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Trade and Current Account Balances in Sub-Saharan Africa: Stylized Facts and Implications for Poverty

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Trade and Current Account Balances in Sub-Saharan Africa: Stylized Facts and Implications for Poverty

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Abstract

This paper examines the main components of Sub-Saharan Africa's balance of payments with a view to understanding the role that trade has played in the evolution of current account imbalances in the region. The paper finds that increasing trade openness in SSA has been accompanied by current account deficits in majority of the countries. The paper also finds that while at the aggregate level net income payments were the main source of the current account deficits in SSA, in the majority of countries the trade deficit was the main driver. Furthermore, the paper argues that the composition of the current account matters for employment and poverty and offers suggestions on how to make trade better work for SSA.

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Note

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Acronyms

BoP	balance of payments
FDI	foreign direct investment
GDP	gross domestic product
IMF	International Monetary Fund
SSA	Sub-Saharan Africa
TNCs	Transnational Corporations
UNCTAD	United Nations Conference on Trade and Development

I. Introduction

African countries depend heavily on international trade and this dependence has increased significantly over the past two decades. Trade is an important source of foreign exchange needed to import the intermediate goods required by local industries. It also enlarges consumer choice, provides access to new technology, and has the potential to enhance productivity and to contribute to employment creation and growth. Some of the factors accounting for the increasing dependence of African countries on trade include: reduction in tariff barriers to trade; developments in information and communication technologies which reduced the transactions costs associated with trade; a global paradigm shift from trade protectionism as a development strategy to trade as an engine of economic growth; and the increasing roles of large developing countries in the global economy. The commodity price boom - that started at the beginning of the last decade and began waning at its end – is another driving factor for the increasing trade openness experienced by African countries over the past few decades. It led to an improvement in Africa's terms of trade and enhanced its capacity to export and import.

Interestingly, the increased role of international trade in African economies has been accompanied by significant and growing trade and current account deficits in many countries on the continent. There are concerns that the increasing current account deficits will increase Africa's future debt burden and make the continent vulnerable to financial crises. Experience has shown that growing current account deficits often presage disruptive economic trends such as sudden stops in capital flows, severe decreases in credit and spending, and sharp economic slowdowns, which generate high unemployment and poverty. Africa's growing current account deficits are also of concern because as a rule of thumb, current account deficits that are above 5 percent of GDP are indicative of long-run sustainability problems. Furthermore, growing current account deficits driven by high trade deficits pose challenges for employment and poverty reduction efforts particularly when the deficits are caused by rising imports of consumer goods that can be produced by domestic industries. Another reason why the current account deficits are worrisome is that a deficit is sustainable as long as there is sufficient international credit to finance it. Up until recently, African countries had relatively better access to international finance than was the case in the past. However, with declining commodity prices and slow growth, the continent is vulnerable to declining access to finance which will make financing of the deficits increasingly challenging.

Against this backdrop, this paper examines the main components of Sub-Saharan Africa's (SSA) balance of payments – current account and capital and financial accounts – with a view to answering the following questions: (a) what role has trade played in observed current account deficits in SSA?; (b) How has the current account been financed and what are the implications?; and (c) what can African governments do to reverse recent trends in the current account and use trade, more effectively than in the past, in support of poverty reduction efforts on the continent? Although a clear understanding of the factors that affect the current account balance is essential, balance of payments categories alone are not sufficient to diagnose the general conditions of an economy. The current account balance reflects, broadly speaking, the difference between national income and expenditure. Making the link to national income accounting, in particular to income, consumption and investment, permits an understanding of the source of a deficit or a surplus. A deficit caused by an increase in final consumption is not the same as one fueled by a surge in investment, as investment contributes to future growth and enhances a country's ability to finance and eliminate the deficit.

Hence, the analysis of the evolution of national income variables allows a better understanding of the evolution of the current account and the associated risks.[1]

Equally important are the analyses of the composition of international trade, because what is being imported and exported is linked to the productive capacity and the structure of the domestic economy. The analysis in this paper will also shed some light on the extent of the linkages that both imports and exports have with the rest of the economy. The degree of such linkages has an impact on the proportion of the value added created domestically, which in turn has an impact on employment and revenue generation, which constitutes the basis of the nexus between international trade, profit, investment, and development. International trade can disrupt domestic linkages. Reliance on the market mechanisms for resource allocation can push a poorly diversified economy towards more specialization, which is particularly harmful for employment creation and poverty reduction. Examples abound of resource-rich countries able to achieve chronic current account surpluses despite poorly diversified economy, limited domestic capabilities and high levels of unemployment and poverty, thanks to a capital-intensive export sector based on specific natural resource endowments with poor linkages with the rest of the economy.

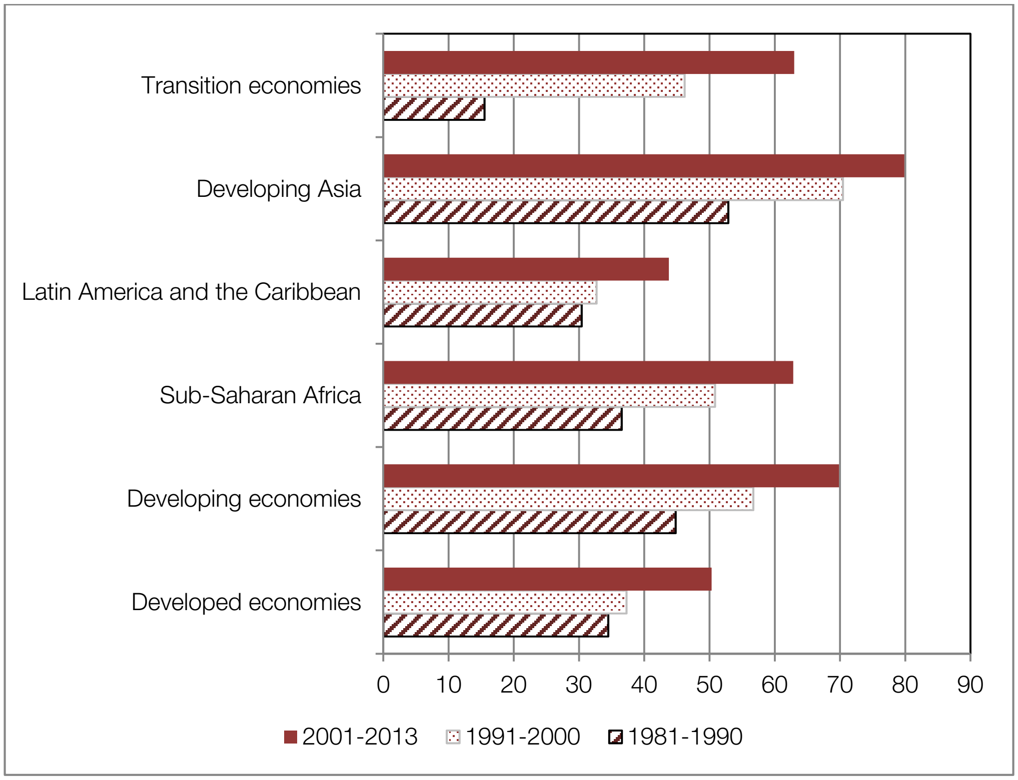
II. What do we know about Trade and Current Account Balances in SSA?

Increasing openness to trade in SSA has been accompanied by current account deficits in many countries

Openness to trade (as measured by the ratio of exports plus imports over GDP) has significantly increased in all the world's regions at least during the last three decades, and SSA is no exception: its average trade ratio increased from 37 percent in the period 1981-1990 to 51 percent in 1991-2000 and 63 percent in the period 2001-2013. As shown in figure 1, SSA has been more open to trade in the past decade compared to the 1980s. It is also more open to trade than developed economies and Latin America and the Caribbean, but less open to trade than Asia. Within SSA, there is a wide variation in trade ratios across countries, ranging from 35 percent in the Central African Republic to 251 percent in Liberia.

[1] See Cusolito and Nedeljkovic (2013); Osakwe and Verick (2009); and Suranovic (1999).

Figure 1: Openness to trade[1] by main world regions, 1981-2013



Source: UNCTADstat. Data downloaded on January 2016.

[1] Measured as the ratio of exports plus imports over GDP

The observed increase in trade openness in SSA over the past few decades has gone hand in hand with a deterioration in the current account. Figure 2 shows that SSA had current account deficits beginning in 1986 until 2000 when large shifts in the trade balance contributed to sizeable current account surpluses. Since then the region also experienced current account deficits in the period 2001-2003 and from 2008 to 2013. Figure 2 also shows that SSA had trade surpluses in the periods 1985-1990 and 2000-2008. Nevertheless, the drivers of the trade surpluses of the 1980s and the 2000s are different. In the 1980s, it was the result of the strong fall in imports in the context of structural adjustment policies that was geared towards increasing trade surpluses through decreasing internal demand, in an attempt to manage the debt crisis. In the 2000s, it was the result of