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Economics

Make the current account count

The current account (CA) balance may seem to be an abstruse economic concept. But when a country persistently spends a lot more abroad than what it is taking in, the current account deficit and the financing thereof can often cause a lot of disruptions in an economy that are not often understood.

In South Africa, we have been experiencing a persistent current account deficit for the last 10 years. Thus far, we have managed to finance our deficit, but for how long is this sustainable?

To really understand why this is such a concern, we need to understand what is meant with the current account. The International Monetary Fund lists three ways of expressing the current account. One way of looking at it is as the difference between the value of exports of goods and services and the value of imports of goods and services. A deficit then means that the country is importing more goods and services than it is exporting. Remember that the current account also includes net income (such as interest and dividends) and transfers from abroad (such as foreign aid), which are usually a small fraction of the total. Expressed this way, a current account deficit often raises the hackles of protectionists, who think that exports are "good" and imports are "bad" - apparently forgetting that a main reason to export is to be able to import.

Another way to look at the current account is as the difference between national (both public and private) savings and investment. A current account deficit may therefore reflect a low level of national savings relative to investment or a high rate of investment - or both. In SA, we are currently experiencing very low levels of savings relative to investment.

A third way to view the current account is in terms of the timing of trade. We are used to intratemporal trade-exchanging bread for wine today. But we can also think of intertemporal trade - importing goods today (running a current account deficit) and, in return, exporting goods in the future (running a current account surplus then).

Countries cannot run current account deficits indefinitely. When a country runs a current account deficit, it is building up liabilities to the rest of the world that are financed by flows in the financial account. Eventually these need to be paid back. Common sense suggests that if a country squanders away its borrowed foreign funds in spending that yields no long-term productive gains, then its ability to repay - its basic solvency - might come into question. This is because solvency requires that the country be willing and able to (eventually) generate sufficient current account surpluses to repay what it has borrowed. Therefore, whether a country should run a current account deficit (borrow more) depends on the extent of its foreign liabilities (its external debt) and on whether the borrowing will be financing investment that has a higher marginal product than the interest rate (or rate of return) the country has to pay on its foreign liabilities.

But even if the country is intertemporally solvent - meaning that current liabilities will be covered by future revenues - its current account deficit may become unsustainable if it is unable to secure the necessary financing.

This is why a high current account deficit, as is the case in SA, starts to create anxiety over whether it would be sustainable at these levels. Such a deficit could possibly indicate a problem with SA's global competitiveness, loose fiscal policy or a consumption binge.

Investment flows that finance the current account deficit are of special concern in the South African context, as they are unpredictable. This is because SA has a very liquid, well-regulated and integrated financial market. Money can easily flow in and out of the country, which severely affects the level of the Rand, as witnessed (again) during the first few months of the year following the spate of bad publicity surrounding the Anglo platinum labour debacle. The Rand also took a beating during March when the South African Reserve Bank announced the fourth quarter current account deficit figure for 2012 at 6.5%, a much wider level than anticipated. The deficits for the second and third quarters were also adjusted wider to 6.7% and 6.8% respectively.

The real risk in the short term is ensuring financing for the deficit remains intact. In the medium term we can only hope that the trade deficit returns to more appropriate levels as the economies of our main trading partners recover. For now it is essential that we spend borrowed money on high yielding assets. This means that the upgrading of infrastructure is of the utmost importance to ensure that intratemporal trade of today pays off tomorrow.

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