Monetary policy and economic recovery in 1986 [1]

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Economic conditions and prospects in South Africa have been fundamentally changed by the socio-political developments that have occurred in this country since late July 1985. We are dealing with a "new ball game". Events such as the social unrest, the state of emergency proclaimed in certain magisterial districts on 20 July and the intensified threats of economic sanctions against the country have resulted in a marked deterioration in overseas perceptions of the domestic political and economic outlook.

Misguided, distorted and erroneous as these perceptions might be, they do exist, at least for the time being. And they are dominating the situation. Among other things, they have resulted in a withdrawal by foreign banks of credits to South African banks and other business enterprises, a net outflow of capital in other forms, a depreciation of the rand, the declaration on 1 September 1985 of a "standstill" in respect of a large portion of South Africa's foreign debt, and the reintroduction of exchange control over non-residents in the form of the financial rand system.

Of particular concern is the present state of political and economic uncertainty that these events have created in South Africa. To this the behaviour of the financial markets since late July bears eloquent testimony. Short-term interest rates have declined considerably. Long-term interest rates have risen sharply. The commercial rand has remained relatively low at a time when the balance of payments on current account has been showing a surplus of more than 5 per cent of gross domestic product. The financial rand discount has widened significantly. What will the rate of inflation be next year? What effects will the "standstill" negotiations have? In the absence of answers to questions such as these, few market participants at present appear to have a time horizon extending more than one or two years into the future.

In these circumstances I believe it is incumbent upon the authorities to keep the financial and business community as fully informed as possible about all relevant matters and, in particular, about the official economic policy stance in the period immediately ahead.

That is the background against which I shall attempt today to present the Reserve Bank's views on "monetary policy and economic recovery in 1986".

Three policy options after the events of late July and August 1985

In the dramatically changed circumstances that came into being after late July and August 1985 and resulted in the reintroduction of the financial rand and the institution of the debt "standstill", the authorities had three broad policy options to choose from:

The first option: classical deflation

The first option was that of defending the rand's exchange rate and fighting inflation by means of "classical deflation". This would have entailed the following:

1. A tightening of monetary policy, including increases in Bank rate with a view to reversing the downward tendency shown by interest rates since early May 1985 and curbing the expansion of Reserve Bank accommodation and bank credit in general.
2. Cuts in government spending and new increases in tax rates, with a view to reducing the budgetary "deficit before borrowing" still further.
3. A renewed tightening of hire-purchase conditions.
4. Continued strict limitations on wage and salary increases in the public sector as an example to the private sector.

This option would have had the following *advantages*:

- The existing surplus on the current account of the balance of payments would have increased still further.
- Despite the political pressures, the rand would probably have appreciated moderately instead of depreciating.
- The inflation rate would probably have declined, amongst other reasons because wages and salaries would have risen by even less than they actually did.

On the other hand, this option (deflation) would have had the following disadvantages:

- The rate of growth of real gross domestic product would have shown a temporary further decline.
- The real average standard of living would have declined further.
- Profits in many sectors of the economy would have shown a temporary further decrease.
- Tax receipts would have declined.
- Unemployment would have increased further.
- Confidence in the future of the economy would probably have been adversely affected.

The rationale for this approach was that, while it would require additional sacrifices in the short term, it would in the long run represent the least harmful way of bringing about the required adjustments in the South African economy – adjustments that had become unavoidable as a result of the withdrawal of foreign bank credits and other foreign capital.

Although the authorities appreciated this reasoning, they rejected this first option, i.e. the option of deflation. They judged that, in the prevailing abnormal circum-

1 Address delivered in Johannesburg on 14 November 1985.

stances, the advantages of an early reduction in the rate of inflation and an appreciation of the rand would be outweighed by the disadvantages of a prolonged recession and increased unemployment. It was felt that the earlier restrictive monetary and fiscal policies had fully achieved their aims of eliminating excess demand and transforming a deficit on the current account of the balance of payments into a huge surplus. To tighten these policies further at that stage would contribute little to removing the underlying causes of the existing difficulties, which were of a political rather than an economic nature.

In short, it was clear at the time that the rand was not depreciating because of undue money creation, overspending, unduly low interest rates and/or an excessive budget deficit. It was declining because of a capital flight produced mainly by overseas perceptions of political developments in South Africa. That this depreciation of the rand's exchange value was likely to exert upward pressure on the consumer price index was evident. But it was equally clear that this pressure would not be of the demand-pull kind. In these circumstances it was deemed inadvisable to exacerbate the recession by defending the rand and curbing inflation through classical deflation.

The second option: reflation plus direct controls over imports, wages and prices

The second option that presented itself was that of "reflation" accompanied by direct controls over imports, wages and prices. This option would have entailed (1) the stimulation of the economy by means of increased money creation and spending; and (2) the use of direct quota import control to cope with the resultant rise in imports, and direct price and wage controls to suppress the inevitable upward pressure on the rate of inflation.

More specifically, the Reserve Bank would have been required to create more credit and money and to reduce its Bank rate still further, with a view to bringing about a rapid and substantial further decline in interest rates generally.

From the side of fiscal policy the required contribution would presumably have been a substantial acceleration of government spending and reductions in certain tax rates. The "deficit before borrowing" would then have been allowed to rise to a much larger figure than the budgetary estimate of R2,6 billion or 2,2 per cent of gross domestic product. Moreover, a sizeable part of this deficit would then have had to be financed by new money creation in order to avoid increases in capital market interest rates.

The choice of this policy option would have had the following *short-term* advantages:

- The rate of growth of real gross domestic product would have risen sooner.
- The real average standard of living would have shown a temporary improvement.
- Certain profits would have increased.
- Certain tax receipts would have risen.
- Unemployment would have been reduced.
- There would probably have been a temporary boost to domestic economic confidence.

The authorities had no hesitation in rejecting this policy option. Given the existence of surplus capacity and unemployment, it was accepted that in the short term the increase in money creation and spending would result in increases in production and employment, and not in significant new upward pressure on wages, salaries, prices and imports. It was equally clear, however, that these advantages would be short-lived. The point would soon be reached where total spending would once again become excessive and exert strong upward pressure on wages, prices, imports and interest rates. Among the adverse consequences this would have were the following:

- The surplus on the current account of the balance of payments would be reduced.
- The rand would once again be viewed as a candidate for depreciation and subjected to downward pressure.
- The rate of inflation would rise, amongst other things because wages, salaries and administered prices would increase sharply.

It was recognised that, in such circumstances of excess demand, the use of direct import quotas would provide no solution. On the contrary, import control would exacerbate the situation in several ways:

- Import control reduces the *supply* of goods and not the *demand* for such goods. In conditions of excess demand, import control therefore becomes highly inflationary – it results in too much money chasing too few goods. This puts upward pressure on prices and wages. Eventually imports rise counterproductively.
- Import control reduces competition and contributes to monopolistic exploitation of the man in the street.
- Import control inevitably entails much bureaucratic "red tape".
- Import control would contravene South Africa's GATT undertakings and encourage retaliation against our exports. In this way it would contribute to South Africa's further isolation.
- The impression that South Africa imports unnecessary luxury goods on a large scale is incorrect. More than 80 per cent of our imports consist of capital goods and intermediate goods. In 1984 our total imports amounted to R21,4 billion. Of this total, imports of consumer goods accounted for only R4,0 billion or 18,7 per cent. Any attempt to eliminate from this figure the "unnecessary luxury" goods by means of import quotas would save very little foreign exchange, inflict harm on specialised South African commercial firms, invite retaliation against our exports and require a totally new and costly system of import control.

— Import control would lead to the establishment or expansion of inefficient and uncompetitive industries producing inferior goods at high cost. This would be inflationary and harmful not only to the ordinary consumer and the agricultural and mining sectors, but also to the many efficient manufacturing firms in South Africa which deserve maximum encouragement.

Another reason for the rejection of this second policy option was the realisation that any attempt to use extensive price and wage controls to curb the inevitable inflationary impact of a combination of reflation and import quotas, would be extremely damaging to the economy. It remains the official view that, at best, price and wage controls can treat the *symptoms* of inflation, never the real *causes*. By distorting *relative* prices and wages, such controls would cause the malallocation of scarce labour and other productive resources, and therefore undermine the growth and soundness of the economy. Moreover, since certain cost increases fall outside the Government's control, unduly strict price controls would result in losses and insolvencies. And, of course, trade unions and wage and salary earners generally would understandably oppose government controls over wages and salaries without strict price controls.

For all these reasons the authorities decided against any policy of combining reflation with extensive direct controls over imports, wages and prices.

The third option: promoting economic recovery and growth while maintaining monetary and fiscal discipline

The third policy option that presented itself was that of promoting economic recovery and growth by monetary and fiscal means while maintaining financial discipline. This was the option actually chosen.

This third option – the present official policy – entails the encouragement of investment and consumer spending with a view to utilising the existing surplus capacity in the economy and raising production, employment and the rate of real economic growth. This option provides for increases in the money supply that are adequate to permit the desired increase in spending and production, but not so large as to contribute to new inflationary pressure.

The present policy

In more detail, the present policy consists basically of the following elements:

— As part of its policy of trying to ensure an adequate but not excessive supply of credit and money, the Reserve Bank has since the beginning of May 1985 reduced its Bank rate in seven stages from 21,75 per cent to its present level of 14 per cent. Whenever necessary, the Bank has made these lower rates effective by means of repurchase transactions and other open-market operations in money market paper. These reductions have contributed to declines of similar magnitude in the commercial banks' prime overdraft rates and in most other short-term interest rates. Compared with 25 per cent in early May, for example, the prime overdraft rate at present stands at 17,5 per cent.

As intended, these interest rate declines have thus far proved fully reconcilable with effective money supply control. Measured over a period of twelve months, the rate of increase in M3 has decelerated from 24,7 per cent in November 1984 to 15,4 per cent in September 1985. The comparable twelve-month growth rate of M1 slowed down from 39,6 per cent in November 1984 to 5,5 per cent in September 1985. Moreover, in the first nine months of 1985 money growth at a seasonally adjusted annual rate showed a negative 2,6 per cent for M1 and again of only 12,5 per cent for M3. The marked decline shown by the velocity of circulation of money between the second quarter of 1980 and the second quarter of 1985 appears to have come to an end in recent months.

Fiscal policy has also been eased moderately in accordance with the more expansionary policy stance adopted since July. Government spending has been stepped up and will now clearly exceed the budgetary estimate of R30,9 billion (an increase of 13,6 per cent). This is partly the result of the recent allocation of additional funds to special job creation and training schemes, the encouragement of small business enterprises and unemployment relief. On the other hand, tax revenue will probably also exceed the estimated amounts, partly as a result of the expansionary effects the depreciation of the rand has had on mining and other export incomes. On balance, the "deficit before borrowing" in the Budget might turn out larger than the Budget estimate of R2,6 billion, but should not amount to much more than 3 per cent of gross domestic product.

It would be inappropriate for me to comment in any way on likely changes in fiscal policy in the Budget of March 1986. The Minister of Finance has, however, on more than one occasion indicated his desire to encourage saving, investment and sound growth by downward adjustments in direct tax rates to the extent permitted by circumstances.

— Hire-purchase restrictions have been relaxed.

— To help finance the additional stabilisation expenditures referred to earlier, while at the same time discouraging imports, an import surcharge of 10 per cent has been instituted.

Inflation – has the emphasis in policy shifted?

In the short term the choice of this third option, as set out above, does imply a marginal shift in priorities from combating inflation to the promotion of growth and employment. But it certainly does not mean that the authorities have thrown in the towel in the fight against inflation. Far from it.

As mentioned earlier, the recent depreciation of the rand from a peak of 53 American cents around the middle of 1985 to its present level of about 37 American cents will no doubt exert some upward pressure on the consumer price index for a while. The recent increase in the price of fuel is an example of this. But the latest money supply and expenditure statistics provide convincing proof that no inflationary pressure is emanating from excess demand. Although a temporary acceleration of the rate of increase of the consumer price index cannot therefore be ruled out, the fears expressed in certain quarters that the rate of inflation might rise to between 20 and 30 per cent in 1986 appear to be totally unfounded. Curbing inflation remains high on the priority list. To this end, the Reserve Bank will do everything in its power to maintain effective control over money creation and spending.

The outlook for 1986

Given the present policy stance, the indications are that the South African economy is at or near a lower turning point of the business cycle. During the third quarter of 1985 the decline in real gross domestic expenditure came to an end, while real gross domestic product began to rise again. With exports buoyant and short-term interest rates showing a persistent downward tendency, the next cyclical upswing is probably not far away. Indeed, it may already have begun.

Of course, the new upswing is starting from a low base and will take time to gain momentum. But a positive real rate of growth of gross domestic product of about 3 per cent is indicated for 1986. This has to be compared with a negative growth rate of about ½ per cent in 1985.

Real gross domestic expenditure is expected to rise by about 4 per cent in 1986. Increases in both private and government consumption expenditure, together with some build-up of inventories, are expected to contribute to this increase. For the time being, no upturn in real fixed investment is foreseen.

As far as the balance of payments is concerned, present indications are that even if the growth rate accelerates to 3 per cent in 1986, the current account will still show a substantial surplus of around R4 billion. In arriving at this figure it was estimated that the value of merchandise exports would rise from about R19 billion in 1985 to around R21 billion in 1986, the net gold output from R14,8 billion in 1985 to about R16 billion in 1986, and the value of imports from R22,6 billion in 1985 to around R28 billion in 1986.

The capital account and the debt "standstill"

What about the existing pressure on the capital account of the balance of payments and the debt "standstill"? Will the need to maintain a sizeable current account surplus in order to repay debt not restrict economic growth? The answer is clearly – yes. Maintaining a large current account surplus year after year, by whatever means, implies a transfer of real resources to the rest of the world. This, in turn, means fewer goods available in South Africa for public and private investment and consumption. But two points need to be made in this regard:

Firstly, for the time being there exist sufficient surplus capacity and unemployment in the economy to permit a marked economic recovery without undue pressure on imports, especially if the depreciated exchange rate of the rand is taken into account.

Secondly, even if South Africa's longer-term economic development is, in the event, constrained by the need to maintain a sizeable current account surplus, there will still be cyclical upward and downward phases in the economy. These cyclical fluctuations will then occur around a lower trend line, but they will still be there. And, as already indicated, the prospects are that 1986 will be a year of cyclical upswing.

A further consideration is that, despite the pressures that make the present debt standstill necessary, the outlook for the capital account of the balance of payments in 1986 need not be excessively gloomy.

If, for example, the growth rate does rise to about 3 per cent in 1986 and if, via a rise in imports, this does lead to a reduction in the current account surplus from, say, R5,8 billion in 1985 to R4 billion in 1986, the net outflow of capital is also likely to decline. This is because, with or without a standstill, a rise in imports will tend to be financed to some extent by overseas suppliers' credits or other credits of one kind or another.

There is normally a strong interrelationship between the current and capital accounts of the balance of payments. While this interrelationship has clearly been altered by recent events, it almost certainly still exists to a certain degree. If this is so, an upswing in the domestic economy accompanied by a rise in imports is likely to be accompanied also by some improvement in the capital account.

The debt negotiations now under way, it must be emphasised, are not being approached as a "winding down" exercise. On the contrary, their ultimate objective is to *normalise* South Africa's relations with foreign financial institutions and markets. We are looking forward to a continuation of not only trade financing but also capital inflows in other forms. It was for this very reason that certain forms of debt were left "out of the net" from the beginning – as a prelude to normalisation. In any event, of the amount of about $10 billion left "outside the net", only a portion falls due for repayment in 1986, and it is expected that most, if not all, of these maturing loans or credits will be rolled over or replaced by new facilities.

This is not to deny that as long as the present overseas perceptions of conditions in South Africa persist, the capital account and the exchange rate will be adversely affected by "leads and lags" and capital outflows in other forms. But for the reasons I have mentioned, the overall balance of payments in 1986 should prove quite manageable. Since the rand is so obviously undervalued at present if judged only by economic criteria, it could therefore appreciate quite readily if political conditions and perceptions improve to any significant extent.

Conclusion

While fully recognising the serious political and economic challenges confronting South Africa at present, I therefore end on an optimistic note.

The policy of monetary and fiscal discipline applied during the past year or more – although it unavoidably entailed considerable sacrifices – has greatly strengthened the ability of the economy to withstand the present abnormal pressure on the capital account. At the same time it has created considerable scope for investment and consumption spending to rise in the period ahead without putting excessive pressure on either prices or imports.

In the implementation of this policy, the use of flexible and realistic interest and exchange rates has played a crucial role. Given the stresses and strains of the past year, any attempt to maintain interest rates at fixed and relatively low levels while simultaneously trying to "peg" the rand to the United States dollar at an unrealistic exchange rate – which is apparently what some critics believe should have been done – would have had disastrous consequences. In the event, the flexible and realistic rates proved their worth as essential shock absorbers and as an integral part of the economic adjustment mechanism.

In the final analysis the gratifying conclusion must be drawn that, despite the unique trials and tribulations experienced by South Africa since July this year, the anticipated scenario for 1986 is one of economic upswing, moderate growth and increased employment, with a sustained, although smaller, surplus on the current account of the balance of payments and no significant demand pressure on prices. Regrettably, the rate of inflation will not be as low and the rate of real economic growth as high as might have been the case under more propitious circumstances for South Africa. But there are nevertheless solid grounds for expecting improved economic conditions in South Africa in 1986.