

The structure of South Africa's external position

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Abstract

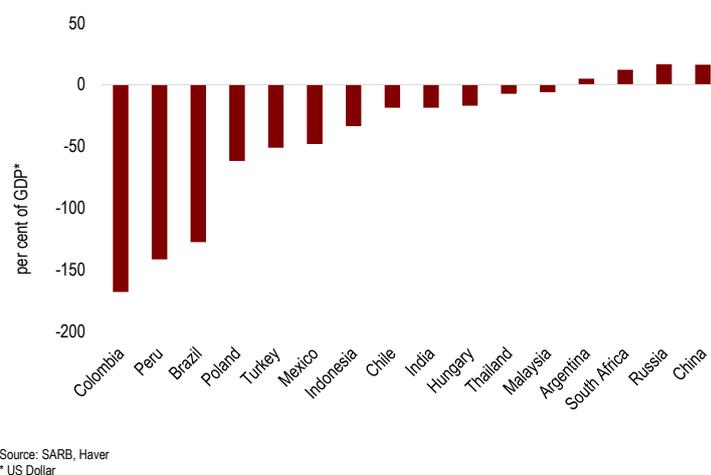
This note examines the structure of South Africa's external position and its implications for assessments of external vulnerability. We argue that much of the improvement in South Africa's external position reflects valuation changes. As such, the external position could deteriorate unless the current account deficit narrows sustainably. The economy's reliance on capital inflows for current account financing has also implied persistence of the deficit on the income account and growing claims on the income of South African assets. Another implication from a significant external funding requirement is exposure to foreign shocks and financing risk. While South Africa's foreign debt has been rising on the back of higher public sector borrowing, the share of foreign currency debt remains low compared to South Africa's peers.

1 Introduction¹

Recent developments in Argentina and Turkey have focused financial market attention on other emerging markets that might be vulnerable to capital outflows as a consequence of rising interest rates in the United States (US) and appreciation of the US dollar. Domestically, the sustainability of South Africa's public debt position has also been the subject of much discussion.

While South Africa has run large twin deficits (fiscal and current account balances) since the global financial crisis (GFC), South Africa's net international investment position (NIIP) has moved into positive territory over recent years and currently compares favourably to other emerging markets (Figure 1). However, this note argues that much of this improvement in South Africa's external position reflects valuation changes. As such, the external position could deteriorate unless the current account deficit narrows sustainably, and that the economy's reliance on foreign savings to finance domestic consumption and investment remains an important macroeconomic vulnerability.

We examine the implications of the financing of the current account deficit for the structure of South Africa's external position and consider the impact of recent developments on the assessment of the country's creditworthiness and vulnerability to balance of payment rebalancing.

Figure 1. NIIP comparison across countries (2017)**2 South Africa's external position**

South Africa has become increasingly integrated with global markets, with both foreign assets and liabilities rising as a share of GDP (Figure 2). Since 1994, foreign assets have risen from 20 to around 150% of GDP,

¹ Thanks to Patrick Sekgoka, Gugu Kortjass, Jeanne Borman, Nongcebo Ngcobo, Elijah Mazibuko, Kgabo Mafodi, and Bontle Mischele for assistance with data and David Fowkes, Zirk Jansen and Piet Swart for comments.

while foreign liabilities increased from around 35 to around 140% of GDP. As a result of the rapid growth in foreign assets, South Africa's net foreign liability position has shifted to a net asset position of 10% of GDP.² As a result of the rapid growth in foreign assets, South Africa's net foreign liability position has shifted to a net asset position of around 7% of GDP. Valuation effects from price and exchange rate changes appear to have had an important impact on the trend in South Africa's net external position, with the external position improving even though there has been continuing capital inflows associated with persistent current account deficits. Figure 3 demonstrates that while negative 'flow effects' associated with current account deficits between 2004 and 2017 would have implied an increase of about 50% of GDP, net foreign liabilities in fact fell substantially and shifting to a net asset position most recently.³ This is a positive development, as it implies a relatively strong performance of foreign assets and that the use of foreign capital has been associated with an increase of national wealth. However, this note argues that the flip side of South Africa's positive NIIP is exposure to foreign equity markets, which can generate volatility in the ratio of external liabilities to GDP, and that the improvement in the external position may be temporary, unless the current account deficit narrows sustainably.

Figure 2. South Africa's external position

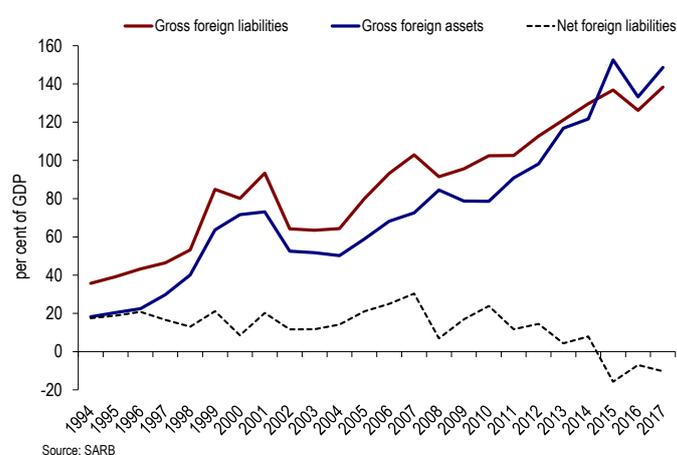
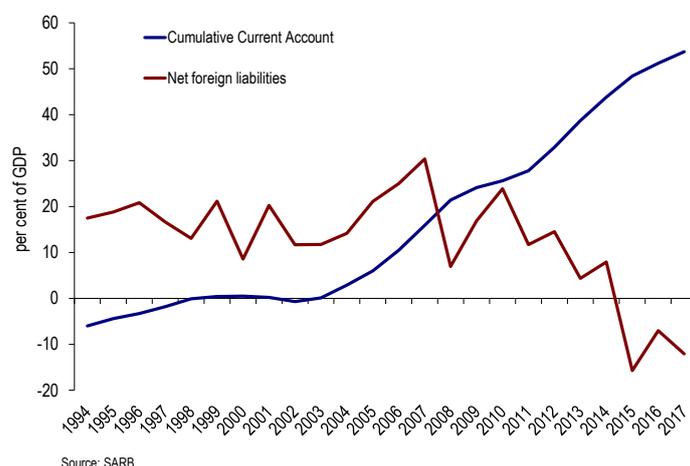


Figure 3. Net foreign liabilities and cumulative current account balances



3 Accounting for the dynamics of South Africa's external position

The financing of current account deficits and the structure of a country's external balance sheet have an important bearing on the evolution of a country's external position. The value of a country's external assets and liabilities will tend to vary depending on movements in the exchange rate and differences in the returns to foreign assets and liabilities. This, in turn, will impact a country's net external wealth.

² The sharp fall in foreign assets and liabilities in 2002 reflected withdrawals of portfolio capital by non-residents in the third quarter and lower portfolio investment abroad.

³ In standard inter-temporal models, the current account deficit equals the change (excluding valuation effects) in the net foreign liability position (see IMF (2002), for example).

Since South Africa's goods trade balance has been marginally positive on average since 2010, South Africa's persistent current account deficit has reflected a small deficit on the services trade balance, along with large transfer payments to the Southern African Customs Union (which total about 80% of gross current transfer payments and almost 1 percent of GDP annually on their own, see Fowkes et al. (2018) for more discussion), and net payments of dividends and interest to the world (Figure 4). The latter reflects the build-up of debt and equity liabilities associated with the portfolio inflows⁴ that have funded persistent current account deficits, as well as recent increases in the average yield on South Africa's foreign liabilities relative to those on foreign assets (Figure 5).

Figure 4. Components of the current account (annual average, % GDP)

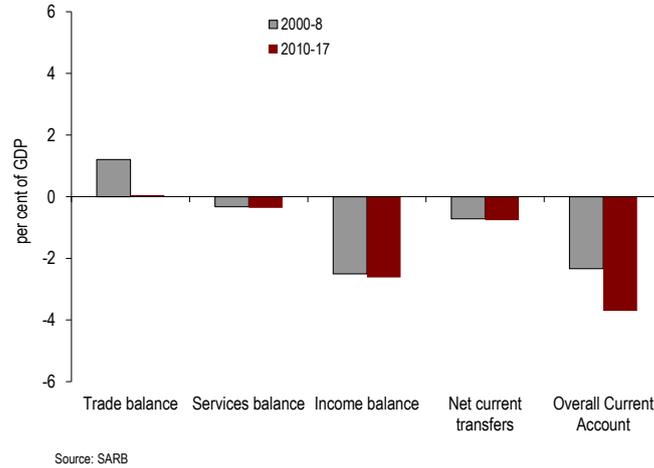


Figure 5. Change in net foreign liabilities and relative yields

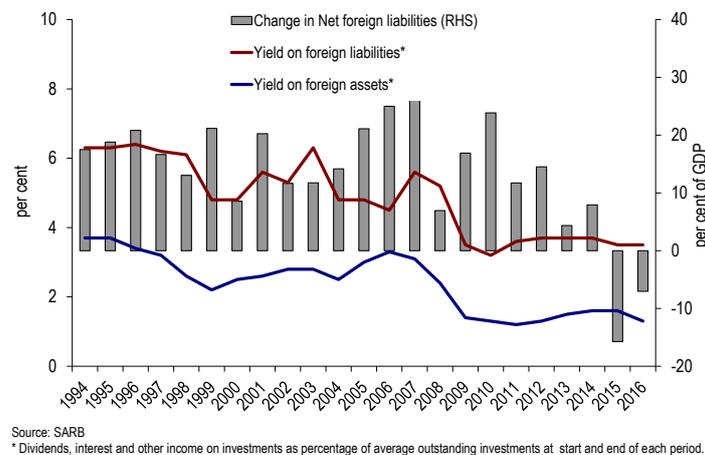


Figure 6 compares the composition of net financial flows over recent years. South Africa has continued to attract more than enough foreign capital to cover its current account deficit, with the bulk of the financing of the current account historically coming from portfolio inflows. The only exception was during the GFC in late 2008, when heightened risk aversion saw substantial outflows of portfolio capital.⁵ At that time, positive net foreign direct investment (FDI)⁶ and sizeable inflows in the other investment category⁷ offset the outflows of

⁴ Portfolio investment is defined as international equity and debt security flows that are not classified as direct investment. The category includes long term debt and equities and money-market debt.

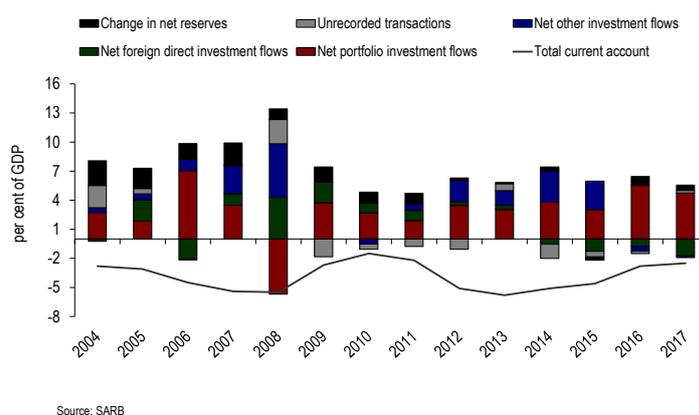
⁵ Foreigners were net sellers of South African bonds and equities at that time and the Johannesburg Stock Exchange lost about 45% between its peak in May 2008 and bottom in November. The rand also came under significant pressure, depreciating by over 55% against the US dollar between August and its weakest level in October of that year.

⁶ FDI consists of all acquisitions of share capital whether equity or debt, where a non-resident owns at least 10 per cent of the relevant domestic enterprise.

⁷ Other investments represent the residual of financial transactions that do not fall under one of the direct investment, portfolio investment or gold and other foreign reserve categories. Other investments include trade credits, loans, currency and deposits, and other assets and liabilities.

portfolio investment. The remainder of financing in 2008 came from the unrecorded transactions category.⁸

Figure 6. Financing of the current account deficit



The yield differential between South Africa’s foreign assets and liabilities reflects the excess yield on foreign direct and non-direct (portfolio and other investment) assets in South Africa over the yield on South African assets abroad (Figure 7). It is interesting to note that the yield differential is larger for direct investment, averaging 3.5% between 2010 and 2017, while the non-direct investment differential averages 2.5% over this period.⁹ The yield differential in Figure 7 is particularly interesting since South Africa’s external liabilities are slightly less skewed towards equities than South Africa’s external assets (Figure 8).¹⁰

Although data availability makes detailed analysis of the relative returns to debt and portfolio equity beyond the scope of this note, a number of factors might be responsible for the positive differential between yields on South African and foreign assets. Compared to South Africa’s peers, these include higher domestic risk premia, the relative profitability of domestic corporates, as well as high relative inflation and expectations of exchange rate depreciation. The tightening of the yield differential in the early parts of this decade owed to improved growth, fiscal consolidation and successful disinflation after the adoption of inflation targeting. Particularly important to the reduction in inflation was increased integration with the world economy, which allowed South Africa to benefit from the global disinflation trend at the time. The recent increase in the yield differential reflected the strong relative performance of South African corporates and an increase in interest rate differentials with advanced economies. The latter owed, at first, to tightening credit conditions globally and a decline in risk tolerance, and from 2008 onward, to monetary easing in other countries relative to South Africa.

⁸ The unrecorded transactions category is a balancing item in the balance of payments that reconciles the recorded change in net reserves with the recorded differences between the current and financial accounts. This category reflects some combination of unrecorded financial flows and errors and omissions in the current account.

⁹ Note that these calculations include dividends and retained earnings on direct investment. While retained earnings on foreign assets (liabilities) are treated as outflows (inflows) of income in the balance of payments, these may or may not actually be associated cross-border flows of income.

¹⁰ Countries like the United States and Australia have historically benefited from favourable valuation effects as their gross foreign assets provided higher returns than their gross foreign liabilities. An important factor responsible for this is that both countries have a higher share of their gross foreign assets in equities than their foreign liabilities and equities have tended to have higher rates of return than debt (see for example Garton 2007a and Garton 2007b).

Figure 7. Yields on South Africa's foreign assets and liabilities

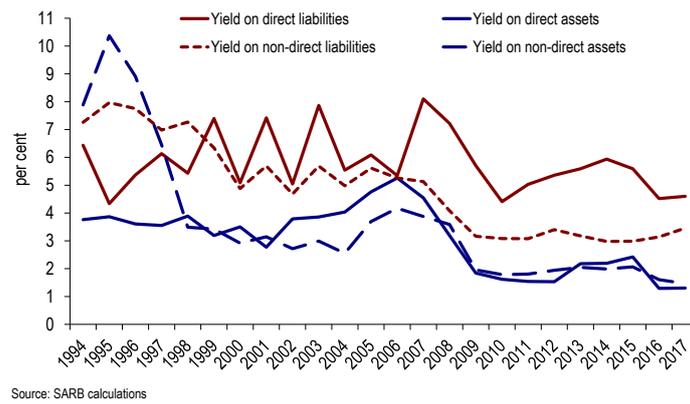
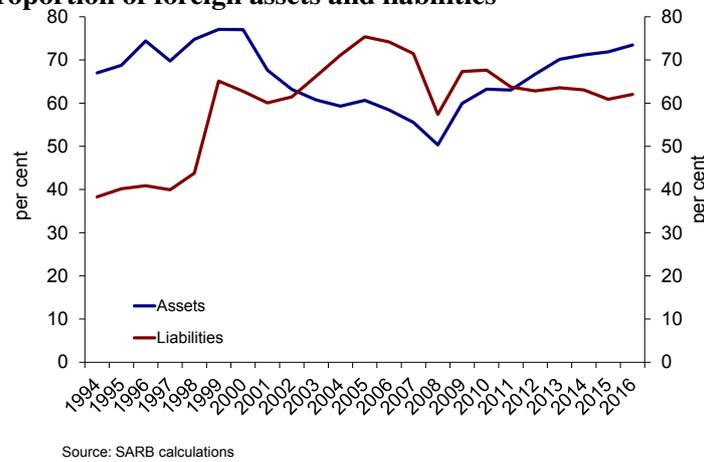


Figure 8. Equity as a proportion of foreign assets and liabilities



3.1 The importance of valuation effects

An important implication of primarily funding South Africa's current account deficits via equity inflows is that foreign investors have been willing to share the exchange rate risk associated with South African investment. While South Africa's overseas assets are mostly denominated in foreign currency, liabilities are denominated in a combination of foreign and domestic currency. South Africa's foreign asset holdings currently exceed its foreign liabilities, which implies that the currency exposure of South Africa's assets actually exceeds that of its liabilities. This implies, in turn, that rand depreciation will tend to have a relatively larger impact on the value of South African external assets than on external liabilities. But the use of leverage and unexpected exchange rate changes can also generate substantial valuation effects. Foreigners will, for example, demand higher returns on rand denominated assets to compensate for expectations of currency depreciation. The accuracy of such expectations, and the extent to which foreign positions are leveraged, will impact the net foreign position. Unfortunately, lack of available data on the portfolio and currency weightings of South African investment abroad precludes detailed analysis of the likely impact of expected and unexpected depreciation.

Instead, Table 1 provides an illustrative decomposition of recent changes in the NIIP to GDP into the contributions of cumulative primary- and income balances, nominal GDP growth and an unexplained discrepancy for the period since the emergence of large and persistent current account deficits.¹¹ The decomposition assumes that

¹¹ This decomposition is based on the following equation: $nfl_t - nfl_{t-1} = -pb_t - ib_t - \frac{g_t}{1+g_t}nfl_{t-1} - k_t + error_t$, where nfl is net foreign liabilities, pb is the primary balance, comprising of exports (x_t), imports (m_t), net compensation of employees (nce_t) and transfers (tfr_t), i.e. $pb_t = (x_t - m_t + nce_t + tfr_t)$, ib is the income balance which is the sum of income receipts from investment less income payments on inward investment, g denotes nominal GDP growth rate in domestic currency, k represents valuation effects and $error$

returns on gross foreign assets and gross foreign liabilities are equal as the data required to decompose changes in gross positions into financial flows and valuation changes is not available for South Africa. As a result, a ‘catch-all’ variable is included, that captures valuation effects, and differences in the model applied to the data and true relationships between flow and stock variables. The breakdown suggests that nominal GDP growth helped reduce the burden associated with the country’s stock of net foreign liabilities, partially offsetting the increase in net foreign liabilities to GDP implied by the accumulation of income deficits, and primary deficits in the post-GFC period. Interpreting the balancing term is problematic because it incorporates valuation changes and errors and omissions, but also reconciles flow- and stock changes.¹² But this simple decomposition suggests that valuation effects contributed to the deterioration in the external position (i.e. increase in the net foreign liabilities) pre-GFC, while favourable valuation effects have played a very important role in the improvement in the external position post-GFC. This is particularly interesting since Figures 7 and 8 suggest that income returns to overseas investment tend to be lower than those on inward investment, on average. Another implication is that the recent depreciation of the Rand probably implies some positive valuation effects that would, all else equal, tend to improve South Africa’s NIIP.

Table 1. Contributions to accumulation of net foreign liabilities (percent)

	2000 - 2007	2010-2017
Cumulative primary deficits*	-2.5	9.0
Cumulative income deficits**	17.5	20.2
Nominal GDP growth	-14.6	-17.9
Valuation effects and errors	21.4	-45.4
Change in net foreign liabilities to GDP	21.8	-34.1

Source: Authors’ calculation * Difference between the current account balance and the net income balance. ** Returns to net foreign liabilities (net payments of interest, dividends and profits).

The section that follows evaluates the risks associated with the structure of South Africa’s external liabilities, as well as the mitigating influence of the composition of South Africa’s external assets.

4 Implications of the structure of South Africa’s external position

Gross portfolio debt liabilities is the largest component of net foreign liabilities, and has increased from 11 to 21% of GDP between 2000 and 2016 (Figure 9). Following a sharp decline in inward-FDI and an increase in FDI by South African companies (possibly reflective of lower confidence in the local economy), net FDI flipped from a net liability position to net asset position in 2014. A net asset position has also been built-up in the portfolio equity category, while the other foreign investment category shifted into a liability position post-GFC.

4.1 Persistent deficit on the investment income account

Relying on foreign savings to finance domestic consumption and investment implies growing claims on the income of domestic assets. The profitability of South African corporates, particularly those in the resources sector, has been an important driver of the income deficit in recent years. Figure 10 demonstrates that periods of higher inflows (adding to existing stocks of portfolio equity liabilities) have generally been associated with higher outflows of dividend payments as a proportion of GDP, although it is notable that there were net outflows of portfolio investment during 2016.

denotes errors and omissions in the current account. All variables are scaled by domestic GDP.

¹² While unrecorded transactions in the South African balance of payments were large and positive pre-GFC (at 5.2 percent of GDP), they have been negative post-GFC (at 3.7 percent of GDP).

Figure 9. Portfolio equity, direct investment and net other investment liabilities and accumulated debt liabilities

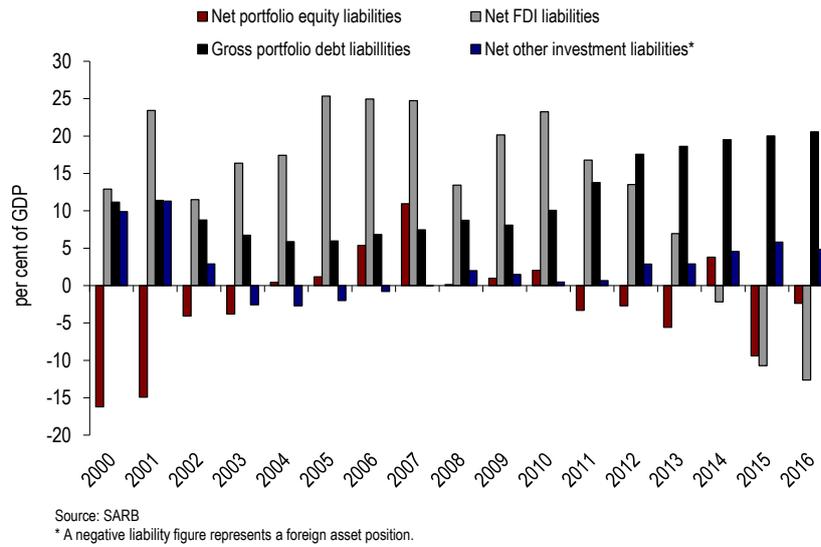
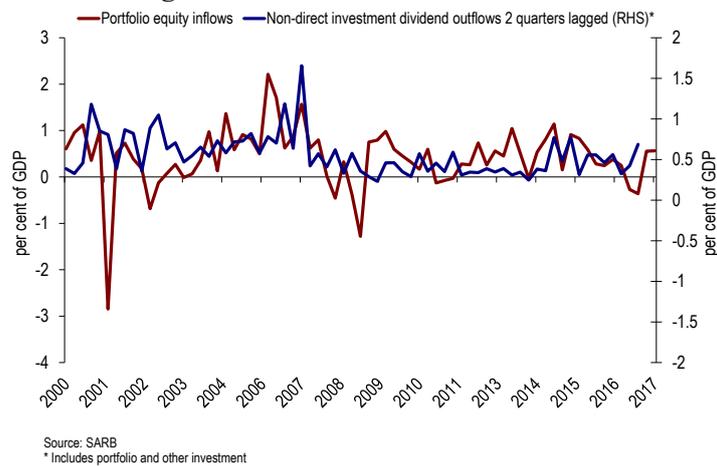


Figure 10. Gross equity inflows and gross dividend outflows



4.2 Rising foreign debt, but relatively low currency risk

South Africa’s foreign currency-denominated debt-to-GDP ratio has risen substantially since the GFC (Figure 11). The rand denominated portion of foreign debt has also grown strongly, but has been relatively stable over recent years. Gross external debt has increasingly been in the form of public debt, although private sector debt has also risen as a share of GDP. Broader public sector debt (i.e. adding the debt of General Government and Public Corporations to Central Government debt) makes up the bulk of South Africa’s total foreign debt (Figure 12). However, as a share of GDP, (more narrowly defined) government foreign debt has fallen from 14% in 2000 to around 9% in 2018 (Table 2).

Figure 11. Total foreign debt as a proportion of GDP*

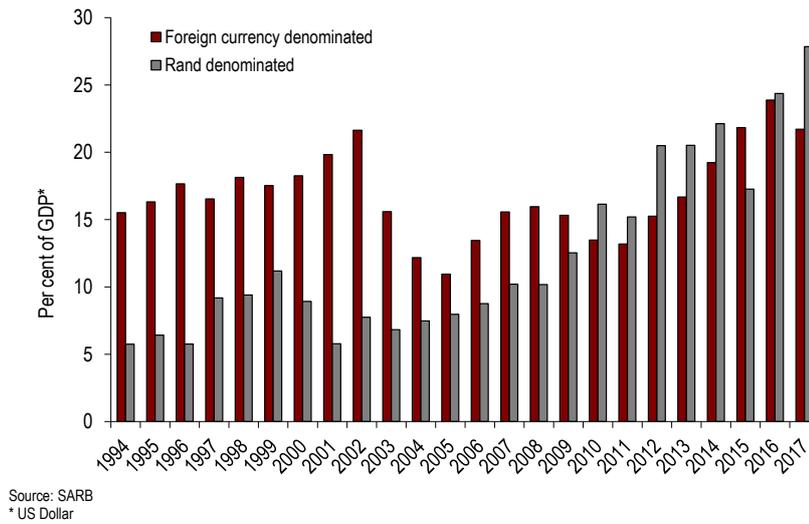


Figure 12. Composition of foreign debt

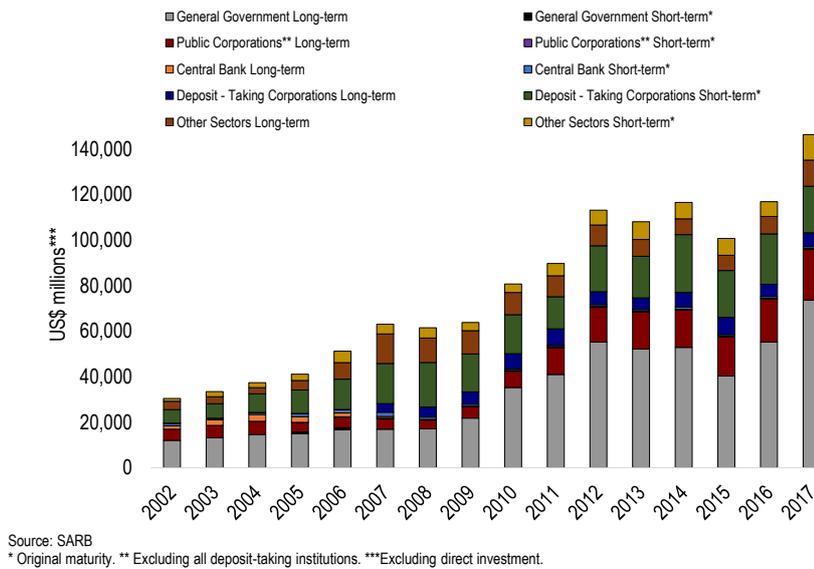


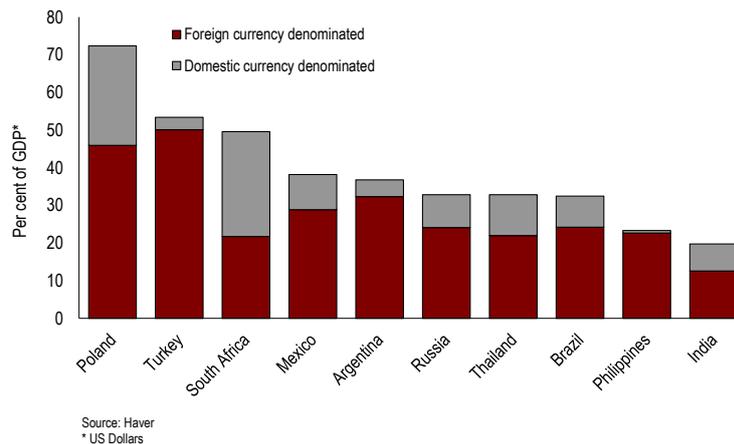
Table 2. Debt indicators (February 2018)

Share of short-term debt maturing in 12 months (Treasury bills) as a percentage of total domestic debt	14%
Share of long-term debt maturing in 5 years as a percentage of fixed rate bonds and inflation linked bonds	8%
Share of inflation-linked bonds as a percentage of total domestic debt	23%
Share of foreign debt as a percentage of total government debt	9%
Weighted term-to-maturity (fixed-rate bonds and Treasury bills in years)	14
Weighted term-to-maturity (inflation-linked bonds in years)	15
Average term-to-maturity (total government debt in years)	15
Average term-to-maturity (foreign debt in years)	9

Source: National Treasury

Funding current account deficits through external debt can make a country vulnerable to changes in interest and exchange rates and external funding conditions. Although South Africa’s foreign debt ratio is a little higher than many of South Africa’s emerging and developing country peers (Figure 13), South Africa has managed to avoid the ‘original sin’ of borrowing overseas with debt predominantly denominated in foreign currencies. In fact, an increasing share of long term offshore funding is being raised in local currency (Figure 14 and Table 2) and foreigners own around 40% of fixed rate government bonds currently in issuance. The potential impact of rand depreciation on debt servicing costs is therefore less great than in countries with higher shares of foreign currency denominated debt such as countries like Argentina, Philippines and Turkey (Figure 13).

Figure 13. Peer group comparison of external debt composition (% GDP*, 2017)



Source: World Bank, SARB

4.3 Limited refinancing risk

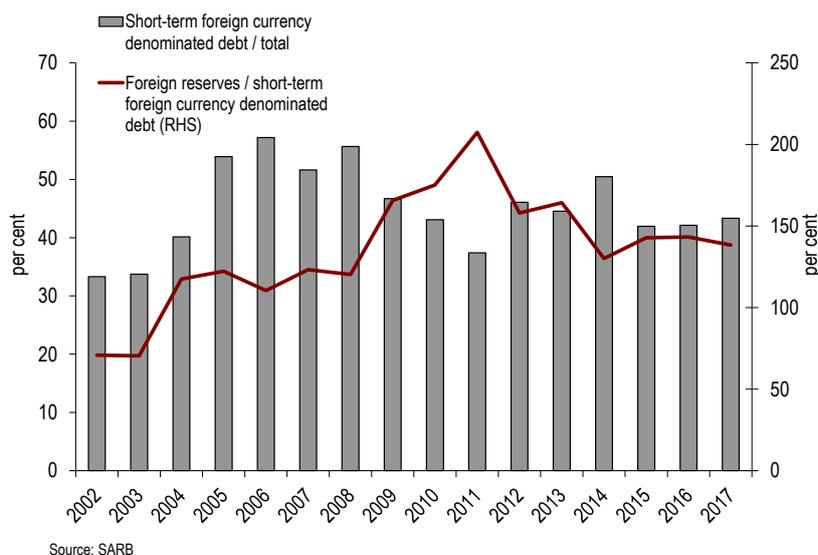
The sophistication of South Africa’s financial markets also facilitates relatively easy and cost-effective hedging of the foreign currency exposure of importers and exporters. Likewise, anecdotal evidence suggests that South African banks hedge a great deal of their foreign currency exposure using financial derivatives. There does, however, appear to be some scope to improve the maturity structure of South Africa’s foreign debt since about 14% of total foreign-currency external debt matures within 12 months (see Table 2). The country’s short-term liabilities tend to be mostly in the form of short-term loans to the private sector and trade finance, which tend to be rolled over, renegotiated or replaced with new facilities. Government has also managed to smooth its amortization profile over time: the average maturity of government debt has increased from around 8 years in 2006 to over 13 in 2018 (Tables 2 and 3). The favourable maturity structure of public debt has helped government increase debt without materially increasing roll-over risks. However, there remains significant fiscal risk from the growing scale of debt and contingent liabilities of the broader public sector, including state-owned companies. The country’s foreign reserves cover a large proportion of total short-term foreign-currency-denominated debt, at about 150%, though the ratio has declined from over 200 percent since 2011 (Figure 14).

Table 3. Maturity of Government fixed income bonds (February 2018)

Maturity Buckets	Percent
0-1 Year	1
1-5 Years	7
5-10 Years	20
10-15 Years	21
15-20 Years	20
20-30 Years	19
30-36 Years	13
Total	100

Source: National Treasury

Figure 14. Proportion of short-term foreign currency denominated debt



5 Conclusion

This note discussed the impact that the structure of South Africa's external balance sheet, and the nature of the capital inflows financing South Africa's current account deficits, have had on the evolution of South Africa's external position. We have also argued that the structure of the economy's external position also has important implications for the types of risks South Africa is exposed to.

The economy's reliance on capital inflows for current account financing has implied growing claims on the income of South African assets. The implication of strong portfolio investment inflows is therefore greater persistence of the deficit on the income portion of the current account. Another implication from a significant external funding requirement is exposure to foreign shocks and financing risk. Though partly mitigated by a low share of foreign currency debt, South Africa's foreign debt has been rising, largely driven by borrowing by the public sector. The economy's dependence on foreign savings also makes South Africa's economy vulnerable to sudden reversals in capital flows, as demonstrated by the large outflows of portfolio capital during the GFC. This note also suggests that much of the improvement in South Africa's external position reflects valuation changes. As such, the external position could deteriorate unless the current account deficit narrows sustainably.

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