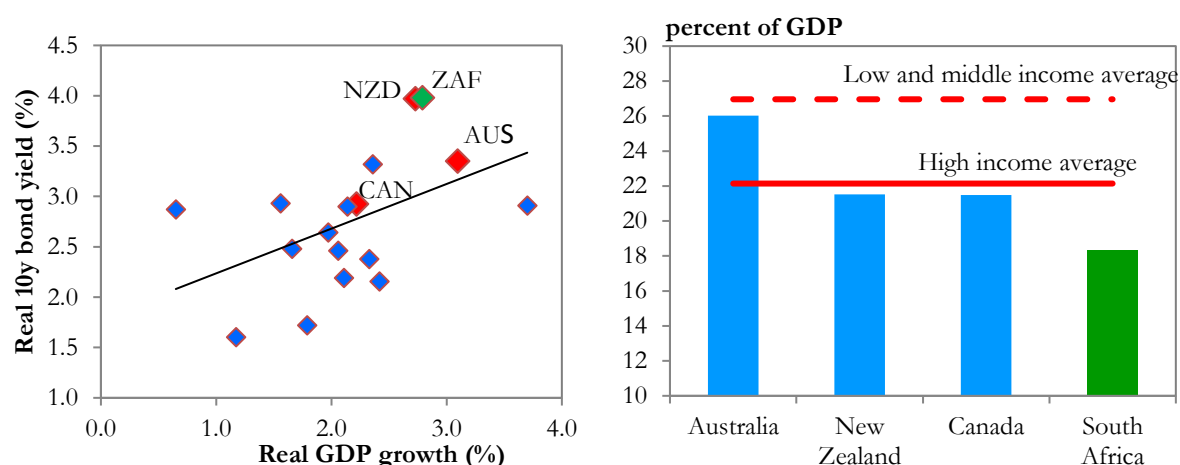
⁸ See www.carmenreinhardt.com and “Fragile by Design: The Political Origins of Banking Crises and Scarce Credit”, by C. Calomiris and S. Haber, Princeton University Press, 2014

that Australia's ratio is in line with international norms, while those for Canada and New Zealand are significantly lower.

Is there a market “risk premium” for large current account deficits?

If a structural and relatively large current account deficit does not lead to undue inflation volatility or frequent misses in the inflation target, it should also have no particular impact on long-term interest rates. Historical data for Australia and Canada suggest that this is indeed the case: Since the 1990s, real ten-year bond yields in these two countries are relatively high by OECD standards; however, this appears consistent with a real growth rate of the economy that is also relatively high (see Figure 9). New Zealand, admittedly, has a relatively high real long-term yield, similar to SA. Yet if one uses the World Bank's average real lending rates series – which might a better proxy than government bond yields of the cost of credit in the economy – New Zealand is in line with the OECD norm.

Figure 9 and 10: Average real GDP growth and long-term yields for selected countries (1990-2017, left) and fixed investment as a share of GDP (1990-2016 averages, right)



Theoretical underpinnings of a “benign” current account

Why do Australia and New Zealand seem to successfully combine large current account deficits, stable to strong economic performance and financial stability? Economic theory may shed some light on the subject. In the 1980s, in contrast to the earlier “conventional wisdom” that large deficits were sources of eventual instability, the “consenting adults” theory argued that deficits were not a problem as long as they reflected optimal inter-temporal decisions by both private savers and borrowers.⁹ Under that approach, instead of being a constraint on potential growth, deficits can *boost* growth by allowing firms to take full advantage of investment opportunities. The theory, however, is only valid if: (1) fiscal discipline is maintained, ensuring that public borrowing does not “crowd out” the private sector; and (2) private agents act rationally and do not systematically over-estimate future potential growth.

The Australian and Canadian example may give some credentials to that theory. Effectively, in both cases, foreign investors have “trusted” that capital flows would be used for optimal investment decisions and not to feed unsustainable bubbles; the good growth and policy performance over recent decades shows in return that so far, this trust has not been misplaced. Admittedly, Australia and Canada have experienced several housing bubbles, and foreign capital has funded consumption as well as investment; yet crucially

⁹ This approach is summarized, among others, by Corden (1991) in “Does the current account matter? The old view and the new”, W.M. Corden, September 1991.

for offshore lenders, this has not impeded the health of the banking system. Canada has large public debt; however, the more balanced NIIP is probably an offsetting factor. New Zealand's real yields suggest investors are somewhat less convinced about the "consenting adults" theory than in the case of Australia. It could be because its fixed investment rate is low relative to peers, resulting in foreign capital feeding more into consumption;¹⁰ it could also reflect investor perceptions that "tail risks" of disruptive crises are higher in New Zealand.¹¹

In summary, the cases of Australia, New Zealand and Canada suggest that it is possible to run relatively large deficits for a long time, provided several conditions are met, namely: (1) well-managed public finances, that allow foreign capital to mostly finance productive investments; (2) a solid banking system that successfully recycles capital inflows into domestic lending; (3) investor trust in the institutional, monetary and financial stability of the deficit country; and (4) deep and sophisticated financial markets that allow private agents to hedge (albeit at cost) against market shocks.

Implications for South Africa and its current account

Should we therefore not worry much about the persistence of SA's current account deficit? In some aspects, the local economy compares favourably to its fellow commodity exporters. It is currently running a positive NIIP, thanks to external liabilities that are (unlike assets) largely denominated in rand; hence, exchange rate depreciation tends to improve the NIIP. FX assets and liabilities of banks are relatively low in SA, with no significant mismatch between the two. Like the "three", South Africa has a fully flexible exchange rate and developed financial markets that provide hedging possibilities. Unlike them, though, the degree of leveraging of the corporate and household sectors is relatively low, meaning that these sectors have some "margin of manoeuvre" before investors view their debt ratios as a major concern.

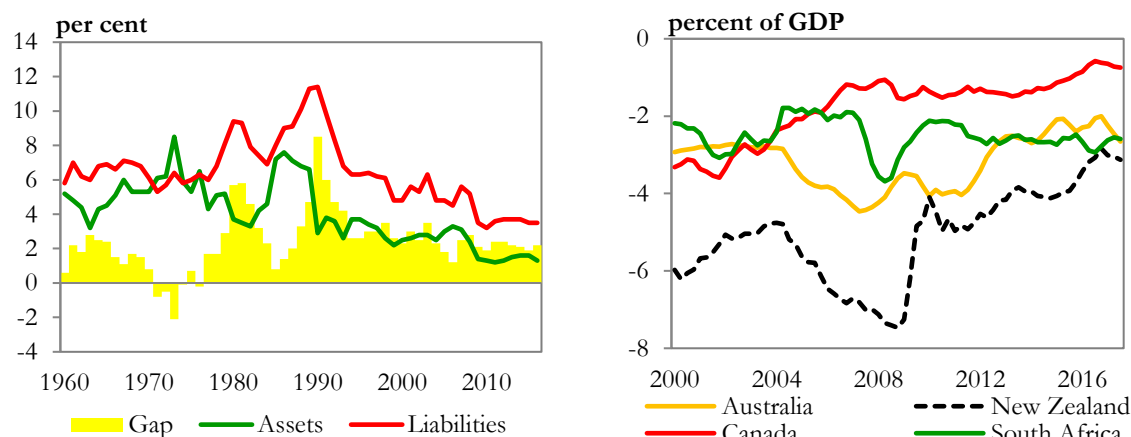
However, in other aspects, SA does not meet the conditions listed earlier:

- Its public debt trajectory has recently been deteriorating, and it faces the "twin deficit" problem of having foreign capital financing public spending rather than private investment. Investors also know that SA being a developing country, any fiscal adjustment can be more difficult and costly to achieve from a political and social point of view than in the "three";
- Its economic growth is currently poor by global standards, resulting in investors questioning the potential return on investments. Indeed, potential GDP growth is estimated to have slowed more in recent years, and generally be more volatile, than in the "three". This may have contributed, among others, to relatively low FDI inflows into SA;
- Policy and institutional uncertainty means that investors do not fully trust that capital inflows will be optimally utilized in the long run. In fact, SA's investment/GDP ratios are lower than the world or EM norms (see Figure 10), suggesting relatively unproductive use of foreign capital. As a result, non-residents require a risk premium on debt instruments;
- The long-term depreciation of South Africa's REER since capital controls were largely removed in the mid-1990s (and the subsequent failure of the external deficit to adjust to a weaker rand) may convince investors that they are justified in continuing to demand such a premium.

¹⁰ Labuschagne and Vowles (2010) argue that the relatively high real long-term rates in New Zealand are not a function of a high inflation or currency risk premium (as inflation and currency performance is no worse than, say, Australia) but are related to low domestic savings. According to them, investors still expect that low savings will eventually force long-term real exchange rate depreciation, even though it has not happened so far. See "Why are real interest rates in New Zealand so high? Evidence and drivers", N. Labuschagne and P. Vowles, New Zealand Treasury Working Paper 10/09, December 2010

¹¹ See "New Zealand's Risk Premium and its Role in Macroeconomic Imbalances," C. Burnside, New Zealand Treasury, June 2011

Figure 9 and 10: Average returns on SA's external assets and liabilities (left) and net external primary income balances (4 qtr. averages, right)



In turn, the “trust deficit” that South Africa suffers from – reflected, among others, in poorer sovereign debt ratings than the other three commodity exporters – can over time limit the ability of the deficit to adjust. Because of the risk premium investors require on SA assets, returns on the country’s external liabilities exceed systematically those on external assets (see Figure 11). This is in contrast to (for instance) Australia.¹² As a consequence, the income account deficit – a consequence of past, accumulated current account deficits – has remained relatively static in SA in recent years, whereas it has declined over time in Canada, New Zealand and Australia, helped by the decline in global real rates in the wake of the Global Financial Crisis (see Figure 12).¹³

Conclusion

The case of Australia and New Zealand, and to some extent Canada, suggest that a structural, relatively large current account deficit need not impede the achievement of solid economic growth, or of monetary policy and financial stability targets. However, this pre-supposes a set of conditions, not all of which are met in South Africa at present. Admittedly, South Africa’s current account and external liability levels do not (by themselves) presently threaten a sustainability crisis or a “sudden stop” in capital flows. Thus, they are not the main variables that should inform current monetary policy choices. Nonetheless, the current account deficit – especially if it widens again as the economy recovers in 2018-19 – is likely to continue being seen as a sign of structural weakness by foreign investors, and could at some point result in a higher risk premium on SA assets. Consequently, addressing its root causes (stubborn public deficits, a low household savings ratio, loss of export market share, inefficient use of production factors and insufficient mining investment) should remain a major government policy goal.

¹² See “Australia’s current account deficit in a global imbalances context”, P. Garton, M. Sedgwick and S. Shirodkar, Economic Roundup Issue 1, Australian Treasury, 2010

¹³ See “Crowding out: diagnosing South Africa’s stubborn current account deficit” by David Fowkes, Thulisile Radebe and Sihle Nomdebevana, Economic Note 2018-04, January 2018