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Global Financial Crisis, Protectionism and Current Account Deficit: South Africa on the Brink?

Peter Draper/Andreas Freytag/
Sebastian Voll

GLOBAL FINANCIAL
MARKETS

University Jena
Carl-Zeiss-Str. 3
D-07743 Jena

University Halle
Universitätsplatz 5
D-06099 Halle

Tel.: +49 3641 942261
+49 345 5523180

E-Mail: info@gfinm.de
www.gfinm.de

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Abstract

The current financial and economic crisis has again raised fears in emerging market economies of capital flight or a sudden stop of capital inflows. Especially the latter is intensively discussed in South Africa. We try to evaluate the danger by focusing on the sustainability of current account deficit in this country during the last years and the long term economic policy developments. We argue that the macroeconomic as well as the relevant microeconomic policy variables speak against a sudden stop. To lower this risk further, the microeconomic environment has to be improved considerably in the next years. This includes mainly reforms in the areas of infrastructure, competition and trade policy.

I. Introduction

The latest developments in the world economy have raised huge concerns and spurred an excited policy discussion about new approaches to economic policy – even including a mooted “New Deal”. This discussion has now reached the emerging economies. In the past the thesis of decoupling was put forward, implying that emerging economies are independent from and not much touched by developments in the OECD countries. Today, it seems as if decoupling was wishful thinking. Rather, emerging markets are experiencing some troubles from the global financial crisis.

South Africa, like other emerging markets and transition economies has run high current account deficits in the last years; all these countries are now under scrutiny. Indeed, even in times of prosperity and growth the current account deficit is perceived as a threat to stability. This position is driven by a strong mercantilist bias: trade surpluses are seen as a benefit to the country and they are claimed to be caused by own competitiveness. Trade deficits are seen as bad and they are therefore viewed as being determined by foreign countries’ unfair practices (Freytag 2008a). However, the trade balance is only one side of the coin – the other side is the capital account. One has to analyse both accounts simultaneously to get a full picture. If – due to intertemporal decision-making – capital account imbalances occur, the whole balance of payments (BoP) will be subject to change, leading to higher imbalances of the current account and/or a change in international reserves. The exchange rate is seen as the main adjustment parameter, which brings about the transfer. From this perspective, it is unclear whether a trade deficit is indeed a problem and an alarming sign for the future

of the country concerned or whether it is "... a symbol of (its) strength" (Griswold 2001).

Despite this logic, in the wake of the global financial crisis, the battle seems decided. Current account deficits in emerging countries are seen as inevitably dangerous during this crisis. In the current discussion two aspects overlap. First, emerging markets exports to the industrialised countries are shrinking because of the economic downturn. This is accompanied by undermined general trust of open markets, the division of labour and international capital flows. The second aspect is more sophisticated. It is feared that the emerging markets will experience a sudden stop of capital inflows implying severe macroeconomic problems such as real depreciation and credit crunches. In both cases, the popular suggestions for policy responses are similar. Not only in the European Union and in the United States, politicians demand both comprehensive and expensive Keynesian programs, and trade as well as industrial policy measures up to Colbert-style protectionism like France for instance. South African politicians add to the list of proposals (e.g., Vavi 2008a and 2008b). Taken literally, we would have to expect a new wave of protectionist measures and capital controls in the future.

This problem certainly is relevant for South Africa, which has been increasingly in the focus of global investors from different countries until recently and from October 2008 suffered from capital withdrawal and a depreciation of its currency, the Rand. So, two questions appear: first, is South Africa in serious danger of a sudden stop? Second, should the political answer be based on protection for South African businesses?

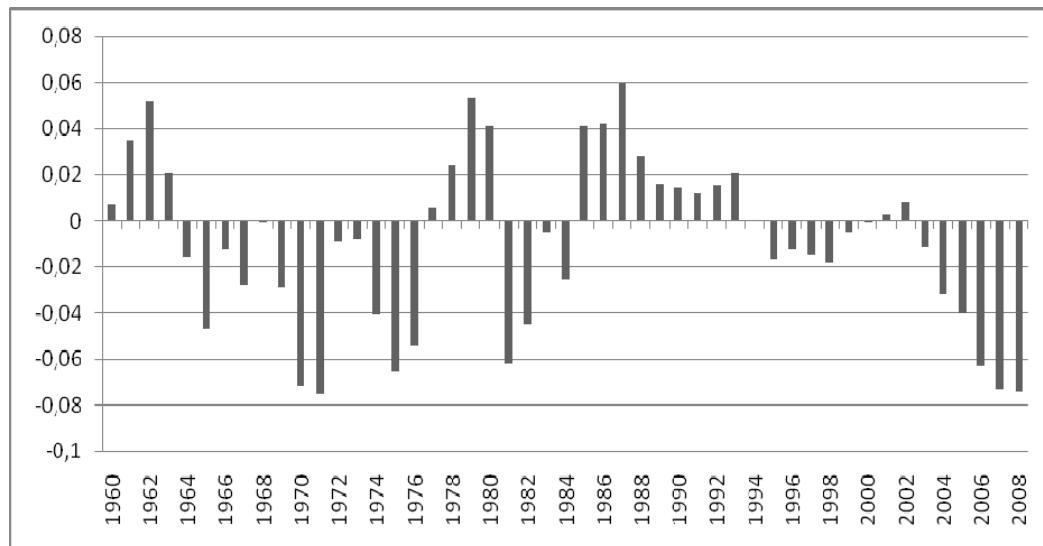
The paper attempts to answer these questions against the background of the global financial crisis and discusses adequate policy measures. We analyse the problem of sustainability from a macroeconomic perspective in section II, comparing developments in South Africa with deficit countries in Europe. We subsequently add a microeconomic view, including some observations about developments in the real exchange rate in section III and an institutional analysis in section IV. Finally, section V scrutinises the demands for trade and industrial policy responses.

II. Sustainability of the South African current account in an international comparison

Figure 1 shows the long term development of the South African current account relative to the GDP. Even during the Bretton Woods era, when capital flows were strictly limited, South Africa experienced current account deficits compa-

rable to the 2002-2008 period. In the 1980s, the current account turned into a surplus, accompanied by huge capital outflows and economic problems. The country was perceived as an unattractive investment target and suffered from its Apartheid regime and subsequent political and financial sanctions.

Figure 1: South African current account 1960-2008, share of GDP.



Source: South African Reserve Bank online, 2009, series KBP5380J.

Since the turn towards democracy in 1994, South Africa has improved its reputation as the leading economic power in Africa. Consequently, foreign capital was increasingly invested. The current account turned into a moderate deficit, interrupted only briefly by the economic downturn in the aftermath of the terrorist attacks in September 2001. Since 2003, the current account deficit has continuously reached high levels, which raise concerns about its sustainability.

To judge these concerns we compare the South African case with selected deficit countries from the EU. These countries were chosen because they experienced a similar economic development from the beginning 1990's on and have a more comparable institutional and cultural background to South Africa than transition economies in Asia or Latin America. Furthermore, like South Africa, they are hit hard by the economic downturn, thus analysing their strengths and weaknesses could provide valuable insights for the South African case.

As the comparison in Table 1 shows the South African current account deficit is not excessive by international standards in itself. In contrast to the strong economic upswing of the last years, it rather seems quite modest. Both high income countries like Spain and Greece and fast developing ones like Bulgaria or Esto-

nia have had much higher deficits on average and in peak since 2002. Therefore, the question of sustainability must be answered carefully.

Table 1: Current Account Deficits of South Africa and selected EU Members, % of GDP

	2 0 0 2	2 0 0 3	2 0 0 4	2 0 0 5	2 0 0 6	2 0 0 7	2 0 0 8	Average	Maximum Deficit
Bulgaria	- 5 , 6 %	- 8 , 5 %	- 6 , 6 %	- 12 , 4 %	- 18 , 4 %	- 25 , 2 %	- 25 , 3 %	- 1 4 , 6 %	- 2 5 , 3 %
Latvia	- 6 , 6 %	- 8 , 2 %	- 12 , 9 %	- 12 , 5 %	- 22 , 5 %	- 22 , 5 %	- 12 , 7 %	- 1 4 , 0 %	- 2 2 , 5 %
Estonia	- 9 , 8 %	- 11 , 3 %	- 11 , 7 %	- 10 , 0 %	- 16 , 7 %	- 18 , 1 %	- 9 , 1 %	- 1 2 , 4 %	- 1 8 , 1 %
Romania	- 3 , 3 %	- 5 , 5 %	- 8 , 4 %	- 8 , 6 %	- 10 , 5 %	- 13 , 5 %	- 12 , 2 %	- 8 , 8 %	- 1 3 , 5 %
Greece	- 6 , 5 %	- 6 , 6 %	- 5 , 8 %	- 7 , 5 %	- 11 , 1 %	- 14 , 2 %	- 14 , 4 %	- 9 , 4 %	- 1 4 , 4 %
Lithuania	- 5 , 1 %	- 6 , 8 %	- 7 , 7 %	- 7 , 1 %	- 10 , 6 %	- 14 , 6 %	- 11 , 6 %	- 9 , 1 %	- 1 4 , 6 %
Spain	- 3 , 3 %	- 3 , 5 %	- 5 , 3 %	- 7 , 4 %	- 9 , 0 %	- 10 , 0 %	- 9 , 5 %	- 6 , 8 %	- 1 0 , 0 %
Hungary	- 7 , 0 %	- 8 , 0 %	- 8 , 6 %	- 7 , 5 %	- 7 , 6 %	- 6 , 4 %	- 8 , 7 %	- 7 , 7 %	- 8 , 7 %
South Africa	0 , 8 %	- 1 , 1 %	- 3 , 2 %	- 4 , 0 %	- 6 , 3 %	- 7 , 3 %	- 7 , 4 %	- 4 , 1 %	- 7 , 4 %
Italy	- 0 , 8 %	- 1 , 3 %	- 0 , 9 %	- 1 , 7 %	- 2 , 6 %	- 2 , 4 %	- 3 , 4 %	- 1 , 9 %	- 3 , 4 %

Source: Eurostat, SARB, 2009.

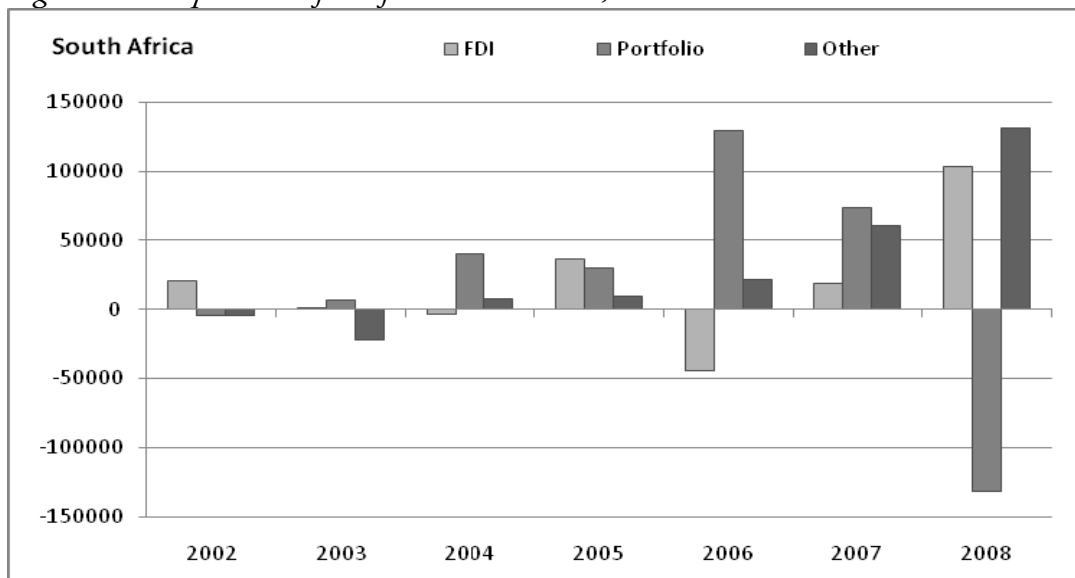
In a recent study, Reinhart and Reinhart (2008) see the danger of a sudden stop for emerging countries without explicitly suggesting that South Africa is among the endangered countries. However, by showing that the probability of a bank, debt or currency crisis is higher when the country experienced a huge capital inflow (a so-called “bonanza”), they hint at the problem that the capital inflows may stop suddenly and substantially. Apart from a general distrust of emerging economies amongst investors, this is also dependent on the macroeconomic stability in the country. As shown by Smit (2007) and the IMF (2007), the overall macroeconomic picture in South Africa is favourable. In particular, foreign debt, the share of foreign currency denominated debt as well as the share of short-term debt are rather low. In addition, fiscal policy is sound, the economy is rather open, the exchange rate is flexible and finally monetary policy is stability oriented and builds up foreign reserves.

However, the macroeconomic stability is only one condition for sustainability. Only if the capital inflows are invested rather than consumed can the current account deficit be sustainable. A closer look at South African net investments reveals first, that portfolio investment exceeds FDI and second, that private investment is outpacing public investment or consumption. Given the maturity of the South African capital markets, this is neither surprising nor worrying. Especially net FDI inflows have been unaffected by the world economic crisis until the end of 2008. Interestingly, the major reversal of (short term) Portfolio in-

vestments in 2008 has been completely offset by other not specified investment forms.

The danger of a sudden stop has its roots in the large share of portfolio investment in capital inflows. Simultaneous to the outflow of these funds, the crisis year 2008 has seen the highest inflows in FDI over the last five years (see figure 2)¹. Apparently, investors still see the macroeconomic conditions in South Africa as favourable to justify a long-term engagement. This supports the macroeconomic view that without a global crisis, the current account deficit has been sustainable. Indeed, recent data confirms that despite the South African economy having been hard hit by the global financial crisis, no exchange rate shock or “sudden stop” has been experienced (Business Day 2009).

Figure 2: Composition of net financial account, Mio. Rand.



Source: South African Reserve Bank online, Series KBP 5683J, 5684J and 5685J

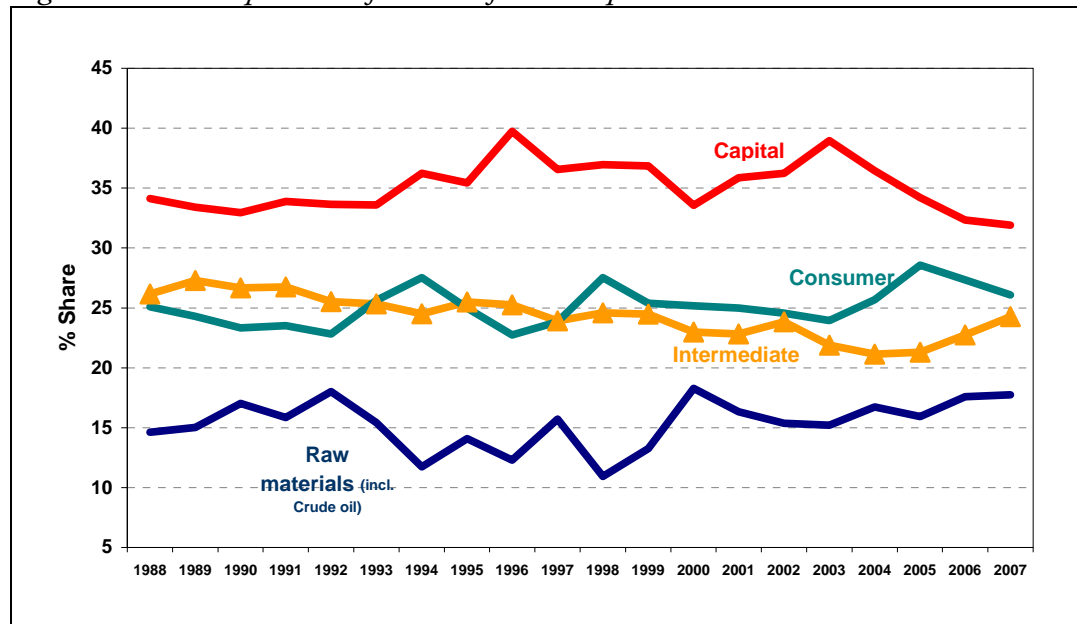
Another – microeconomic – question is how the additional purchasing power has been used: Imports mainly related to final consumption would mean that the capital inflows were used for the purpose of consumption rather than investment, indicating low sustainability. A higher share of capital and intermediates means investment and stronger participation in the international division of labour, leading to higher value added in the future, enabling the economy to pay back its debt and get a higher living standard simultaneously.

So how did the import structure change after 2002? As figure 3 with data from the South African Reserve Bank and Industrial Development Corporation

¹ This holds even when the 36.7 bn ZAR-deal of the Chinese Bank ICBC with the South African Standard Bank, the biggest FDI-Deal in South Africa since 2005, is excluded.

(IDC) makes clear, there was no significant change in the composition of South African imports. The shares of capital, intermediate, and consumer goods remained more or less constant. After 2003, a small decrease in the share of capital goods imports can be observed, which was partly compensated by an increase in intermediate goods. Lately, the share of raw materials increased, related to the world wide price surge for raw materials.

Figure 3: The composition of South African imports 1988-2007



Source: South African Reserve Bank (2001 and 2008), IDC

To get a better impression of the sustainability of a current account deficit and the economic results, we briefly analyse the current and capital account composition of selected Eastern European countries and comment on their sustainability.

The surplus in the financial account of the South-Eastern European countries Bulgaria and Romania has been driven by FDI in exceptionally large parts. From 2008 on, tendencies of overheating could be observed in both countries: strong wage increases (European Commission, 2009, pp. 52 and 98) go hand in hand with declining shares of capital goods and rising shares of consumer goods on total imports (see Figures 4 and 5), indicating a less sustainable utilization of the current account deficit.

Figure 4 Net Financial Account elements of selected EU members, Mio. Euro. Source: Eurostat.

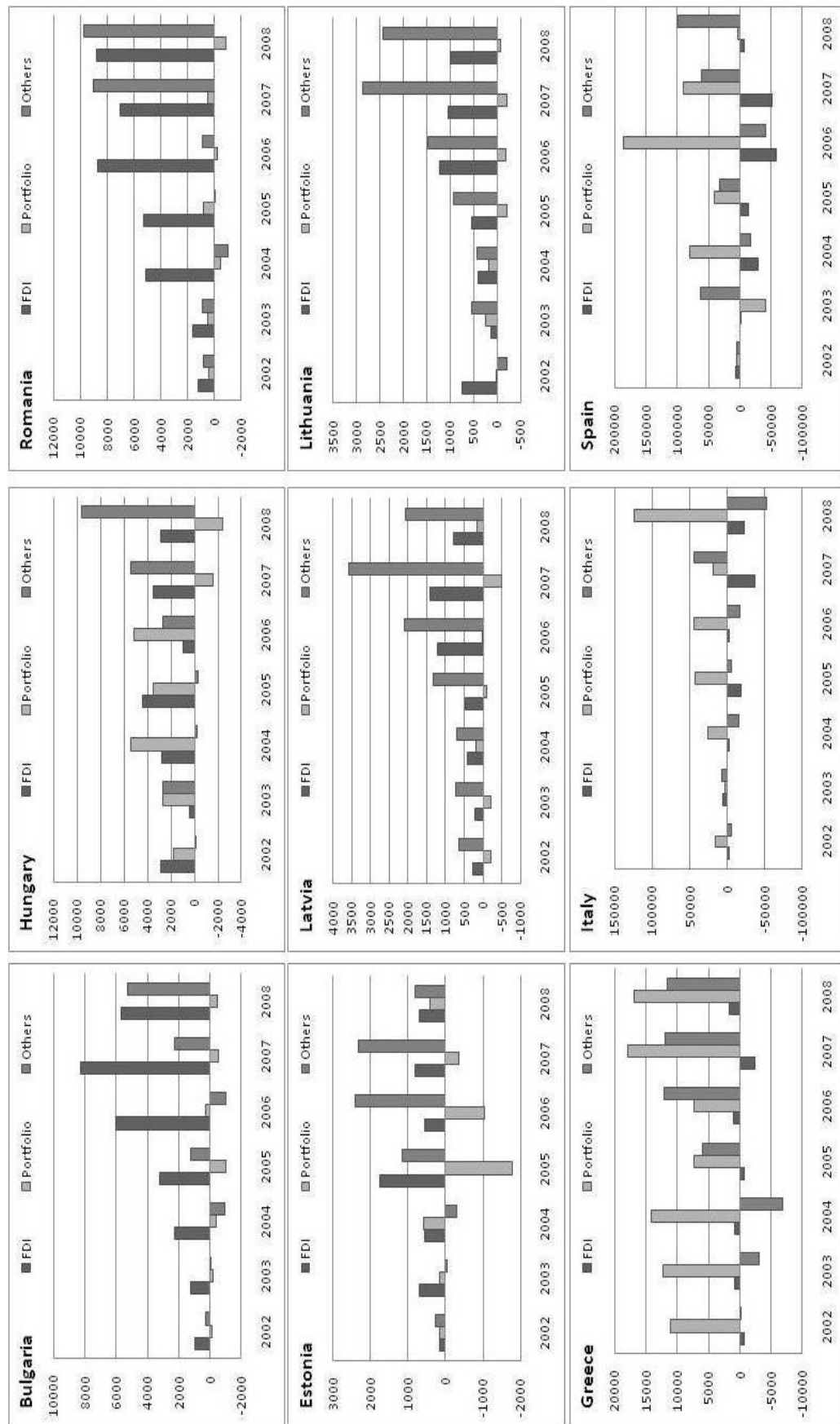
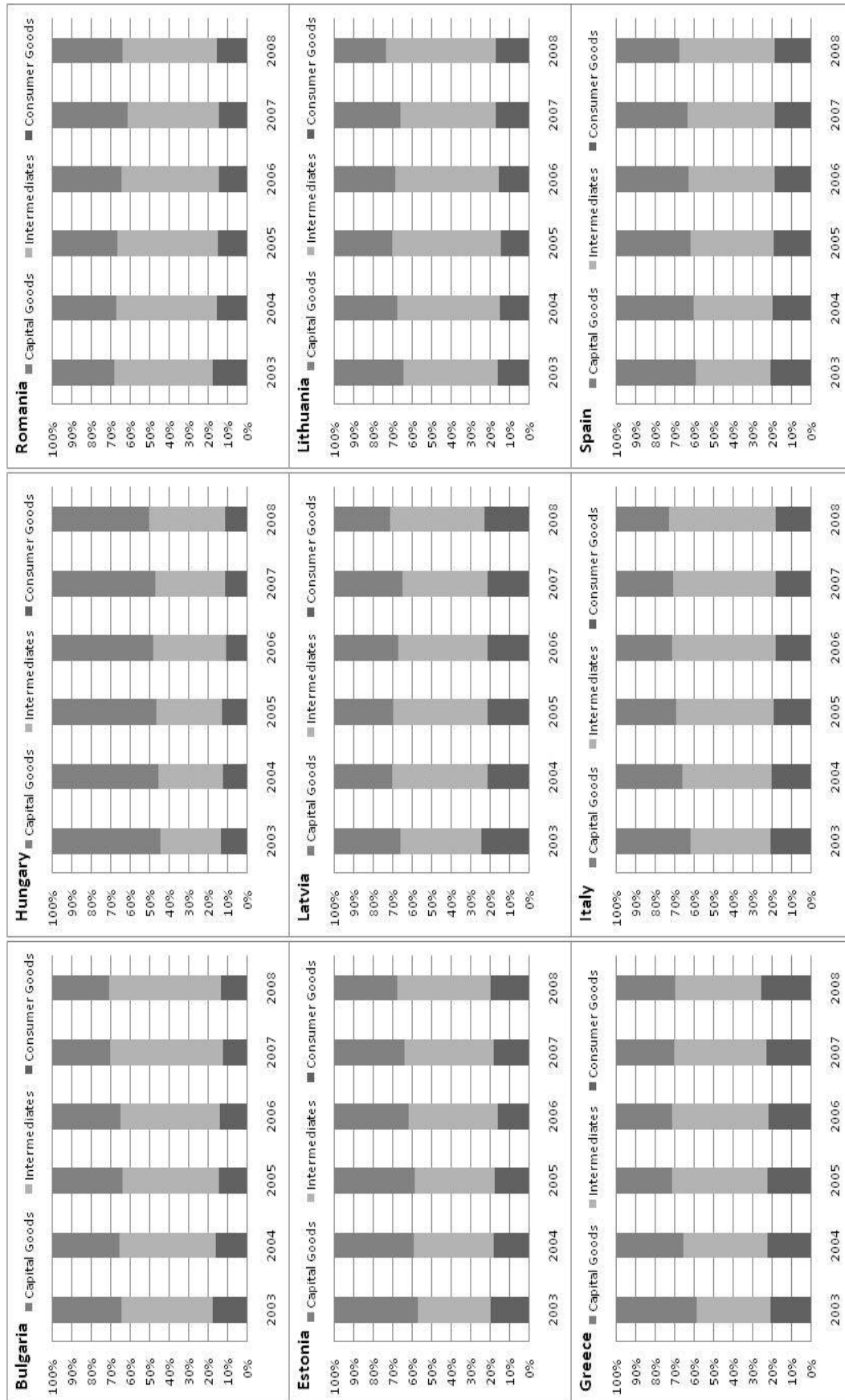


Figure 5: Composition of Imports in selected EU member states. Source: Eurostat



Hungary, the former showcase of an East-European transition economy, suffers from political distress and structural problems like high public deficits (IMF, 2009). From 2006 on, short-term oriented capital inflows dominated over FDI. Therefore, the persistently high shares of capital goods on total imports – with a positive return in the medium to longer term – were financed by short term funds. As domestic spending deviated from macroeconomic and microeconomic fundamentals, Hungary has become one of the early and most prominent victims of the financial crisis in Europe.

Looking at the Baltic countries, the picture is mixed. On the one hand, the net developments of portfolio investments are negative in most years, indicating that inhabitants of these countries invested in the rest of the world according to their risk-diversification strategies. On the other hand, there is a stable net inflow of FDI. Thus, we can not state that the capital surpluses have been highly speculative in general. The three countries show a relatively steady pattern of import composition, with a slight development from capital goods to intermediates, indicating the gains from structural change and an increasing participation in international trade through specialization and value added. The problems that led to overheating from 2007 on were a housing boom, the expectation of an early adoption of the EU currency and strong increases in government spending.

In contrast, the three South-European countries Greece, Italy and Spain are more worrying from the beginning, as the current account deficit comes along with net FDI outflows in many years and is financed mainly by portfolio investments. Therefore, the sustainability of these net capital inflows has to be questioned with exceptionally worrying implications for Greece, as the increasing current account deficit there goes in line with rising shares of consumer goods on total imports, fiscal problems, and an unfavourable microeconomic environment regarding markets regulation (OECD, 2007, 2009).

Which differences prevent South Africa from becoming a financial crisis victim, such as the European transition economies? First, lacking the back up of a (financially) strong European Union, investors risk perceptions and thus capital inflows have been less exaggerated than in the new EU member states. However, without EU-membership and corresponding access to EU-funds, these economies would have been hit much harder by the first waves of the financial crisis, leading to further erosion of investor sentiments - but this is only the other side of the same coin. Although the net effect is difficult to calculate, volatility has increased. Second, the free floating of the exchange rate allowed the Rand to follow its function as an adjustment parameter (IMF, 2008, pp. 16, 24). Third, financial sector development and regulation are modern and effective; which has

been substantial for fact that South Africa has not suffered a banking crisis.² This includes early measures of stricter lending standards since June 2007 (IMF, 2008, p. 6) and a constant inflation targeting regime of the SA Reserve Bank. The comparative evaluation of South Africa's current account deficit gives therefore fewer hints for a sudden stop like in other emerging economies.

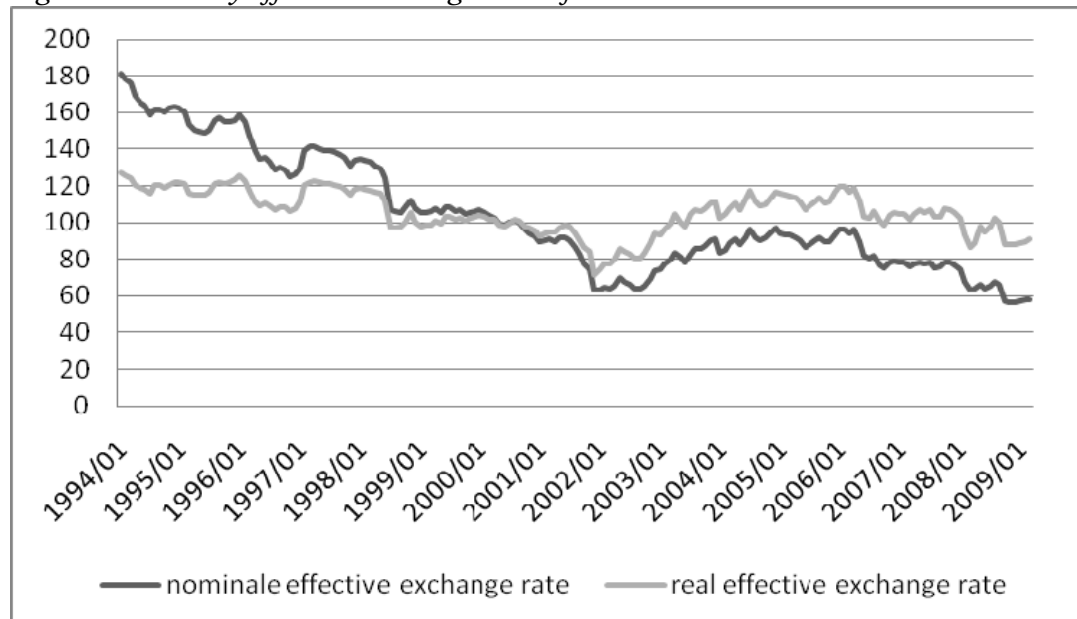
III. The real exchange rate and structural change in the economy

To explain the emergence and normative properties of the current account deficit, there are a number of theoretical strands.³ We focus on the intertemporal approach when analysing the dynamics and policy conclusions of the South African current account deficit since 2002. The exchange rate plays a major role in this dynamic process. It is seen as an adjustment parameter to manage the transfer from a change in the capital account to the corresponding change in the current account in South Africa. Huge capital inflows can cause a nominal and real appreciation because they are an increase in purchasing power in the capital importing country. Indeed, after 2002 the Rand appreciated nominally and in real terms. It was only in mid-2006 that the effective exchange rate started to depreciate.

² Additional factors include South Africa's continued use of exchange controls, and the oligopolistic structure of the financial system which has ensured high margins for the four major players and hence less risk-taking.

³ In the current public discussion one can distinguish opposing views. The first is the "competitiveness" approach, arguing that a competitive depreciation of the domestic currency leads to a trade surplus, which is assumed, but not well argued to help the country. Based on older strands of the intertemporal approach such as Böhm-Bawerk (1914), Obstfeld and Rogoff (1994) developed the second, microeconomic, utility maximising framework to analyse the determinants of a current account imbalance. The exchange rate is not a policy instrument, but an adjustment parameter. For an overview see Freytag (2008b).

Figure 6: Monthly effective exchange rates of the Rand, Indices: 2000/08=100



Source: South African Reserve Bank online, 2009, series KBP 5376m, 5378m.

Following the intertemporal reasoning, the (real and nominal) appreciation from 2003 to 2006 was economically necessary in order to allow the transfer from the capital account to the current account, thereby contributing to the structural change of the South African economy. The real exchange rate in this context is defined as the domestic relative price of tradables (P_T) and non-tradables (P_N).⁴ For a small open economy such as South Africa, P_T is more or less fixed internationally. One has to bear in mind that South Africa is geographically far from relevant world markets, so that prices may differ because of transport costs; however, this difference will not change over time because of the law of one price. By contrast, P_N is not fixed, but changes with a change in purchasing power. Therefore, it is reasonable to assess the relative prices between the two types of goods, which is difficult. We draw on the distinction made by Blignaut, Farrell and Rangasamy (2008) and use this to categorise goods and services into tradables and non-tradables.⁵

The development of both prices for tradables and non-tradables between 2000 and June 2007 (shortly before the appreciation stopped and inflation took off) indeed show that there is a difference: P_T as price index for the weighed basket of tradables in historic metropolitan areas (series P0141, Statistics South Africa 2008) increased by 40.75 per cent, whereas P_N as the respective index for non-tradables increased by 49.75 per cent. From July 2007 to July 2008, the prices

⁴ This provides the advantage of easily calculating the development of the real exchange rate by calculating domestic price indices $e_{real} = P_T/P_N$.

⁵ See Annex, table A1 and Freytag (2008b) for a more detailed analysis.

for tradables (+12.2 per cent) and non-tradables (+12.5 per cent) developed similarly.

Although the results of this exercise do not formally prove that the exchange rate is an adjustment parameter to foster structural change, we see that the prices for tradables grew more slowly than the prices for non-tradables between 2000 and 2007. Thus, the pattern of the exchange rate development is in line with the change of relative prices. We now proceed by taking a look at structural change in the South African economy, to analyse the role of the real exchange rate changes.

Because of the real appreciation, in theory the tradable sector typically faces higher input prices accompanied by constant output prices and, thus, relatively shrinks as exports and import competing domestic sales decline (or grow slower), whereas imports increase. If the capital inflows hold for a longer time, the domestic economy adjusts in such a way that the tradable sector declines relatively and the non-tradable sector increases relatively. Due to the increase of the prices for non-tradables, it becomes more attractive to invest into this sector and less attractive to invest into tradables. In the medium run, the net capital inflows will foster structural change. The appreciation stops when the economy has adjusted to the capital inflows and can even be reverted (Ragnitz 1989).⁶ In this situation the real appreciation is costly but somewhat necessary to allow for the structural change to occur. In the South African case, non-tradables indeed grow faster than tradables during the period of appreciation. We compare the sectoral development of value-added for the periods 1994-2002, i.e. before the current account swung into deficit, and 2002-2007.⁷

Table 2: Structural change in South Africa (change in value-added)

	1994-2002	2002-2007
Agriculture	7	-3
Mining	-4	7
Tradables	29	21
Non-tradables (excl. government)	38	37

Source: Statistics South Africa (2008, Series P0441), own calculations.

The result of this exercise is striking. Whereas the production of agricultural products increased in the first period after democratization, it shrinks thereafter. Mining obviously was dependent on the world market prices. The relatively declining performance of agriculture and mining is in line with development the-

⁶ This can be explained as follows: as in the overshooting model developed by Dornbusch (1976), the money market responds faster to new signals than the goods and service markets (Knight and Scacciavillani 1998, pp. 20-22). The capital inflow is increasing demand and therefore prices (both for non-tradables), as long as the production does not increase, which takes longer. Once it has increased, prices fall again.

⁷ See Statistics South Africa (2008), P0441, 2000 prices. For an overview see table A2 in Annex.

ory. The interesting part of table 1 is at the bottom. Non-tradables output grew faster than tradables output throughout the whole period, but significantly more so in the second sub-period, when net capital inflows increased and the current account swung into deficit. On an annual basis, the growth rate of value added of non-tradables increased from 4.1 to 6.5 per cent, whereas the growth rate of tradables value added only slightly increased from 3.2 to 3.9 per cent. In other words, the increase in the relative prices of non-tradables has encouraged investors in this sector. It grew faster than the tradables sector. Structural change was mastered by the South African economy, at least to a certain extent.

A careful and moderate conclusion is that structural change in South Africa has continuously taken place in the past years. The real exchange rate obviously functions as an adjustment mechanism. Obviously structural change was fostered by the real appreciation, which was partly caused by net capital inflows.⁸ After an adjustment of the supply side, the net capital inflow has been accompanied by a simultaneous current account deficit – it does not need an appreciation any longer. The Rand depreciates in real terms. It is too early to draw final conclusions at this stage and it remains to be seen how the real exchange rate will develop in the future. From an economic policy perspective however, there is no need to be concerned and to intervene in the foreign exchange market because of the current account in general. This holds all the more as structural change is a permanent companion of economic development in South Africa, as elsewhere.

IV. Institutions, Political Economy and Regulation

Latest research in institutional and development economics has come to the conclusion that institutions play a major role in explaining a country's economic performance. It has been shown that governance structures are relevant for economic growth and development as well as for the capability of countries to utilise foreign aid. The international development community including the World Bank has started to take governance structures into consideration when assisting governments in developing countries. By the same token, the ability of countries to attract foreign capital very much depends on institutional quality (e.g. Dluhosch, Freytag and Krüger 1996).

By institutions, we understand the set of formal and informal norms and rules valid in a society. These emerge spontaneously or are created in a political decision. Institutions can be interpreted as constraints and incentives for individuals

⁸ This analysis does not allow for an assessment of the welfare, in particular labour market effects of structural change. Also, it does not imply that South Africa is free of structural problems (see section V.).

in both politics and the economy.⁹ Institutions are difficult to identify and measure. In particular it is hard to distinguish institutions from economic policy. For instance, is a labour market regulation an institution or a policy measure, which can be easily changed?

Table 3: Governance indicators in South Africa since 1990

	African average 2007	South Africa						
		1990	1999	2000	2002	2003	2005	2007
HDI	0.51 (2005)	0.735	0.742	0.696	0.666	0.658	0.674	n.a.
CPI	2.9	n.a.	5.0	5.0	4.8	4.4	4.5	5.1
PR	4.3	5	1	1	1	1	1	2
CL	4.0	4	2	2	2	2	2	2
EF	5.7 (2005)	5.3	6.3	6.8	6.8	6.9	7.1	7.0

Source: UNDP (2008), Transparency International (2008), Freedom House (2008), Gwartney, Lawson et al. (2009).

Despite these difficulties, there are a number of measures for institutions. Needless to say these measures suffer from a number of shortcomings, the most important of which is their arbitrariness, as both the choice of criteria and the outcome depend on the very persons measuring an institution. Nevertheless, it helps to compare different indicators over time to assess the development of the institutional and governance quality of a country. If these indicators follow a similar path, they can be regarded as being consistent. For the purpose of this study, we have chosen five indicators, the Human Development Index (HDI), the corruption Perception Index (CPI), Freedom House's Political Rights (PR) and Civil Liberties (CL) score and finally, the Index of Economic Freedom (EF) of the Fraser Institute.¹⁰

The governance indicators show that there was no significant change after 2002, but earlier, after 1990, as a comparison of the shaded figures for 1990 with all subsequent scores shows. These indicators also show that the governance quality in South Africa is moderate. The country is somewhere below the world-wide average with respect to human development, economic freedom and corruption, whereas the degree of political rights and civil liberties is rather high.

⁹ There is an ongoing discussion of what institutions and institutional economics are. It would be counter-productive for the purpose of our study to enter into this discussion. The interested reader may refer to the collection of basic articles in Hodgson (1993).

¹⁰ For a description of the indicators see (Freytag 2008b).

What strikes one, however, is that Political Rights have been reduced in 2007 in comparison to the years after 1994.¹¹ This is due to a reduction of the score in the sub-categories “Functioning of government” and “Rule of law” (Freedom House 2008), which is in line with the rather low sub-score (5.5) for group 1 of the index of Economic Freedom (Gwartney, Lawson et al. 2008)¹² and indeed has attracted increased international attention (e.g. OECD 2008, The Economist 2008).

The role of these aspects in international capital movements cannot be sorted out easily, but must not be underestimated. Although institutional factors do not seem to be of utmost importance for the emergence of the net capital inflows in South Africa (Freytag 2008b), their deterioration may add to the danger of a sudden stop. In particular, this holds as competitors for capital such as European transition countries have steadily gained ground with respect to their governance quality. They have been able to attract foreign capital (gross flows) to a great deal. In other words, to compete with these, South Africa needs good governance. This holds all the more, as South Africa is a relatively small country in a regional neighbourhood of states with dubious reputations and consequently may be grouped together with these countries.

A decision to withdraw capital may be of long-term consequence, as it normally takes time to regain the reputation lost in the process of declining governance quality. Despite this warning, it is unjustified to draw a gloomy picture. The ‘institutional quality’ of South Africa is moderate in an international context, but still exceptional in Africa. The country has managed the transition period after the end of Apartheid rather well and has all chances to further improve the governance structure. Such a development is the easier, the better the economy performs. Beside macroeconomic policy and institutions, microeconomic policies such as competition policy, labour market regulation, regulation in general and trade policy all play a role in this process.

From both perspectives, the situation does not seem too worrying. However, there are a number of problems, which may impede structural change and encourage protectionist demands in the future. The most urgent problem is unemployment (Rodrik 2006, pp. 2f), which is coupled with weaknesses in the educational system and rather low productivity of the South African economy (Eyraud 2009).

¹¹ Freedom House (2008) publishes two indicators biannually, the indicators of Civil Liberties and Political Rights, respectively. Both range from one to seven. The higher the score the less freedom the citizens of a country have. A score of 2 indicates that the country is almost free.

¹² The Fraser Institute (Gwartney, Lawson et al. 2009) publish an index of Economic Freedom, which is based on 21 criteria within five groups. This indicator ranges between zero and ten, a higher score indicating higher economic freedom. A country is interpreted as free if the score is 7.5 or higher.

Apart from the labour market problems, the OECD points to a very important impediment for further development, namely politically created barriers to market entry. Concentration in markets for goods and services is high, but declining since 1996. According to indicators of product market regulation used by the OECD (2008, pp. 64 and 89-97), the regulatory barriers to run a business are considerable and much higher than the OECD average. These barriers deter foreign investors and domestic entrepreneurs. In combination with the already mentioned weaknesses of public administration or the functioning of government, they form a sort of growth ceiling (Gouws 2008).

This growth ceiling is even reduced by a third major problem, namely monopolistic or oligopolistic structures in network sectors¹³, which form bottlenecks for the further development of the South African economy. These sectors are electricity, transport and telecommunication. As they produce important inputs for the tradable sector in South Africa (both goods and services), low quality and high prices keep productivity in South Africa low. As a matter of fact, productivity growth between 2000 and 2005 in South Africa has been rather mediocre and slower than in some other emerging markets such as China and India (OECD 2008, p. 57, Eyraud 2009). A neglect of these bottlenecks will probably further reduce productivity growth. Low productivity growth is not adding to the high-tech potential of the country, which already has a low share in global high-tech exports.

Although the net effect of low productivity and high input prices on the current account cannot be forecast in advance, it seems that the problems in the network industries diminish gross flows and reduce the welfare enhancing international division of labour. The net effect on the trade balance depends on the reaction of international investors. If they maintain their net portfolio investment in the country, the current account does not change. Nevertheless, the poor performance of the network industry certainly hampers both the price competitiveness of downstream industries, as well as the ability of South Africa to attract foreign capital. It also reduces international trade to the disadvantage of the South African economy.

V. Assessing Policy Responses

Our analysis as well as much of the macroeconomic work so far has shown that the sustainability of the South African current account deficit is not endangered under normal circumstances. However, the financial crisis is not normal; a business-as-usual strategy is not justified. The Harvard Group, the IMF and the

¹³ Network industries are industries characterized by a network (e.g. pipelines, cables, tracks). Economically, they are of interest because of economies of scale and their economy-wide usage.

OECD have made clear the structural problems of the South African economy. In addition, the parallel existence of high unemployment, increasing inflation and increasing current account deficit is encouraging an intensive policy debate. We focus on two inter-related aspects: trade and industrial policies.

1. National Industrial Policies 2009

The South African government has been willing to take an active role to increase employment, foster structural change and growth. In 2006, the Accelerated and Shared Growth Initiative for South Africa (AsgiSA) was introduced to tackle the constraints as discussed above. Whereas the diagnosis that South Africa needs to speed up structural change and strengthen the economy's capacity to master it is widely shared, there are doubts about the strategies (OECD 2008).¹⁴ Flowing from AsgiSA, there is a recent program, called the National Industrial Policy Framework (NIPF). Its core stated objective is to promote diversification of the South African economy, particularly through building manufacturing industry and growing associated exports. This fits with one of the core findings of the Harvard group (Hausmann 2008) to the effect that South Africa needs to both grow and diversify its export basket in order to sustain the current account deficit and address its unemployment crisis.

The NIPF is directed at supporting certain, clearly identified industries – it thereby takes it for granted that the government has the knowledge to identify these key industries. The Harvard Group suggested picking industries or activities that promise “...new products, new processes, new geographical zones or new forms of organisation...” (Hausmann 2008, recommendation 12). It remains unclear what exactly is being planned as details are lacking (Draper and Alves 2007). Direct intervention is politically tempting but economically risky. First, the main difficulty for the government or its agencies is to identify those industries that create jobs and growth in the future. Much information is needed. The problem is that this information is generated during the process itself and best so on markets. Admittedly, private agents face the same lack of knowledge, but markets normally generate and process information and knowledge faster than governments. The general phrase for any governmental effort to mimic the market as information generating instrument is governmental “preference of knowledge” (v. Hayek 1975). Given that under the conditions of globalisation, especially value-chain splicing and complex specialization as well as the high speed with which knowledge ages, it is even more difficult to forecast future economic structures. In other words the world has changed very much since the 1950s/60s; hence the traditional “picking winners” approach as practiced in East Asia is much more complex now (assuming it worked in the first place). It seems even more demanding in times of global downturn.

¹⁴ See also Rodrik (2006) as well as Frankel, Smit and Sturzenegger (2006) for extensive analyses.

Second, industrial policy programs are prone to rent-seeking activities and corruption. The decision about who to support cannot be made without uncertainties, arbitrariness and personal contacts. This opens discretionary leeway for politicians and rent seeking scope for lobbies. Thus, an industrial policy program may lead to biased outcomes, and this may discourage investment.

Third, the supported industries may become used to the support and diminish their efforts to catch up with world market leaders, to innovate and to improve their performance. Subsidised industries e.g. in Germany provide lots of evidence for this argument. The government should be aware of this and take remedial measures such as making payments contingent on co-funding by the industry etc. Otherwise, the increase in productivity remains wishful thinking.

Because of these general shortcomings and with respect to the South African current account position, it has to be acknowledged that the NIPF contains a distinct risk. Experience in Asia in the second half of the 1990s suggests that one cause of the Asian crisis was the governments' interventions in the credit markets channelling funds into "strategic industries", thereby forcing banks to take high risks. Some of the targeted industries did not succeed on world markets. The subsequent crisis cascaded and ended in a macroeconomic disaster in several countries (Corsetti, Pesenti and Roubini 1999). In today's situation, misplaced interventions may even reinforce the crisis; the knowledge problem is crucial. This, however, does not discourage observers to suggest the very same policy for South Africa (e.g. Rodrik 2006).

By the same token, the South African government has obviously, come to a similar conclusion. In its "Green Paper", the Presidency (2009) argues that long-term planning based on expert committees is the necessary fundament for short-term oriented policy. National Planning is about to identify an "ideal objective or 'end-state'" whose achievement is secured by "five year strategic frameworks and an annual Programme of Action" (The Presidency, 2009, pp.6 and 14). What becomes clear is the focus on industrial policies, i.e. public networks and promoting structural change by an "industrial strategy" after the South-Asian model. The detailed planning and implementation shall take place on every government level and in every state owned enterprise, which will also make the operational decisions. Obviously, the Green Paper is driven by an optimistic picture of the abilities to directly control and regulate economic processes and outcomes.

2. Is there any role for trade policy?

Trade policy is a sibling of industrial policy. Both are directed at improving the competitiveness of domestic enterprises on the world market. Theoretical rea-

soning and overwhelming empirical evidence shows that in the medium and even more so in the long run, free trade and open markets for goods and services serve this purpose best.¹⁵ It is clear that the road to free trade is bumpy, as structural change will destroy jobs more rapidly than create new ones. It is the task of the government to acknowledge this fact and to mitigate the unavoidable short-term negative effects of structural change, mainly via social and education policy. Trade restrictions do not help, as they slow down the process of structural change and therefore, diminish the speed at which new jobs can emerge.

In addition, trade policy cannot “improve”¹⁶ the current account. Assume that South Africa increases trade barriers in certain industries to restrict trade and grants subsidies to other sectors to increase exports. Assume further that savings and investment decisions are not changed by this policy package. The increase of trade barriers means two things: first, demand for foreign currency is decreasing, implying an appreciation of the Rand. Second, prices for imported goods increase (due to tariffs). Imports are indeed reduced. This hurts the consumers (mostly the poorest) and – more important with respect to BoP issues – increases the input prices for the tradables sector. Thus, exports are hurt; as a standard phrase has it: import protection is export taxation!

The subsidies for selected export industries add to the picture, as the subsidies reduce the costs for the enterprises and allow them to reduce the prices for these export goods. Consequently demand for them increases, which causes the currency to appreciate further. Other – not subsidised industries – suffer export losses. Moreover, the subsidies have to be financed with taxpayers’ money. Hitherto successful exporters earn good profits and pay high taxes. If their taxes are used to promote exports of other firms, which leads to the exports of the former shrinking, the tax base is shrinking also. Taxes have to be increased, a vicious cycle may be the consequence. Thus, it is the rent-seeking activities that partly decide about success and failure on export markets. Again, there is wide empirical evidence that protection to support certain industries represses structural change, for instance in OECD countries such as France, Germany or Italy. Those emerging countries that reformed their trade policy have been successful in creating new jobs (Sally 2008). Indeed, as SAIIA’s research project on the political economy of trade reform shows, failure to consistently reform in this direction means that during macroeconomic crises reform becomes more painful.¹⁷

¹⁵ For a very good theoretical account see the textbook by Feenstra and Taylor (2008). A recent empirical analysis is provided by Sally (2008). For South Africa see Hausmann and Klinger (2006), Edwards and Lawrence (2006) as well as Sandrey et al. (2007).

¹⁶ The phrase “improve” is misleading, as a proper positive BoP theory does not have normative implications.

¹⁷ Details are available at: http://www.saiia.org.za/index.php?option=com_content&view=article&id=103&Itemid=202.

With respect to the trade balance, the protection does not change the deficit. The only consequence is that gross flows, both imports and export diminish. The reduced division of labour costs employment and growth world-wide, but particularly so in South Africa. The trade deficit remains high, as it is not a matter of trade policy, but of saving and investment decisions.

3. Policies to foster competition

Our main thesis is that South Africa indeed can benefit very much from the net capital inflows. If they are maintained, they can be used to invest further, creating new jobs, thereby lifting the living standard of the poorest and increasing savings in the country. Higher savings would automatically reduce the net capital inflows in the future. Therefore, the country should not attempt to artificially reduce net capital inflows via policy means.

This implies not to target certain industries with the means of traditional industrial policy. Picking the winners may not be an appropriate strategy as the risk of failure is high. This risk is neither due to moral failure nor to a lack of effort. Uncertainty about future conditions in the world economy is simply too large to make good predictions about it and in particular its structure. A second related question deals with trade barriers on imports. It has been shown theoretically as well as empirically as an inappropriate response to a deficit in the current account.

Thus, a sector oriented strategy is not adequate. Having said this, the government should not be inactive. Rather, there is plenty of room to manoeuvre. In the NIPF, this has been addressed as cross-cutting policy measures. We strongly support the view that the government should address the problem of low productivity by fostering technological change and basic technologies, and by enhancing education policy at all levels of the educational system.

Next, the government should tackle the bottlenecks in infrastructure, i.e. electricity, transport and communication. The lack of networks' productivity and the high costs of using the network infrastructure are not mainly a problem of capacity, but rather of organisation and competition. The government should take efforts to liberalise, de-monopolise and finally regulate these – and other – sectors (OECD 2008) according to experiences in other countries. To give an example, efforts to enhance the quality and reduce the prices of telecommunications will be very beneficial for other sectors, e.g. the financial industry. Here a shift towards opening up this sector to foreign competition would be of essential

importance.¹⁸ If it is possible to attract foreign investors in the telecommunication industries, a boost in productivity through out the economy could be the consequence. This would be a contribution to a beneficial debt cycle, enabling the repayments of accumulated deficits.

VI. Conclusions

The political reactions to the current account deficit in South Africa have been moderate so far. This holds particularly against the background of the crisis. The discussion of the institutional and microeconomic foundations and consequences of the South African current account deficit since 2003 has taken up many reasonable arguments and the government has avoided responding in a premature and inadequate way. The question is whether the government may loose temper because of the crisis and subsequent political pressure.

This paper is an attempt to add a few more arguments – institutional and microeconomic – to the discussion and to show that there is scope for political action. However, this action should not be directed at supporting certain industries by means of selective trade and industrial policies. Rather, the government should make use of instruments which it has already generated to increase domestic competition and thereby productivity, improve education and further open markets, in particular for services such as telecommunication, transportation and energy.

Given that the global savings rate will certainly remain high – it is not unlikely that it will be even higher than hitherto – savings need a safe heaven. After a period of timid, if not irrational behaviour, international investors will again start to carefully analyse investment locations. We expect that the criteria for the selection will not substantially differ from the past: macroeconomic stability, institutional quality and a pro-competition microeconomic regulation. Protectionism and short-term populism would make South Africa a place to circumvent.

¹⁸ The legal basis for this is the Fourth Protocol of the WTO, which includes binding roles for market access and regulation in telecommunications. The signatories experienced a significant quality increase and price reduction in the industry, benefiting downstream industries.

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Draper is Project Head: Development through Trade at SAIIA; *Freytag* was SAIIA's Bradlow Fellow for 2008, *Voll* is lecturer at the Friedrich-Schiller-University, Jena. Correspondence should be addressed to: Andreas Freytag, Friedrich-Schiller-University, Jena, and ECIPE, Brussels, a.freytag@wiwi.uni-jena.de, +49 (0)3641 943 250.

Annex: Data*Table A1: Tradables vs. non-tradables (historical metropolitan areas), for the calculation of relative prices*

Products	of which	weight (per cent)	T or NT
Food		20.99	T
Non-alcoholic beverages		1.10	T
Alcoholic beverages		1.40	T
Cigarettes, cigars, tobacco		1.14	T
Clothing and footwear		3.25	T
Housing		22.14	NT
Fuel and Power		3.49	T
Furniture and equipment		2.53	T
Household operation			
	household consumables	1.25	T
	domestic workers	3.48	NT
	other household services	0.09	NT
Medical care and health exp.		7.15	NT
Transport			
	vehicles	5.95	T
	running cost	7.05	NT
	public and hired transport	1.84	NT
Communication		2.98	T
Recreation and entertainment		3.31	NT
Reading matter		0.39	NT
Education		3.48	NT
Personal care		3.67	NT
Other		3.32	T

Structure after weights: 47.4 per cent tradables and 52.6. non-tradables

Source: Statistics South Africa, Series P0141, own assessment, based on Blignaut, Farrell and Rangasamy (2008).

Table A2: Tradables vs. non-tradables, for the calculation of value-added

Sector	T or NT
Agriculture, forestry and fishing	T
Mining and Quarrying	T
Manufacturing	T
Electricity, gas and water	NT
Construction	NT
Wholesale and retail trade, hotels and restaurants	T
Transport, storage and communication	T
Finance, real estate and communication	NT
General government	not included
Personal services	NT