A big change, not for the better 11 May 2017

Before SA was downgraded to sub-investment grade in April, a fundamental change had already occurred in SA's financial relationship with the world. That relationship is succinctly captured by the country's current account balance (CAB). This measure reflects whether SA sells more to the rest of the world than it imports. In SA the CAB has historically mostly been in deficit, but the change is that the deficit has decreased substantially over last four years.
In 2013 the deficit hit an all-time high (for the democracy period) of minus 5.9% of GDP. In 2014 it declined to -5.4%; in 2015 to -4.4% and in 2016 to
-3.3%. In the last quarter of 2016 it came to a low of -1.7%.
The result of this decline is that when the recent downgrades occurred, in response to that disastrous cabinet reshuffle, SA was less of a deficit country; less dependent on foreign capital. It partly, but of course not fully, explains why the reaction of the Rand and the capital market to the downgrade was relatively subdued.
Compare that -1.7% to -4.9% when the Nenegate cabinet reshuffle happened and one can understand why the reaction now was much more muted.
Looking at the cabinet reshuffle from a Current Account Balance (CAB) point of view, the timing could not have been better.

What is not to like?

So what is not to like? Surely it is good news if the country is less dependent on foreign capital. It can withstand political shocks better; the ratings agencies can keep their opinions to themselves; the country can paddle its own canoe.
Not so fast.
It is a matter of simple arithmetic that a lower CAB also means less investment and consumption, which add up to less growth. Likewise it is simple arithmetic that a smaller CAB also means that foreigners are advancing you less money. None of these two developments is good news. (For those readers interested, we supply a technical note on the arithmetic and how the relationships hang together at the bottom of this note.)

SA's experience

This is exactly what the numbers tell us. Growth has fallen from 2.5% in 2013 to a mere 0.3% last year. As the current account deficit went down, growth also went down.
Also, both consumption and investment have declined substantially over the four years – by a combined 2% of GDP. If that does not sound like a lot, it is a decline of some R86 billion … or R164 000 per minute, 24 x 7!! Think of it as a lot of turnover the economy NO LONGER has.....

SA's time of surpluses was also a time of poor growth

It is again a matter of simple arithmetic that to run such a CAB deficit, capital has to flow into the country to finance it. In a deficit country it is when the CAB goes to nil that one must worry – it means less capital inflows and less growth.
Again that is what the numbers tell us that about SA. Of the 49 years for which we have data, the country had a deficit in 33. In one year the balance was precisely nil% - 1994! - and in the remaining 15 years there were surpluses. The surplus years were years of political and economic stress. During Sharpeville, the state of emergency of the 1980s, the currency crisis of 2001…those were the times that the CAB went positive… because foreigners stopped advancing us money and the current account was forced into surplus. It is when the CAB balance goes to nil that one must worry…

The 1985 experience

For nine years between 1985 and 1993 SA ran surpluses on its current account, accompanied by deficits on its capital or financial account. And for the same nine years growth was way below average.
In August 1985 Chase Manhattan announced it would no longer grant loan facilities to SA. Two weeks later PW Botha made his infamous Rubicon speech in Durban and SA's financial isolation became complete. (The parallel with Zuma shuffling his cabinet whilst the country was under review by the ratings agencies, could not be more perfect.) Over the next nine years foreigners advanced us very little money; economic growth slumped; per capita incomes declined and the country got poorer.
That is the real point about foreign funding: have less of it and you will grow more slowly. A bit like a businessman or a farmer who obstinately says he will not borrow money to grow his enterprise... well, then the enterprise is likely to stay small.

A repeat of 1985?

Are we looking at a repeat of the post-1985 experience? No and yes.

No, because SA is unlikely to be cut off from foreign funding as comprehensively as in 1985. SA has a well-functioning capital market, well integrated into world markets. Foreigners will still advance us their savings, but charge us more interest– certainly higher than without a downgrade. That effect we have already seen. "Monopoly capital" is now collecting more from us than before the downgrade.... ! Irony of ironies.

Yes it will be a repeat, because the real cost of less foreign money is less growth. All economic forecasters have lowered their growth numbers since the April downgrade. Like the post-1985 period we are again looking at a period of growth lower than population growth – thus a systematic process of getting poorer.

Getting poorer

One of the successes of democratic SA has been that it reversed the two decades-long decline in per capita incomes (population growth higher than economic growth) that we endured before democracy. That long decline was reversed after democracy; by 2014 per capita incomes were 33% higher than in 1993. During Zuma's second term that achievement has been thrown away.

Per capita incomes are now lower than in 2013. The cabinet reshuffle and consequent downgrades have ensured that they will decline further. No democracy can sustain that indefinitely.

How to get out

The country got out of the post-1985 slump by making substantial structural changes to the economy. It was uncoordinated and haphazard, occurring in the slipstream of the political transition, so nobody noticed except those directly involved. But from agriculture to transport to broadcasting, to mention just a few sectors, deep structural changes occurred.

Productivity improved dramatically from 1995 and growth was spurred from 0.11% p.a. in the post-1985 period to 4.3% p.a. from 1994 until the global financial crisis. A very significant step change indeed.

The post-2014 period of getting poorer will require similar structural reforms to re-ignite growth (think SOEs, regulatory reform, broadband connectivity, electricity…). On past track record, the Zuma administration is unlikely to deliver on this. So until there is a government, or some confluence of events that can tackle structural reform, we will follow the post-1985 road – population growth will exceed economic growth.

So What?

- The apparently subdued reaction of the financial markets to the cabinet reshuffle and subsequent downgrades has a lot to do with a sharply lower current account deficit.
- The smaller deficit is in itself evidence of significantly lower growth and less foreign money coming into the economy.
- Even if the ratings remain unchanged, SA is now firmly on a getting-poorer path: economic growth is lower than population growth.
- As post 1985, the only way out is by structural reform that enhances productivity. Currently, the prospects of that are limited.

Technical note:

(To prevent the inevitable tedium when discussing a very technical topic, I have broken it into nine steps.)

1. It all starts with what a country produces (GDP). For practical purposes that is a country's income. If you deduct from that what the country consumes, you are left with a balance called savings. Common sense really: income minus consumption is available for savings.
2. From savings is deducted what the country invests. If it invests more than it saves the result is a deficit. Call this the internal balance or savings deficit: the country's production (GDP) minus consumption and investment. These two paragraphs are summarised as S –I.
3. The external balance is the difference between exports and imports; known as the current account. It is summarised as X – M.
4. When a country runs a savings deficit it logically means the country imports extra goods from other countries. "Extra" as in more than it produces; think of it as excess to production that gets imported. Thus the internal balance (S – I) is equal to the external balance (X – M). It can be summarised as S – I = X – M.
5. To pay for those extra goods and services which a country imports, capital inflows are needed; otherwise how will you pay for it? It is no good having Rands, you need foreign currency to pay for a smartphone or imported maize and the foreign currency comes from foreign capital inflows. Trade is on the current account, financial flows are on the capital account. These two are in a symbiotic relationship. A deficit on the one (current account) requires a surplus on the other (capital account).

6. That is why deficit countries (like the US, UK, SA) can be called capital importers and surplus countries (like China, Germany, Japan) can be called capital exporters.
7. When the financial inflows on the capital account exceed the deficit on the current account, a country's reserves will increase; when the inflows are less than the deficit the reserves will be run down.
8. The symbiotic relationship between current and capital accounts is how capital scarce countries grow themselves: they supplement their own lack of savings by importing other peoples' savings; that enables more consumption and investment; and thus more growth. In a deficit country a reduction in the current account means less consumption and investment. Reduce those two items and you reduce growth.
9. The trick is of course ensuring that others remain willing to advance you their savings. Then you can run a deficit on the current account financed by a surplus on the capital account. Endanger that and foreign inflows will decrease; investment and consumption will decrease and as a consequence growth will decrease.