



CURRENT ACCOUNT DEFICIT NARROWS AS SPENDING EASES, EXPORTS GAIN

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Introduction

The SA Reserve Bank (SARB) released its September Quarterly Bulletin (QB) yesterday, which provided data on a number of key economic developments during the second quarter of 2008 (2008Q2). The QB confirmed that the current account deficit (CAD), the broadest measure of SA's trade with the rest of the world, narrowed during 2008Q2, while it also contained data on the Q2 GDP figures when measured from the demand side.

Smaller trade deficit narrows CAD

The CAD improved from 8.9% of GDP in Q1 to 7.3% (measuring R164.4bn when expressed at a seasonally adjusted and annualised rate¹) during Q2.

According to the SARB, the smaller shortfall was as a result of a significant improvement in the **trade deficit**, which halved to R31.3bn (previous R61.4bn). After falling by 7.2% in Q1, the volume of merchandise exports increased by 12.2% in 2008Q2. The export rebound was mainly as a result of a 10% rise in mining exports as local mines increased output to compensate for the production declines suffered during Q1 in the aftermath of the electricity supply problems. Despite the Q2 mining export improvement, the (unadjusted) customs trade data² for the first six months of 2008 continue to reflect the negative impact of the January mine closures.

Figure 1 (on the next page) plots the difference between SA's monthly export revenue from gold and platinum and the oil import bill. From January 1998 to the end of 2007, precious metals export revenue (on average) exceeded the oil import bill by R1.5bn. During the first six months of 2008, the positive gap came down to R888 million. Another way of looking at it is to compare the first six months of 2008 with the corresponding period of 2007. During the first half of 2007, SA gained R16.3bn on the trade balance when precious metals export revenue is compared with the oil import bill.

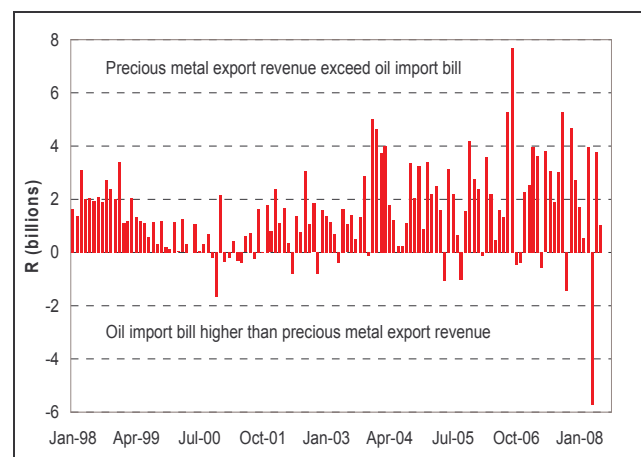
The "gain" came down to R5.3bn during the first six months of 2008. The deterioration can be explained by the surging oil prices as well as a fall in the volume of gold and platinum exported due to the electricity crisis. Brent crude oil averaged \$109.4/bbl during the first half of 2008 versus \$63/bbl in the corresponding period last year. We only have the gold and platinum export volume data for the year to end May 2008. In the first five months of 2008, the combined volume of gold and platinum exported plunged by 19.7% y/y. We calculate that if SA had exported the same quantity of gold and

¹ Throughout the rest of the report the abbreviation *saar* will be used for seasonally adjusted and annualised.

² This refers to the monthly trade statistics released by the SA Revenue Services.

platinum in 2008 as during the first five months of 2007 and with the higher gold and platinum prices, the country would have received an extra R8.1bn in export revenue. From gold and platinum exports alone, the electricity crisis cost the country R8bn. It could, however, be argued that gold and platinum prices would not have increased to record highs were it not for the SA mine closures.

Figure 1: Precious metal exports versus oil imports



Source: Calculated from SARS customs data

Returning to the QB, the SARB said that the volume of imports increased only marginally during Q2 amid the deceleration in domestic demand (see below). However, a 40.4% surge in the value of crude oil imports lifted the overall import value by 12.6% during Q2 to R760.9bn (saar). The fact that the oil price gain in Q2 surpassed that of SA's key export commodities resulted in the terms of trade (i.e. the difference between SA's import and export prices) weakening by 4.7% following a 5.6% gain during 2008Q1.

While the trade deficit halved, the shortfall on the services, income and transfer account remained stable, measuring R133.1bn (saar) and thus remaining the key driver of the CAD. According to the SARB, higher net service payments were more than neutralised by lower net dividend payments to non-residents during Q2.

Where did the CAD funding come from?

The CAD was once again financed by foreign capital inflows. The QB highlights that if unrecorded transactions are included, capital inflows (measured on a quarterly, unadjusted basis) amounted to R44.8bn in Q2. The inflow was sufficient to finance the CAD of R39.1bn³. The dominant form of financing for the CAD in recent years has been **foreign portfolio inflows**, i.e. foreign buying of SA stocks and bonds. After a net portfolio capital outflow of R20.5bn during Q1, Q2 saw an inflow of R22.5bn. Portfolio flows were again mainly responsible for the Q2 CAD financing. However, more up to date figures indicate that these flows have been negative thus far in Q3.

Net foreign direct investment, or FDI, flows moderated sharply to only R981 million during Q2 from more than R35bn during Q1. The robust Q1 inflow was driven by the Standard Bank/Industrial and Commercial Bank of China deal. **Net other investment inflows**, which were mainly responsible for funding the CAD in Q1, also eased (from R29.7bn to R19.2bn) during Q2. The SARB mentions that in light of a decline in non-resident rand and foreign-currency deposits with the domestic banking sector, SA banks utilised foreign credit facilities to a greater degree during Q2.

Despite the fact that slower domestic demand and a lower oil price (if sustained) should help to moderate the CAD further, concerns remain about the sustainability of CAD funding. In the BER's view, CAD financing continues to pose a threat to the rand, particularly in an environment of US dollar

³ The unadjusted figures are used in order to directly compare capital inflows with the CAD.

strength and falling precious/base metal prices. Our current view is for the rand to average R8.05/\$ in the final quarter of 2008, but there is a real risk that the currency could be weaker.

Q2 spending trends

The QB also provided a breakdown of Q2 GDP growth from the demand side. For the first time since 2001Q1, gross domestic expenditure (GDE)⁴ declined when measured on a q/q (saar) basis. GDE fell by 4.2% (the weakest performance since a 13.8% decline in 1999Q1) after surging by 14.2% during 2008Q1. The Q2 decline was distorted by a sharp reversal in **inventory investment**, which declined by R6.8bn after a R9.8bn increase during Q1. The SARB said that inventories subtracted 4.7 percentage points from Q2 GDE. The inventory fall was mainly concentrated in the mining and manufacturing sectors, which is somewhat difficult to explain as both mining and manufacturing output increased sharply during Q2. Furthermore, GDE was dragged down by a large residual (or error term) of R16.4bn.

In light of the distortion, it is more appropriate to look at the trend for **domestic final demand** (consisting of household expenditure, government spending and gross fixed capital formation). Final demand moderated sharply to 2.2% q/q saar from 7.5% in Q1. While final demand eased sharply, GDP growth accelerated from 2.1% to 4.9% in Q2, thus pointing to a rebalancing of growth towards the production side of the economy and helping to explain the narrowing of the CAD.

While the growth rebalancing is welcome news as it moves the economy away from an (over) reliance on consumer demand, it is questionable whether this will last as especially the manufacturing sector (in light of the weak domestic and external demand) may find it difficult to repeat the strong Q2 performance. All the major final demand categories posted weaker growth in Q2.

Table 1: Real final household expenditure (q/q saar)

	2007			2008	
	Q2	Q3	Q4	Q1	Q2
Durable	-15.7	8.9	2.5	-8.1	-14.9
Semi-durable	22.7	3.5	8.4	10.5	2.4
Non-durable	3.9	5.2	1.9	3.0	0.2
Services	6.0	2.9	4.0	4.3	6.5
Total	4.9	4.4	3.8	3.3	1.2

Source: SARB

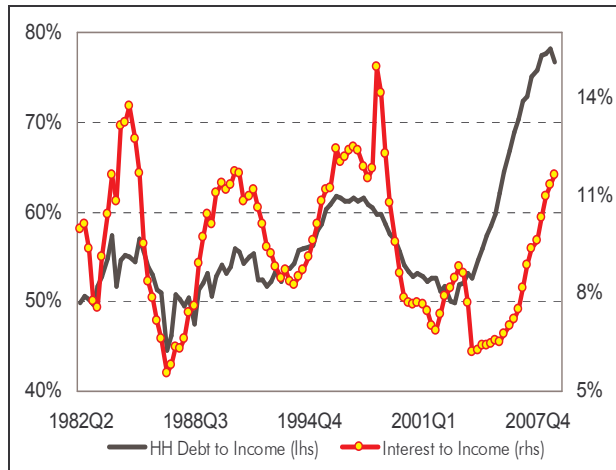
Table 1 sets out the trends for **household consumption expenditure** during 2008Q2. Overall, household spending moderated further to 1.2% saar, which was the weakest performance since 1999Q1. Unlike in Q1, the weakness was spread across the major spending categories with durable goods consumption (mainly furniture and appliances) falling deeper into negative territory, while spending on semi-durable (clothing and footwear) and non-durable (mainly food and beverages) goods eased meaningfully. The moderation for non-durable goods was in reaction to the mounting fuel and food costs during Q2.

Services was the only spending category that saw faster growth as increased outlays on household services as well as transport and communication services offset slower spending on the other services categories.

Figure 2 indicates that the **household debt to disposable income ratio** broke a four-year rising trend in Q2 as the more challenging macro environment resulted in consumers not taking on new debt. The ratio declined to 76.7% from 78.2% previously. However, **debt service costs** rose further to 11.6%, the highest since the 12.3% recorded during 1999Q1.

⁴ GDE is the broadest measure of spending in the economy.

Figure 2: Debt service costs rapidly ticking higher



Source: SARB

Government spending declined by 1.4% q/q in Q2. This decline is also somewhat technical as it comes from a high base in Q1 when government expenditure was boosted by the acquisition of a **submarine** as part of government's Defence Procurement Programme. Finally, **gross fixed capital formation** (GFCF) also posted slower, albeit still fairly robust, growth in Q2. All the major investment categories (private, public corporations and general government) showed softer growth. Overall GFCF growth increased by 9.1% q/q (saar) versus 16.9% during the first three months of 2008.

In all, the demand side GDP numbers continue to reflect that the economy is under strain from higher interest rates and accelerating price pressures. Besides the improved inflation outlook, the QB provides a sound justification for why the SARB decided to leave the repo rate unchanged at its August interest rate meeting.

Wage demands rise, productivity falls

The Bulletin reports that the growth in **nominal unit labour costs** accelerated significantly to 10.2% during 2008Q1. According to Andrew Levy Employment Publications, the average rate of wage settlements amounted to 8.3% in the first half of 2008 (6.8% during the same time in 2007). Meanwhile, labour productivity growth moderated from 2.6% y/y during 2007Q4 to 1.8% in 2008Q1. Recent reports point to wage costs remaining on an upward trend - BHP Billiton awarded employees at its Hillside Aluminium smelter an increase of 15%, while lower-income workers at Exxaro received a 13.5% wage rise.

From an inflation (and employment) point of view the higher wages are certainly not good news and could (along with the large current account deficit) prevent the SARB from cutting interest rates before the middle of next year. However, if GDP growth moderates at a faster rate than currently foreseen, rates could start to fall earlier next year.

At this stage, the BER expects GDP growth of 3.4% for 2008.

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