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External trade trends: Current account deficit widens

Highlights

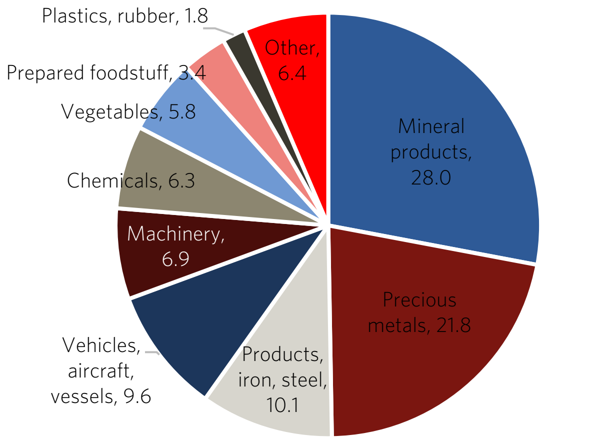
- According to the South African Reserve Bank (SARB), the current account deficit as a ratio of gross domestic product (GDP) widened from negative 0.9% in the first quarter of 2023 to negative 2.3% in the second quarter.
- The goods trade surplus dropped sharply from 1.6% of GDP to 0.4% in the second quarter on account of volume and price effects. Quarterly growth (q/q) in the volume of imports (3.2%) far outpaced growth in the volume of exports (0.9%). Meanwhile, the value of imports increased and export prices decreased over the same timeframe.
- The International Monetary Fund (IMF) forecasts a sharp deterioration in SA's current account balance from negative 0.5% in 2022 to negative 2.3% of GDP in 2023 due to falling commodity prices, weaker global demand and higher capital goods imports in light of the energy crisis.
- The majority of SA's exports are raw materials exported to China. This structure has created a big reliance on the mining sector and China's economic growth which places SA's trade in a vulnerable position. The composition of the country's imports highlights the lost opportunity of exporting raw materials produced locally which could have benefited the trade balance, employment, economic growth and reduced overall vulnerability.
- SA's top bilateral trading partners have remained broadly unchanged over the past years but the IMF highlights a shift in terms of regional trade from advanced economies to other countries.
- The share of SA's trade to world trade has historically been low and has declined gradually since 1982 despite successful trade liberalisation in the democratic era.
- Following the halt in tourism during the pandemic, which led to a significant drop in the industry's contribution to GDP, in-bound tourism volumes are firmly on the recovery path which will support growth. However, tourism volumes are still below pre-pandemic levels and the recovery in tourists from Brazil and China continues to lag.
- Operation Vulindlela, a project office in the Presidency, has introduced visa reforms (an extension of the e-Visa system and visa waivers) aimed at easing access to promote tourism in SA. If implemented accordingly by the Department of Home Affairs, these reforms are said to facilitate growth in the tourism sector which could also create meaningful employment opportunities.
- Foreign policy and geopolitics have been in the limelight over the past few months. This has negatively affected sentiment about the country and increased concerns about more damaging consequences such as an exclusion from the African Growth and Opportunity Act (AGOA) and possible secondary sanctions. Recent developments of a favourable finding from the Lady R (Russian vessel) inquiry and successful hosting of the BRICS summit have dissolved some of the foreign policy risks, but upcoming key events such as the AGOA Summit and the European Union (EU)-SA Summit remain important to watch.

- Pressure on exported commodity prices and a ramp-up in imports, partly attributable to the renewable energy sector, has driven the current account deficit wider. We expect the deficit to widen to 2.2% of GDP from a deficit of 0.5% last year, following two years of current account surpluses when commodity prices were more buoyant. Moreover, SA is likely to post a wider budget deficit than initially guided by National Treasury earlier this year due to less favourable commodity prices, pressure on household finances and additional costs associated with negating loadshedding. As such, SA should publish a twin deficit this year, which will weigh on the rand in the near term.

Unpacking SA's trade composition

SA has a wide range of natural resource endowments and this is evident in the composition of its goods exports. According to merchandise trade statistics published by the South African Revenue Service (SARS), the two biggest export product groups are mineral products (ores, crude, coal, petroleum and electricity) and precious metals (gold, platinum, diamonds, jewellery and other precious metals). Since 2010, these two product groups cumulatively accounted for an average of 44% of the total value of exports. Base metals and articles of base metals (iron, steel and aluminium) are the third biggest category followed by vehicles and accessories. See chart 1 for the composition of exports in 2022.

Chart 1: Composition of SA exports in 2022, by value

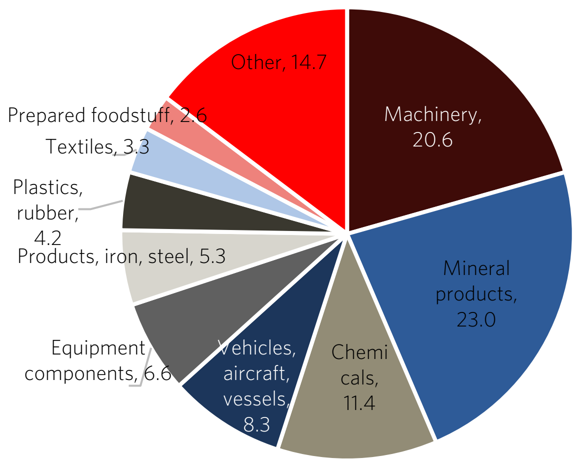


Source: SARS, Momentum Investments

The share of mineral products has been on an upward trend from 22.4% in 2010 to 27.9% in 2022, likely driven by the growing demand from China, which has consequently led to a downward trend in the share of precious metals to total exports from 22.4% in 2010 to 17.6% in 2019. This trend was temporarily broken by the post-pandemic commodity boom which led to the share of precious metals increasing to 28.4% in 2021 and surpassing mineral products as the top traded product group in that year. The subsequent decline in commodity prices has resulted in a decline in the share of precious metals to 21.8% in 2022.

In terms of imports, SA mostly purchases machinery (cell phones, electrical equipment, machinery, catalytic converters, computers and mechanical appliances) and mineral products. These two product groups account for an average of 42% of the total value of imports. Chart 2 below shows the composition of imports in 2022.

Chart 2: Composition of SA imports in 2022, by value



Source: SARS, Momentum Investments

Machinery as a share of total imports has been decreasing from 25.2% in 2010 to 20.6% in 2022. Possible driving forces for this outcome can be explained by lower fixed investment spending, a rise in corporate savings, lower corporate credit growth and generally lower economic growth which hampers demand. The mineral products share also dropped from 19.5% in 2010 to 14.26% in 2020 and rebounded to 23% in 2022 due to higher commodity prices. During 2010 and 2019 when the share of the top two traded product groups was declining, chemicals and equipment components picked up. Unlike exports, the total value of imports is less concentrated among the top nine products as seen by a bigger share of 'other' (14.7% in 2022) which implies that SA imports are less concentrated.

While mineral products are a big portion of both exports and imports, SA is a net exporter of these goods. The downside of being a net exporter of mineral products is that SA ultimately imports goods produced with its raw materials. This represents forgone opportunities to add value, create employment, generate higher revenue from exports and reduce imports to improve the trade balance. To combat this, the Department of Mineral Resources published a beneficiation strategy in 2011 which "provides a framework that seeks to translate the country's sheer comparative advantage inherited from (the) mineral resources endowment to a national competitive advantage" through optimising the linkages in the selected mineral value chains (energy commodities; iron and steel; pigment and titanium metal production; autocatalytic converters and diesel particulate filters; and jewellery fabrication). Progress around beneficiation has been slow and *Mining Weekly* partly attributes this to a lack of coordination from transforming the comparative advantage (mineral endowment) to a competitive advantage as well as declining mining production. The strategy document also identified five key constraints to beneficiation. Some of the constraints are still a barrier over a decade later, including:

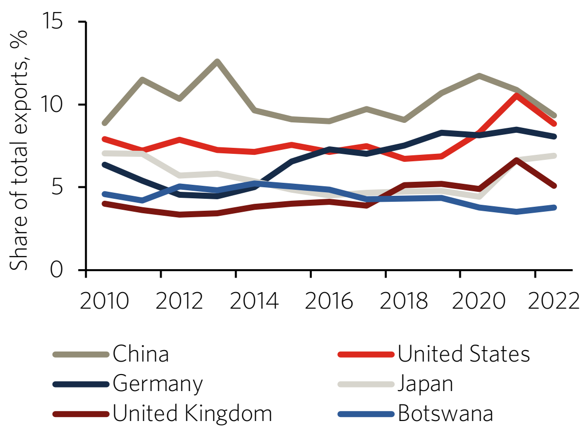
- Limited access to raw materials for beneficiation due to long-term contracts and unfavourable pricing.
- Insufficient supply/access to critical infrastructure (rail, water, ports and electricity).
- Lack of research and development.
- Shortage of skilled labour.
- Access to international markets.

In 2021, the government stated that beneficiation remains one of government's priorities.

SA's five major export destinations are China, the United States (US), Germany, Japan and the United Kingdom (UK). Collectively, these countries account for over a third of the total value of SA exports. As seen in chart 3, China has remained the top export destination for the past decade but we have witnessed an ongoing drop in demand since the onset of the pandemic. Weaker economic growth prospects for China despite the economy reopening in January 2023 will likely suppress China's demand for our products and its overall share of SA's exports.

SA exports the bulk of its top traded category (mineral products – mostly ores) to China along with iron and steel. The US, Japan and UK mostly import precious metals while Germany imports the bulk of vehicles and accessories.

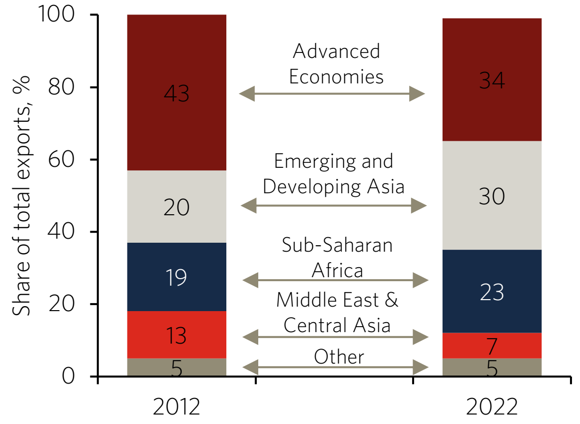
Chart 3: SA's major export destinations by share



Source: SARS, Momentum Investments
Botswana was part of the top five from 2010 until 2017 when it was overtaken by the United Kingdom

Regionally, the IMF notes that SA's export partners have diversified between 2012 and 2022 (see chart 4) which has helped to mitigate global shocks. The share of exports to advanced economies has decreased from 43% to 34% and almost halved for the Middle East and Central Asia (13% to 7%). On the other hand, SA has increased its footprint in Emerging and Developing Asia as well as Sub-Saharan Africa.

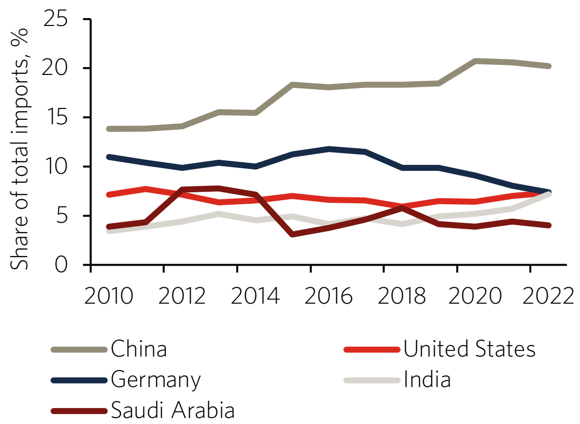
Chart 4: Weaker demand from advanced economies



Source: IMF, Momentum Investments

The top five countries that SA imports from are China, US, Germany, India and Saudi Arabia. SA imports most of its machinery from China, Germany and the US, mineral products from Saudi Arabia and we get the bulk of chemicals from China, Germany, US and India.

Chart 5: China and India gradually accounting for a bigger share of the total value of imports



Source: SARS, Momentum Investments

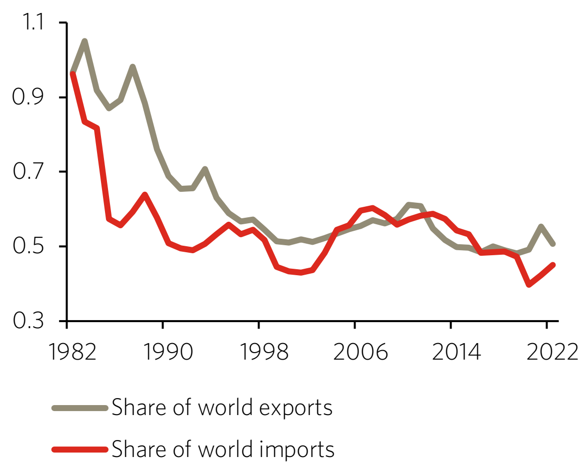
As seen in chart 5, the share of imports from China has increased meaningfully from 13.9% in 2010 to 20.2% in 2022. The share of imports from India has also grown over this period to around the same level as the US and Germany by 2022.

The volume of trade in SA has partly been influenced by the country's trade regime. During the apartheid government, the IMF notes that SA's "trade regime was characterised by a high and complex tariff structure and extensive import controls". This limited the country's access to the global economy. The process of trade liberalisation started in the early 1990s when trade sanctions were being lifted upon evidence that the apartheid regime was nearing an end.

Apart from the lifting of sanctions, the democratic government's direct efforts toward trade liberalisation included simplifying the trade regime. The International Trade Administration notes this was successful because reforming and simplifying the tariff structure reduced tariff rates from an average of 20% in 1994 to an average of 7.1% in 2020. Furthermore, steps were taken toward replacing quantitative restrictions with ad valorem tariffs and the IMF notes that quantitative restrictions on imports were virtually eliminated by 1998. Another component of trade liberalisation involved entering into preferential trade agreements such as the Southern African Customs Union (SACU), Southern African Development Community (SADC), Economic Partnership Agreement, African Continental Free Trade Agreement (AfCFTA) and AGOA.

These measures have collectively enabled greater participation from SA in global trade. However, domestic trade is a very small portion of total global trade and the country's share has dropped greatly from 0.97% of world exports and 0.96% of world imports in 1982 to 0.51% and 0.45%, respectively in 2022 (see chart 6).

Chart 6: SA's declining share of world trade, %



Source: World Bank, DNA Economics, Momentum Investments

DNA Economics attributes the declining share of exports to the nature of the exports (mostly commodity products), the country's dependence on large but mature countries, deteriorating competitiveness and slower trade reforms. Other elements driving SA's declining share of world trade include exogenous factors such as cheaper labour costs in countries such as India, Mexico and Vietnam and China's growing manufacturing industry. According to the United Nations Conference on Trade and Development (UNCTAD), China accounted for only 1.2% of global merchandise exports in 1982, but by 2009 China was the world's largest exporter. This trend continued through to 2020 when the country accounted for 14.7% of total exports, vastly ahead of the US as the second highest exporter (8.1% of global exports in 2020 from around 11% in 1982).

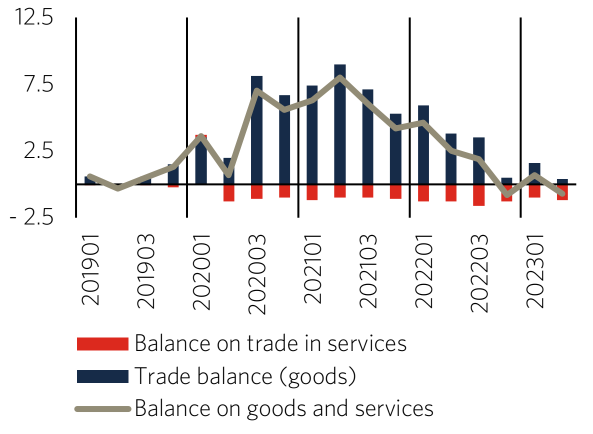
Current account under renewed strain from falling commodity prices

SA's current account balance was relatively flat between 1960 and 1994 when the country was largely closed off from the rest of the world. Following the lifting of trade sanctions and government's measures to liberalise trade and capital transactions in the democratic era, SA's current account began recording persistent and larger deficits. Since 1995, SA's current account averaged negative R58.8 billion, with the largest average current account deficit recorded in 2013 at R206 billion, or 5.3% of gross domestic product (GDP). From 2013, the current account balance gradually improved to reach an all-time high surplus of R227 billion in 2021 (3.7% of GDP). This improvement can largely be attributed to the merchandise trade balance narrowing from negative 1.9% of GDP in 2013 to 0.7% of GDP in 2019. This was driven by growth in the value of export receipts outpacing import payments. Moreover, the current account benefited from the post-pandemic commodity boom during 2020 and 2021. However, commodity prices have been coming down and the current account is taking a knock.

Following the better-than-expected improvement in the current account deficit to negative 0.9% (revised) in the first quarter of 2023, SA's current account deteriorated to negative 2.3% of GDP in the second quarter, reversing the first quarter improvement. The wider deficit was slightly worse than the Reuters median consensus of negative 2.1%.

This wider current account deficit was mainly due to the sharp decline in the merchandise trade surplus from 1.6% of GDP in the first quarter of 2023 (revised) to 0.4% of GDP in the second quarter (lowest level in three years as seen in chart 7). Developments in merchandise trade resulted in the balance on goods and services switching from a surplus (0.7% of GDP in the first quarter) to a deficit (negative 0.7% of GDP in the second quarter). Services trade had a very minimal impact as the deficit widened marginally from negative 1% of GDP in the first quarter (revised) to negative 1.2% of GDP in the second quarter.

Chart 7: Goods trade surplus narrows sharply, % of GDP



Source: SARB, Momentum Investments

The lower goods trade surplus was owing to a faster acceleration in the volume of imports (3.2% q/q) compared to exports (0.9% q/q) coupled with an increase in the price of imports by 0.6% q/q while export prices declined by 1.2%.

The other components of the current account changed only marginally between the first and second quarters and no revisions were made. Net transfers increased slightly from 0.3% of GDP to 0.5% and the income deficit narrowed from negative 1.3% to negative 1.1% of GDP.

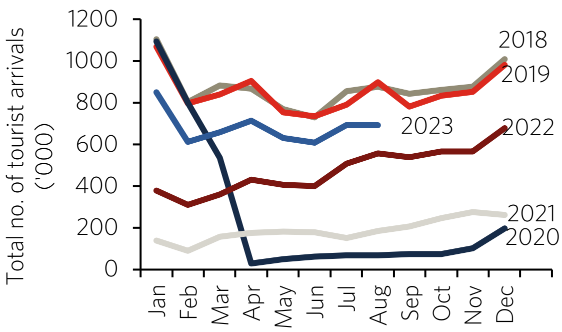
In its latest external sector report, the IMF forecasts a notable deterioration in SA's current account balance from negative 0.5% in 2022 to negative 2.3% of GDP in 2023. This expectation is due to falling commodity prices, weaker global demand and higher capital goods imports in light of the energy crisis. According to Trade and Industrial Policy Strategies (TIPS), R47 billion worth of solar panels, batteries, and inverters were imported in the first half of 2023. This was exponentially higher than R5.6 billion imported in 2022. TIPS further notes that the rising demand for these products could have been an ideal opportunity for local industrialisation instead of relying on imports from other countries. The ongoing power cuts will likely result in sustained demand of these alternative energy sources. The IMF expects SA's current account to deteriorate further to 2.5% of GDP in 2024 and improve to about 2% of GDP over the medium term. This improvement partly hinges on the speed of implementing the reforms to address the energy crisis as well as progress made by the private sector to reduce demand from the grid.

It is likely that a current account deficit driven by a rise in consumer-related imports would be more inflationary than a current account deficit driven by a rise in capacity-building fixed investment, which could drive trend growth rates higher in the medium to longer term.

In-bound tourism continues firmly on the recovery path

The tourism sector was one of the hardest hit sectors during the COVID-19 pandemic as international and domestic travel came to a standstill due to lockdown restrictions implemented globally. According to Stats SA, the number of tourists visiting SA dropped by 72.6% in 2020 when travel restrictions were at a peak. 2021 tourism volumes saw a further drop of 19.5% but the volume of tourist arrivals has since recovered. In 2022, the number of tourists arriving in SA increased by 152.6% but remained 44.3% below pre-pandemic levels. The recovery in tourism has continued into 2023 with the number of travellers in the first seven months of this year being 70.6% (1.97 million) higher than in the same period a year ago (see chart 8).

Chart 8: Tourism volumes have recovered but remain below pre-pandemic levels

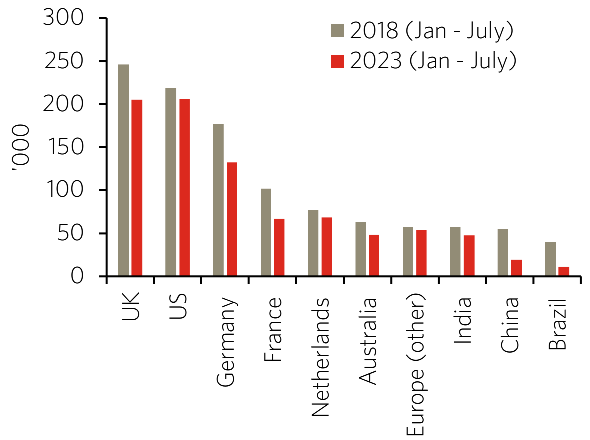


Source: Global Insight, Stats SA, Momentum Investments
Data until July 2023

Historically, the bulk of arrivals into SA originate from African countries, particularly members of SADC. Since 2010, tourists from Africa account for an average of 75% of total tourist arrivals and the remaining 25% are overseas visitors. When the pandemic hit, the biggest drop was in overseas arrivals (negative 74.5% in 2020) and the biggest recovery was also within this category (284% in 2022), albeit still below pre-pandemic levels. Europe and North America cumulatively account for almost 80% of overseas tourists and Asia accounts for around 10%.

In the first six months of 2023, tourist volumes from Asia were almost double (99.5%) that recorded in the same period last year. The bulk of this growth was due to Chinese inbound travel which grew by 265.1% y/y on the back of the China lockdown restrictions being lifted in January 2023. Nevertheless, the volume of visitors from China (YTD – January to July 2023) is 64.2% lower than the same period in 2018 (see chart 9).

Chart 9: China and Brazil's tourism recovery lagging

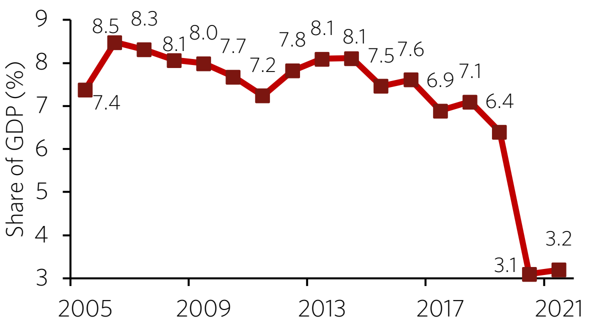


Source: Global Insight, Stats SA, Momentum Investments
Top 10 overseas countries according to 2018 statistics

In the first seven months of 2023, the volume of tourists from African countries registered at 72.7% higher than the first seven months of 2022 and 66% higher among overseas tourists. However, both African and overseas travel volumes are still below pre-pandemic travel volumes.

Stats SA notes that the gross value added by tourism decreased by 40.7% between 2019 and 2020. Over this period, Statista reported a drop in the contribution of travel and tourism to GDP from 6.4% to 3.1% (lowest contribution since 2005 as seen in chart 10). The industry accounted for a slightly higher share in 2021 (3.2%) but this was still half of what was recorded in 2019 and came in below the long-term average of 7.1%. The industry's contribution to economic growth was likely higher in 2022 and the World Travel and Tourism Council (WTTC) estimates a contribution of 4.3% in 2023.

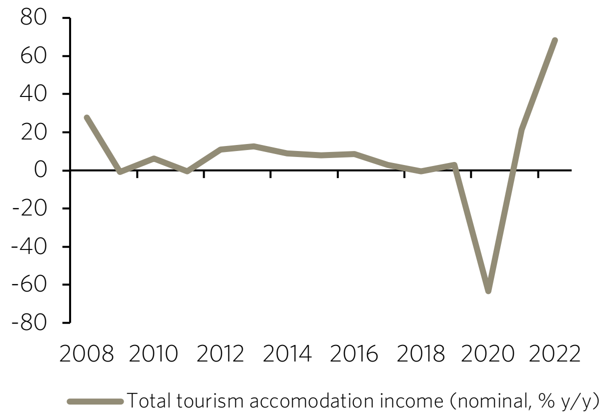
Chart 10: Tourism dropped to lowest GDP share in 15 years



Source: Statista, Momentum Investments

Seasonally adjusted total nominal income from tourism accommodation (includes accommodation, restaurant, bar sales and other income) dropped by 63.4% y/y in 2020 (see chart 11). In line with the recovery in tourist arrivals observed from 2022, income generated from accommodation increased by 68.3% y/y but income levels were still below pre-pandemic levels. In June 2023, the total income generated from accommodation was 4.9% shy of the average income recorded in 2019. Income per unit stay (hotel rate) was more in June compared to the average price during 2019 which means the below pre-pandemic total income is due to the volume of tourist arrivals which has not yet reached pre-pandemic volumes. Moreover, tourists are booking fewer nights for accommodation which signals that they may be spending less time in the country than before. The shorter trip may be a consequence of the higher cost of living globally.

Chart 11: Income from tourism accommodation



Source: Global Insight, Stats SA, Momentum Investments

The drop and subsequent rebound witnessed in tourism volumes is also reflected in the employment statistics. According to the WTTC, employment in the industry contracted by 30% y/y from 1.51 million jobs in 2019 to 1.06 million jobs in 2020 and there was a slight growth of 1.9% y/y in 2021 to 1.08 million jobs. The Council expects exponential growth of 800 000 jobs to 1.9 million by 2023.

Employment growth from tourism could be supported by the reforms to the visa regime under Operation Vulindlela if implemented accordingly by the Department of Home Affairs. The two main focus areas of the visa reforms include attracting skills and promoting tourism through expanding visa waivers and implementing an e-Visa system. According to the second quarter Operation Vulindlela progress report, over 160 countries now have eased access to SA through visa waivers and the expansion of countries covered in the eVisa platform (34 countries from 14 previously). There is an intention to extend the visa waiver to 10 more countries. The government acknowledges that tourism is important for job creation because it's a labour-intensive industry, particularly among lower-skilled workers. It also supports many small businesses, hence efforts to ease barriers to tourist entry into the country.

Foreign policy risks have significantly subsided

In May 2023, the US ambassador to SA, Reuben Brigety, accused SA of supplying weapons and ammunition to Russia in December 2022. These allegations strengthened concerns about SA's foreign policy stance on Russia and heightened fears of SA being removed from trade benefits under AGOA. The Lady R inquiry established by President Cyril Ramaphosa released a finding in August 2023 that no arms were loaded onto the Russian vessel. The findings note that the arms on the ship were an old order (pre-pandemic) that SA had placed from Russia. This is a positive finding for SA as it reduces the risk of being removed from AGOA and decreases the likelihood of moving the AGOA forum from being hosted in SA in November 2023. Prior to the Lady R findings, Standard Bank stated that even if SA remains eligible for AGOA benefits, the benefits may be reduced. A Republican Party win in the US elections next year poses a risk for SA's eligibility. As such, SA is not in clear waters yet.

In August 2023, SA hosted the 15th BRICS summit. Leading up to the summit, SA's non-alignment stance in the Russia-Ukraine war was under the microscope on the back of the Lady R accusations and the possibility of Russian President Vladimir Putin attending the BRICS summit in person, while there is an arrest warrant against him issued by the International Criminal Court (ICC). The decision taken for Putin to attend the summit virtually de-escalated much of the geopolitical risks surrounding the summit.

In Ramaphosa's address to the nation a few days before the BRICS summit, he highlighted the country's need to "seek strategic partners with other countries rather than be dominated by any other country". He further noted that "stronger relations with other countries, manifested through investment and trade relations" can help "grow our economy, create more opportunities for new businesses and create jobs". These statements were a way to emphasise the country's commitment to non-alignment and clarify government's consciousness about the importance of foreign policy.

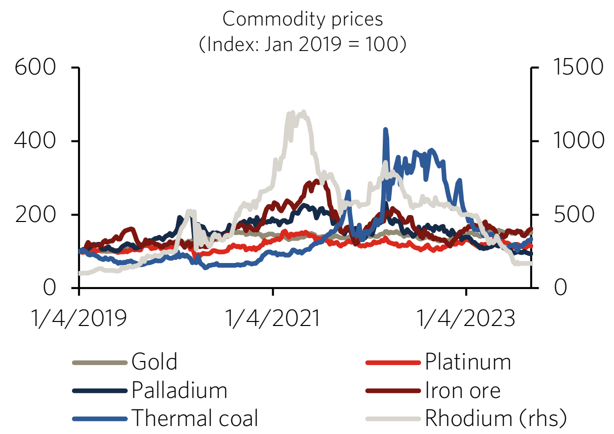
In our view, these were the key developments from the BRICS summit:

- China was the biggest winner within BRICS because of the accelerated shift into US- and China-aligned blocs.
- Increased cooperation (e.g. agriculture) between members and a bigger focus on Africa.
- No well-defined policy agenda such as at the Group of Seven (G7) level.
- No aggressive rhetoric to challenge the West but the bloc is asking for reform in global governance structures.
- Potential for an expansion of trade and investment but gains so far have been limited.
- Reducing the role of the dollar in trade and financial flows. However, barriers to a common currency remain high.
- BRICS bank share of funding in US dollars will still likely be greater than 70% in three years.
- Autocratic tilt from the extension of blocs membership by six countries namely, Argentina, Egypt, Ethiopia, Iran, Saudi Arabia and the United Arab Emirates. New members will formally join the bloc from January 2024.

SA's external trade account affects its level of relative vulnerability within Emerging Markets

While commodity boom times stand to benefit net commodity exporting nations (such as SA), it can create an overreliance on favourable commodity prices. If these commodity windfalls are not used appropriately, the country can suffer from fiscal problems, a weaker currency and higher inflation down the line. Recent developments in SA stand as a testament to this. On the back of the pandemic commodity boom, SA's current account balance moved from a deficit to a surplus in the first quarter of 2020 for the first time in nearly two decades. Moreover, higher commodity prices led to higher corporate income tax collections which supported the country's fiscal position during a time where it was needed most to soften the impact of the pandemic, but the prices of SA's key commodity exports have dipped (see chart 12) which has introduced mounting pressure on government's fiscal balances especially because fiscal measures to support consumers during the pandemic (e.g. social relief of distress grant) are still in place.

Chart 12: SA's key commodity export prices have eased from the (post) COVID-19 high



Source: Bloomberg
Data until 5 September 2023

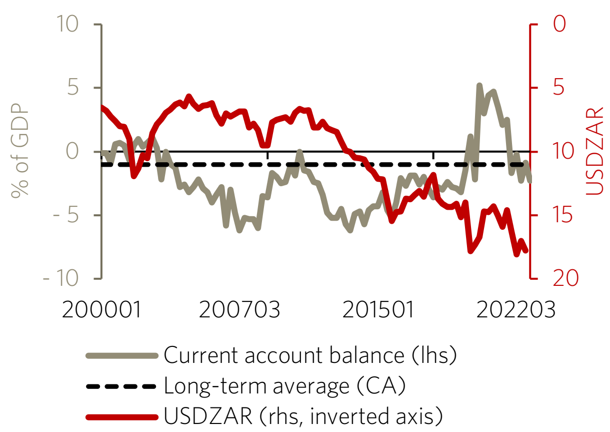
The IMF expects SA's fiscal deficit to be wider at 6.5% of GDP in fiscal year 2023/24 compared to negative 3.9% of GDP announced in the February 2023 budget. This, together with the expectation of a wider current account balance exacerbates the twin deficit problem, adding to the country's vulnerability to external shocks.

The IMF sets out recommendations for SA to address its fiscal challenges to create fiscal space to respond to shocks, namely:

- Reducing the public sector wage bill.
- Reducing costly and inefficient subsidies.
- Reducing transfers to poorly performing state-owned enterprises (SOEs).
- Strengthening the fiscal framework (introducing a debt ceiling, addressing deficiencies in public procurement and improving public investment management).
- Strengthening revenue administration to broaden the tax base.

All else equal, a widening of the current account increases SA's vulnerability to foreign inflows and weakens the rand (see chart 13). The reason behind the widening of the current account deficit, nevertheless, matters given that an expansion of the deficit due to fixed investment-related activities could bode well for future growth as it increases the country's capacity. However, a widening due to consumer-driven imports could end up being inflationary.

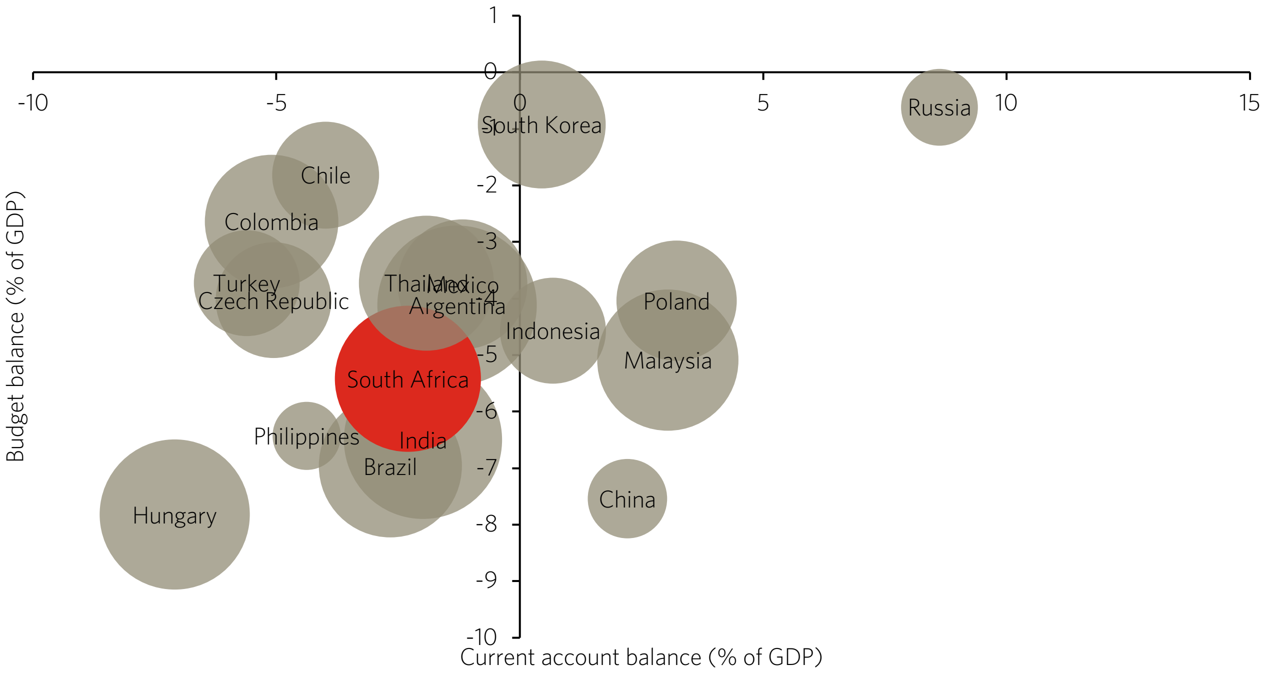
Chart 13: Rising current account deficit raises rand vulnerability



Source: Bloomberg, SARB, Momentum Investments

Outside of the current account, overall economic and fiscal performance, the local political backdrop, central bank policies and the global financial market environment are all important drivers of SA's relative vulnerability as well as the rand. Although we expect the rand to appreciate over the next year, due to its current undervaluation and an expected improvement in risk appetite (once interest rate cuts set in globally towards the second half of next year), the rand is likely to drift weaker in the medium to longer term as SA's fundamentals continue to deteriorate relative to its emerging market peers.

Chart 14: Comparative twin deficit across key emerging markets



Source: Bloomberg, IMF, Momentum Investments
Size of bubble is reflective of government debt-to-GDP
Chart uses the latest quarterly data points available from Bloomberg. In the absence of quarterly data, we used annual data for 2022 from the April IMF World Economic Outlook. Annual data for the budget balance was used for China and South Korea. Annual data for government debt-to-GDP was used for Argentina, India, Mexico, Russia, South Korea and Thailand,