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Crowding out: diagnosing South Africa's stubborn current account deficit - January 2018

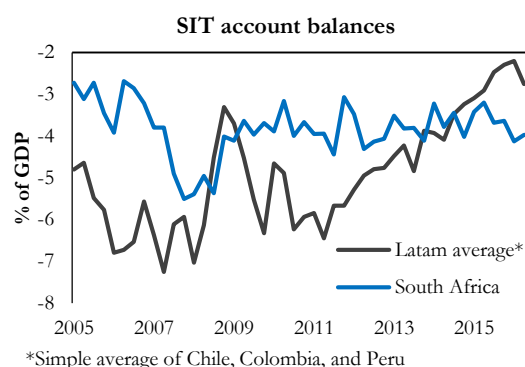
David Fowkes, Thulisile Radebe and Sihle Nomdebevana

Abstract

South Africa runs a persistently negative Services, Income and Transfers account, which has kept the current account in deficit despite a large improvement in the trade balance. The stubbornness of this deficit is surprising; amongst Latin American peers, SIT accounts have narrowed sharply. This is because these accounts are dominated by dividend payments, which are in turn closely related to commodity investments. South African net dividend flows are more independent of commodity prices and consequently less flexible. South Africa also makes large transfer payments to neighbouring countries, an obligation with no parallel in Latin America. Finally, South Africa has sold large amounts of debt to foreigners, at relatively high nominal interest rates, creating a growing interest payments deficit. This last factor in particular threatens to crowd out investment by absorbing scarce inflows of foreign savings.

Introduction¹

South Africa's current account balance resembles an iceberg. There is a small positive trade balance above the surface, with a much larger Services, Income and Transfers (SIT) deficit below. This SIT deficit has kept the broader current account balance in deficit despite a large adjustment in the trade balance. The trade balance has received the bulk of research attention, probably because it is the swing variable in the current account, whereas the SIT balance has been stable.² However, the very stability of the SIT account is both puzzling and problematic.



In various peer economies, the SIT account has adjusted much more than in South Africa. Part of the explanation is simply that South Africa makes large transfer payments to SACU countries, an outflow that has no parallel amongst our peers. However, a more significant factor is that income payments have behaved very differently. In Latin America, income accounts are dominated by dividend payments, and these payments are closely related to commodity prices. This means dividends move in the opposite direction to trade balances, creating a kind of countercyclical buffer. By contrast, South Africa's net dividend payments tend to be more stable. This is because investments by non-residents in South Africa are more diversified and therefore less volatile; furthermore, South Africa's more positive international investment position generates offsetting dividend receipts. Over and above dividends, South Africa is also unusual because its income account features substantial interest payments. These income payments have expanded

¹ The authors are grateful to Zirk Jansen, Jean-Francois Mercier, Erik Visser, Theresa Alton and Theo Janse van Rensburg for valuable comments.

² See D. Fowkes and R. Walter (Jun 2016) 'Current account rebalancing: an exploration of the trade data', *South African Reserve Bank*, Available at:

<http://sarbhub.departments.resbank.co.za/sites/Research/ResearchPapers/Lists/Economic%20Notes/Attachments/42/EN1619.pdf> and T. Janse van Rensburg and E. Visser (Jan. 2017) 'To zero and beyond? Estimating South Africa's structural trade balance', *South African Reserve Bank*, available at: [http://zarbhub/Intranet/Research.nsf/40f5f6b806a09fb242256a01003c1e9e/53861a70371a8abc422580b40044f9cb/\\$FILE/EN1703.pdf](http://zarbhub/Intranet/Research.nsf/40f5f6b806a09fb242256a01003c1e9e/53861a70371a8abc422580b40044f9cb/$FILE/EN1703.pdf)

substantially in recent years, due to government having sold large amounts of debt to foreigners, at relatively high nominal interest rates.

These fiscal actions risk a new form of crowding out. Because the current account deficit settles near 3% of GDP even in the trough of the business cycle, renewed growth is likely to push the deficit to unsustainable levels as imports and dividend payments rise. Although fiscal policy is best-placed to address this problem, lower nominal interest rates would also have helpful effects. This implicates relatively high inflation expectations, and therefore monetary policy, in South Africa's current account problem.

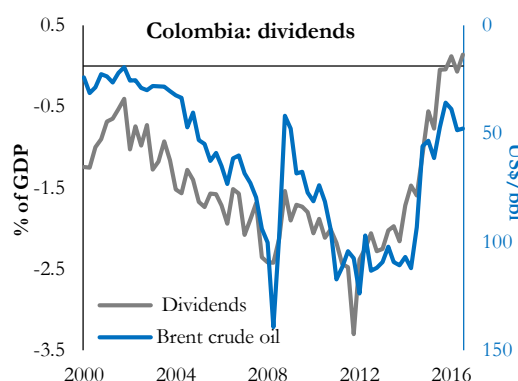
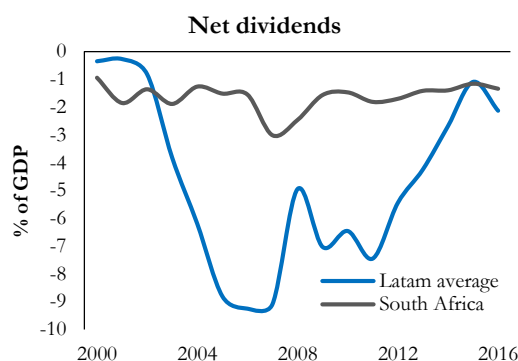
South Africa's current account adjustment in comparative perspective

South Africa has experienced significant current account rebalancing. From an annual deficit of 5.9% of GDP in 2013, the CAD is expected to dip to -2.2% in 2017. The improvement is entirely due to the trade balance, which has fallen from -2.1% to +0.6% of GDP. The SIT deficit remains near 4% of GDP, as it has throughout the post-crisis period.

Latin American countries have also achieved current account rebalancing, over a similar time frame to South Africa, with deficits peaking around 2013 and narrowing by 2016. Unlike South Africa, however, several Latin American countries have seen their SIT accounts adjust by substantial margins. In particular, Chile, Peru and Colombia have seen SIT balances improve by an average of roughly 4 percentage points of GDP.³ This process has been driven by falling dividend payments, in turn explained by lower commodity prices and weaker domestic growth.

In Colombia, for instance, net income payments have shadowed oil prices. As an example, Ecopetrol – the largest petroleum company in Colombia – halved its dividend payments after oil prices collapsed, and a year later halved it again. The country's overall dividends account in the balance of payments improved from a 3.3% deficit at the end of 2011 to a small surplus in late 2016.

The commodity prices-income account link is also clear in Peru. For example, the share price of Volcan Compania Minera (a large mining company⁴) peaked at the height of the commodities boom. Since then the share price has fallen in line with profits, and dividend growth has been negative in every year since 2012. The profit recession has spread across the economy, with dividends in the retail and financial industry declining substantially. This decline in dividend payments has had marked effects on the balance of payments, subtracting almost 6pp of GDP, peak to trough, over a four year period.



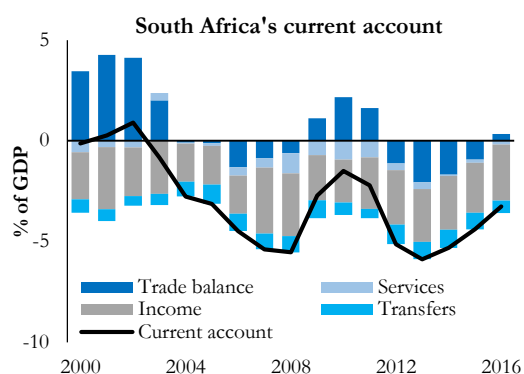
³ The Brazilian case is somewhat different. The SIT balance has been persistently in deficit at nearly -4% of GDP throughout the post-crisis period. This mainly reflects a large services deficit (almost -2% of GDP) as well as substantial interest payments (over 2% of GDP), in line with Brazil's high interest rates and unusually large debt stock (around 80% of GDP). Dividends payments have shrunk, as they have elsewhere in Latin America, from a trough of -2.5% of GDP to around -1% of GDP). Transfers are negligible but positive. Like South Africa, the trade balance has moved deficits to small surpluses.

⁴ Although this is not Peru's largest miner, larger firms such as BHP Billiton have more international exposure and so their dividends payments reflect Peruvian conditions less clearly.

The pattern is much the same in Chile, where falling copper prices have driven the income deficit from almost 8% of GDP at the peak of the commodity super-cycle to 2.6% at the end of 2016.⁵

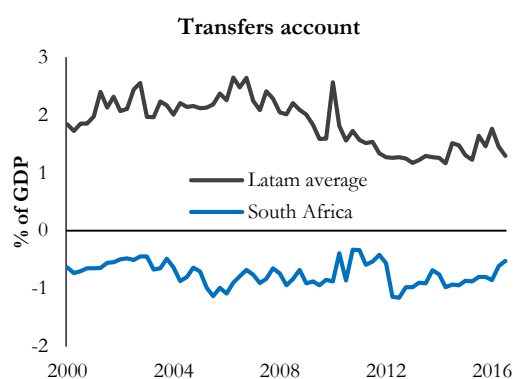
Decomposition of South Africa's SIT account

South Africa runs consistent income and transfers deficits; by contrast, services tend to behave like trade, shifting between deficits and surpluses in line with the upswings and downswings of the business cycle. For this reason, our analysis of the SIT account focusses on transfers and income payments.



Transfers

Transfers are dominated by payments to SACU countries, which are worth roughly 1% of GDP annually.⁶ These kinds of payments are non-existent in Latin America, where transfer surpluses are more common. (For instance, Chile's surplus is slightly over 1% of GDP, and Peru's is over 2%.) For this reason, South Africa's large transfer deficit is clearly part of the reason its SIT account looks different to those of its Latin American peers. A more difficult problem than identifying this transfer payments exceptionalism is determining what portion of these payments are genuinely transfers.



Where South Africa collects custom duties on goods destined for other SACU members, these should be repaid (in this sense, South Africa is merely a clearing house for other countries' tariffs). Furthermore, the existence of a common SACU tariff wall diverts demand to fellow SACU members and away from other countries.⁷ For instance, BLNS countries would be better off buying cars at world prices, instead of having to pay the tariffs that shelter South Africa's motor industry. Transfers compensate the BLNS countries for these losses, and are in this sense the price of trade benefits for South Africa. As such, they should be 'netted out' of the current account.

Yet these corrections explain too little of the overall transfer payments, and therefore do not solve the transfer problem. As recent research has demonstrated, full compensation for the effects described above would cover only about a third of current transfers.⁸ The remaining two-thirds are essentially development payments. This interpretation is consistent with the extreme dependence of the BLNS states on transfers for fiscal revenues, as well as the highly unequal division of the revenue pool in per capita terms (see table). As such, 'true' transfer payments are probably around 0.7% of GDP.⁹ Regardless of the appropriateness of these transfers – which is a subject beyond the scope of this note – such large transfer deficits are not part

⁵ Though the income component accounts for most of the scale and movements in the SIT account, two other important considerations are movements within the services and transfers account. These two components are less cyclical, with relatively weak correlations to other balance of payments items.

⁶ Average: 2000q1-2016q3.

⁷ Following the classic argument by Jacob Viner, *The Customs Union Issue*, 1950

⁸ Yash Ramkolowan, "What is fair SACU customs compensation to the BLNS?" 15 May 2017, available at:

http://www.dnaeconomics.com/pages/trade_policy/?zDispID=NewsArtWhat_is_fair_SACU_customs_compensation_to_the_BLNS

⁹ Based on 2014/15 financial year figures.

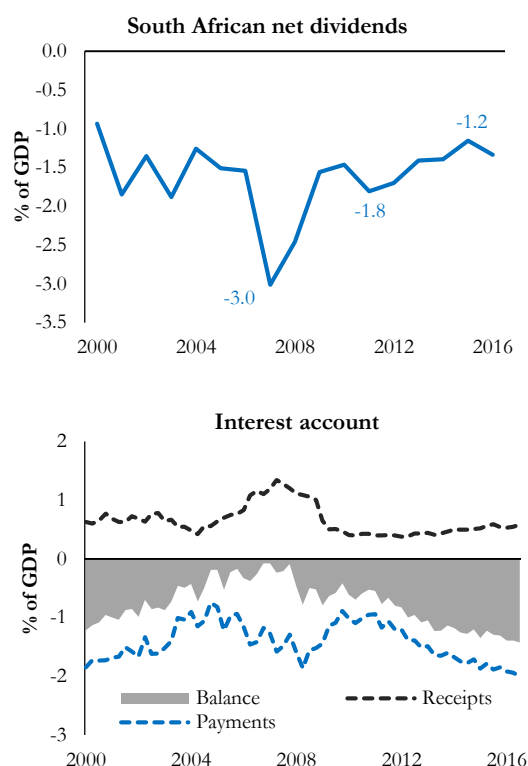
of the Latin American experience and are therefore a significant part of the explanation for differences in SIT balances.¹⁰

Share in Common Revenue Pool (2015/16)					
	Share in CRP (R million)	% of Total	% of GDP	% of Gov Revenue	CRP per capita
Botswana	18,663	22.2	11.5	29.5	8,664.3
Lesotho	5,802	6.9	25.3	41.8	2,995.4
Namibia	15,771	18.7	10.0	29.0	6,857.0
South Africa	37,771	44.9	0.9	3.5	675.6
Swaziland	6,188	7.3	16.1	47.0	5,466.4

South Africa's income account problem

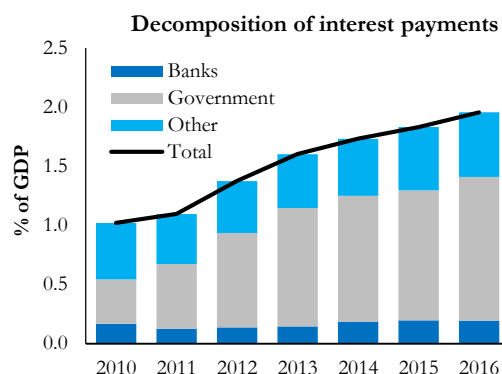
South Africa's income account has been fairly stable throughout the post-crisis period, at about -3% of GDP. Its sub-components, however, have been more volatile, with smaller dividend deficits and larger net interest payments.

Dividend payments have contracted by about 0.6pp since 2011, a small adjustment relative to the Latin American experience. The change has not been larger because foreign investment in South Africa stretches well beyond local commodity operations, to encompass a range of other domestic enterprises as well as South African firms with operations abroad. For this reason, the correlation between terms of trade and dividend payments is much stronger for Latin American countries than South Africa. (The Latin American average is 0.9; South Africa's correlation is 0.3.) Furthermore, part of the South African dividends improvement is due to stronger dividends receipts. This is consistent with a positive net international investment position, whereas the Latin American countries all have substantially negative net positions. Had South Africa's income account followed only dividend payments, the SIT account deficit would therefore have narrowed, just not to the extent seen in the Latin American cases.

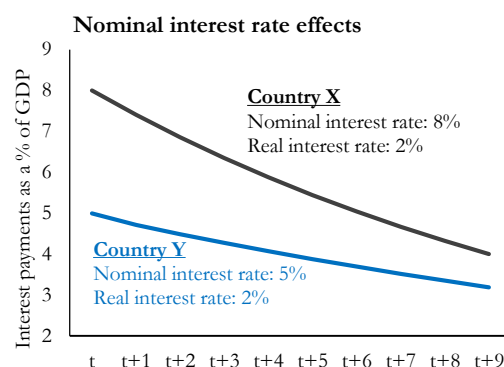


¹⁰ The reader may be wondering if transfer payments are pro-cyclical, seeing as they increase with higher imports and fall with lower ones. However, these payments are designed to be relatively stable: the revenue formula draws on the next-year forecast for assigning shares, but the final amounts are adjusted by two-year-ago outcomes.

A more fundamental explanation for South Africa’s stubbornly large income deficit is that interest payments have been rising. The growth of this sub-category is entirely due to government debt service costs, in turn reflecting rapid growth in debt as well as increased purchases of domestic debt by foreigners. South Africa’s debt to GDP ratio has risen from around 30% in 2010 to over 50% now; meanwhile, the proportion of total debt held overseas has shifted from 22% in 2010 to 39% in 2017 (average, ytd)¹¹. Accordingly, interest payments by government to foreigners have tripled from 0.4% of GDP in 2010 to 1.2% in 2016. We do not see the same trends in Latin American countries because these countries typically achieved fiscal consolidation, containing debt burdens at lower levels. They also have lower interest rates.¹² For instance, South African 10-year bonds trade at a spread of about 2.2pp over Latin American equivalents. This has mainly to do with inflation compensation, not tighter monetary policy: real policy rates of Chile, South Africa, Colombia and Peru have all been close to zero over the post-crisis period. By contrast, breakeven rates are on average 3.1% higher in South Africa relative to these three countries, reflecting higher inflation expectations (as well as inflation risk premia).¹³



Nominal interest rate differentials have real effects on the size of the current account deficit, measured as a proportion of output. As a matter of arithmetic, higher *nominal* rates will cause a country to devote a larger portion of income to debt repayments across the entire term of a loan. To illustrate this point, the figure below illustrates interest payments as a share of GDP for two hypothetical countries. In both cases, we assume an initial loan worth 100% of GDP, a real growth rate of 2% and a real interest rate of 2%. However, one country has a 6% inflation target and the other has a 3% target. The nominal interest rate is therefore 8% in the first case and 5% in the second, and nominal GDP growth rates are 8% and 5% respectively. As the graph shows, the higher inflation country ends up with larger debt repayments relative to GDP for the full term of the loan.



Crowding out

Large income deficits may create a novel form of ‘crowding out’. Traditionally, this term has described fiscal spending which reduces demand elsewhere in the economy, leaving total output no higher. (The so-called ‘Treasury view’ of early Keynesian debates.) Crowding out can also occur via the current account because there are constraints on the total deficits a country can run. In the South African case, the danger is that government debt payments will use up scarce inflows of foreign savings, which then cannot be used for other purposes.

It is difficult to assess current account sustainability. The problem has duly attracted a large literature, which finds that sustainability depends on a wide range of variables, including exchange rate arrangements, national investment positions and the composition of deficits (for instance, a country which is borrowing to invest should be able to sustain a larger deficit than one borrowing to consume). The International

¹¹ The 2017 figure is an average from January to August 2017. Available at: <http://investor.treasury.gov.za/Holdings%20of%20domestic%20bonds/Historical%20government%20bond%20holdings.xls>
¹² The proportion of debt held by foreigners, however, is generally similar, averaging 38% for Chile, Colombia and Peru versus 39% for South Africa.
¹³ 2017 average differentials in sovereign government and inflation linked bonds.

Monetary Fund (IMF) has attempted to model sustainability based on these sorts of considerations. The model results indicate South Africa's current account should be -0.8% of GDP, although off-model factors would justify a larger deficit. In its most recent Article IV assessment, the IMF staff concluded that the prevailing current account deficit was approximately 1.5%–2.5% of GDP *larger* than could be justified by fundamentals and optimal policy settings.¹⁴ Nonetheless, South Africa does not appear to be having difficulty financing a deficit of between 2% and 3% of GDP, even if such deficits are too big given fundamentals. Larger deficits, however, typically prove problematic to finance, and are ultimately forced down through a process of currency depreciation, rising inflation, tighter policy settings and lower growth.¹⁵

Current account implications of the 2017 MTBPS

In the most recent *Medium Term Budget Policy Statement*, National Treasury described a debt path in which government debt passes 60% of GDP by 2021. In this baseline scenario, total interest payments rise from 3.4% of GDP currently to 3.9% in 2020/21. If we assume the *proportion* of total interest payments going to foreigners remains unchanged from current levels, close to 60%, then outgoing interest payments would be higher by around ¼pp of GDP by 2020/21. If we assume foreigners buy a larger portion of the debt, so that their share of payments rises to 65%, then the figure is more than ½pp of GDP. Although the Treasury forecast assumes somewhat higher interest rates on the overall debt stock, as existing bonds mature and are rolled over, they also anticipate a decline in the sovereign risk premium, which may not transpire. Furthermore, the forecasts face upside risk from exchange rate depreciation, which would affect the foreign-currency denominated portion of the debt. Interest payments in the current account will therefore end the decade at least 1¼–1½pp of GDP above 2010 levels, at around 1.7% of GDP.

This outlook underpins some unpleasant arithmetic. If we assume net transfer payments close to 1% of GDP, income payments slightly above 3% of GDP (with dividend payments below their post-crisis average of -1.5% of GDP, but interest payments making up the balance), and a balanced services account, then the SIT balance is already -4% of GDP. Adding even a small business cycle upswing, with stronger imports creating a trade deficit as well as higher dividend payments, moves the overall current account number beyond 5% and into unsustainable territory.

Conclusion

South Africa's SIT balance has been stable despite a sharp deceleration in growth over the post-crisis period. This is puzzling in that peer economies have seen SIT deficits narrow, aiding rebalancing. The puzzle is resolved by three factors: South Africa's more modest dividend payments adjustment, its unusually large transfer payments and rising interest payments. Of these, the last is a larger, and growing, problem. Higher foreign interest payments are likely to crowd out investment flows and therefore threaten medium-term growth – in turn making the debt burden less sustainable. Both fiscal and monetary policy can help address this problem, the former through containing borrowing and the latter by moderating interest rates, over the medium term, through reduced inflation expectations.

¹⁴ IMF, "South Africa 2017 Article IV Consultation"

<http://www.treasury.gov.za/publications/other/imf/2017/IMF%20Art%20IV%20report.pdf>, July 2017, esp. p. 42

¹⁵ In this sense, the current account-depreciation-inflation nexus is a better indicator of slack than the output gap-inflation relationship.