

The capital outflow – present situation and prospects*

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Financial versus trade sanctions

The issue of trade sanctions against South Africa has been very much in the news of late. Additional trade sanctions in one form or another now appear to be inevitable. But it remains to be seen how comprehensive they will be and whether they can in practice be made effective. This talk today, however, is not about trade sanctions. It is about the financial "sanctions" that have been in existence for more than a year now and that are having a serious adverse impact on the South African economy.

These financial "sanctions" have resulted not in the first instance from conscious decisions by governments or legislatures but rather from the deterioration over this period in overseas perceptions of South Africa's socio-political situation. Foreign investors, bankers and businessmen have been troubled by uncertainty and concern about the nature, extent and possible consequences of South Africa's domestic political problems. As any well-informed observer must know, these perceptions are exaggerated and distorted if not completely erroneous. But the point is that for the moment they do exist.

The result has been a substantial withdrawal of foreign capital and credits from South Africa for more than a year and a half now. Moreover, for political reasons, South Africa is not only denied normal access to credits from international financial institutions and central banks, but is also required to repay existing credits to the International Monetary Fund. By force of circumstances South Africa has therefore become a capital-exporting country.

This politically induced pressure on the capital account of the balance of payments poses a greater threat to the South African economy than the kinds of trade sanctions that are likely to be imposed. It has already resulted in a weaker exchange rate, a higher inflation rate and a lower rate of real economic growth than would otherwise have prevailed.

Current account surplus: the implications

As long as the capital outflow continues, South Africa will have no choice but to run a large current account surplus. This is what we did in 1985, what we are doing again in 1986 and what we shall continue to do in 1987. According to the Reserve Bank's latest revised balance of payments estimates, the current account surplus in 1985 amounted to R5,9 billion. Present indications are that the surplus for 1986 will be between R6 billion and R7 billion. And although it is too early to pretend to know what the surplus will be in 1987, present projections suggest another large surplus of more than R5 billion in that year.

The fact that South Africa has been able to produce surpluses of this magnitude largely through the application of monetary and fiscal policies represents a notable adjustment performance. But it stands to reason that the need to maintain a sizeable current account surplus for any length of time must inevitably restrict South Africa's longer-term economic growth. Achieving a large current account surplus year after year, by whatever means, implies the 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, and therefore a lower long-term growth rate than would otherwise have been possible.

Capital movements after the debt standstill and reimposition of non-resident exchange control

To cope with the capital outflow, South Africa imposed a partial debt standstill in September 1985 and at the same time reintroduced exchange control over non-resident equity investments in the form of the financial rand system. In the abnormal political and economic circumstances of the time these drastic steps were unavoidable. But while they succeeded in preventing certain types of capital and credit outflow, they also had some counter-productive effects.

For example, certain South African debentures and notes issued abroad that might otherwise have been rolled over, had to be repaid. In addition, as foreign credits for imports became difficult to obtain, some importers had to make cash payments "up front". In general, the expectation that in these circumstances the rand would depreciate produced unfavourable "leads and lags" in current foreign payments and receipts, which are recorded in the balance of payments statistics as an outflow of short-term capital.

The result was that the net capital outflow (excluding changes in so-called "liabilities related to reserves") of about R2,5 billion during the third quarter of 1985 was followed by an even larger net outflow of about R4,4 billion during the fourth quarter. During the first and second quarters of 1986 this outflow declined to R1,6 billion and R1,0 billion, respectively. In addition, as the Reserve Bank, the other banks and the Government repaid large amounts of short-term debt inside and outside the "net", foreign liabilities "related to reserves" declined by R2,3 billion during the first half of 1986. If these reserve-related repayments are included, the total net capital outflow during the first half of 1986 therefore amounted to R4,9 billion.

The ways in which capital continued to leave the country despite the restraining effect of the debt standstill and the tightening of exchange control, included loan repay-

* Address delivered to SABRITA (South Africa-Britain Trade Association) in Cape Town on 8 September 1986.

ments sanctioned in the national interest and leads and lags in current payments, which in the nature of the case do not contravene the exchange control regulations.

Over the twelve months ended June 1986 the large capital outflow more than neutralised the current account surplus and kept the exchange rate of the rand under pressure. The minor adjustments made to exchange rate procedures in January and December 1985, such as paying the mines in rand instead of dollars for gold bullion and compelling exporters to take out forward cover, had relatively little effect on capital movements and the exchange rate.

Capital outflow: comparing the second half of 1986 with the first half

Looking ahead, present indications suggest that the worst of the capital outflow is now behind us. During the first half of 1986 the current account surplus amounted to R2,9 billion, i.e. to much less than the total capital outflow of R4,9 billion during this period. In these circumstances the rand at times came under severe pressure and the official gold and foreign exchange reserves (excluding valuation adjustments) declined by about R2 billion.

The capital outflow of R4,9 billion during the first half of 1986 consisted of the following:

Repayments in terms of the interim debt arrangements (i.e. "inside the net")	R1 082 million
Repayments in terms of the proclamation (i.e. "outside the net"):	
Repayments of bearer bonds and notes	R 320 million
Repayments to the IMF	R 345 million
Repayments by Reserve Bank	R1 004 million
Other capital outflows (including repayments of trade credits and leads and lags in general)	R2 156 million
Total	<u>R4 907 million</u>

For the second half of 1986, however, the position looks much more favourable. For this period the current account surplus is estimated at between R3 billion and R4 billion. And present indications are that the net capital outflow during this half-year should be considerably less than this amount.

Using for calculation purpose the latest available exchange rate of R1 = \$0,42, repayments on bearer bonds and notes during the second half of 1986 are estimated at R252 million and repayments to the International Monetary Fund at R536 million, of which R216 million has already been effected in August. Repayments of credits by the Reserve Bank amounted to R172 million during July and August and are not expected to be large during the remainder of 1986. It is anticipated that, as during the first half of 1986, public corporations will be net borrowers rather than net repayers during the second

half of 1986, i.e. apart from the repayments of bearer bonds and notes already mentioned.

In total, these repayments already made or still expected to be made during the second half of 1986 amount to roughly R1 billion. To this must be added possible capital outflows in the form of further repayments of trade credits and new unfavourable leads and lags, plus the usual "errors and omissions". At this stage it is impossible to say how large these amounts will be. But since the new wave of adverse leads and lags that commenced round about May 1986 has already shown signs of petering out, the net outflow under this heading during the rest of 1986 is unlikely to be substantial.

Unless something unforeseen happens, therefore, the net capital outflow (including debt repayments) during the second half of 1986 should be substantially less than the expected current account surplus. The result is likely to be an increase in both the gross and net official gold and foreign exchange reserves and a further appreciation of the rand.

Looking still further ahead, it is too early to draw firm conclusions about likely capital movements in 1987. Anticipated repayments in that year include R821 million of bearer bonds and notes, R1 114 million to the International Monetary Fund, and R114 million during the first half of 1987 in terms of the existing interim debt arrangements. Public corporations are not expected to make any net repayments in 1987, i.e. apart from their share in the repayments of bearer bonds and notes referred to above. For the rest, the outcome will depend mainly on the behaviour of leads and lags in general and trade credits in particular, and on any further debt repayments "within the net" that might be agreed upon during the new round of debt negotiations scheduled for the second quarter of 1987.

Effects of recent rise in gold price

How will the capital outflow and the overall economic position of South Africa be affected by the recent rise in the gold price? The answer obviously depends on whether the higher price level will be sustained or not. We should therefore not count our chickens before they are hatched. But there is no doubt that if the gold price remains above \$380 per ounce the South African economy stands to benefit substantially in a number of ways.

To begin with, the current account of the balance of payments will naturally tend to show a larger surplus than it would otherwise have done. Over a full year every US \$50 increase in the price of an ounce of gold adds more than US \$1 billion or R2,5 billion (at an exchange rate of R1 = \$0,40) to the value of South Africa's gold output.

Secondly, the rise in the gold price, if sustained, would add impetus to the current recovery in the domestic economy. Apart from the familiar "multiplier" effects on spending and income flowing from the increased rand value of the gold output, there will also be expansionary financial effects. The money supply will probably tend to

rise more rapidly, which under present conditions is desirable, and interest rates will tend to remain low. At the same time government tax revenue from gold mining should tend to rise.

Thirdly, the capital account of the balance of payments should improve. This is not only because the expectation that the higher gold price will strengthen the rand should have a favourable impact on the leads and lags, but also because the high rate of domestic economic growth should serve to keep capital in the country that might otherwise have flowed out.

Fourthly, the rand should strengthen further in the foreign exchange market and this, in turn, should help to curb the rate of inflation.

The recent increase in the gold price, even if sustained, does not, of course, mean that South Africa's economic difficulties are now over. But it will certainly be of material assistance – along the lines I have referred to – in overcoming the harmful effects of the existing financial "sanctions". It should also contribute towards preventing the irrational and emotional forces behind the present sanctions and disinvestment campaigns from transforming South Africa into some form of "siege economy". In addition, the higher gold price might well serve to provide the spark of business and consumer confidence required to bring about more rapid domestic economic expansion.

It is important, however, not to allow the rise in the gold price to blind us to the fact that for any lasting solution of our economic difficulties there are at least four basic requirements:

Firstly, we must continue to apply an appropriate short-term monetary and fiscal strategy.

Secondly, it is important to proceed with the formulation and publication of a long-term economic strategy for South Africa, dealing with such matters as "inward industrialisation", export promotion, import substitution, manpower issues, rural development and the role of government in a market system in which private initiative and effective competition have important functions to perform.

Thirdly, law and order must be maintained.

Fourthly, there must be comprehensive further political and constitutional reform.

Conclusion

There is no doubt that the scope now exists in South Africa for a more vigorous cyclical upswing in the short term and a higher real average rate of growth in the medium and long term.

During the 1983-84 mini-boom, when government spending and the Budget deficit were excessive, monetary policy had to carry the main burden of curbing over-spending in the economy and correcting the current account of the balance of payments. That inevitably entailed high interest rates. From March 1985 onwards, however, more fiscal measures were added to the policy "mix", and

this opened the way for the Reserve Bank to lead interest rates downwards.

In retrospect it is now clear that while this policy of monetary and fiscal discipline in the nature of the case entailed sacrifices, it fully achieved its objectives of eliminating excess demand and producing a large current account surplus. This has, among other things, enabled South Africa to repay about US \$3 billion of foreign debt since the end of 1984 and has greatly increased the country's ability to cope with both financial and trade sanctions. In these and other ways, monetary and fiscal policy has laid the foundation for more rapid growth in the period ahead.

Will the South African economy now be able to build on this foundation? Will the scope for more rapid economic growth now be utilised? Will the benefits conferred on the economy by the recent rise in the gold price be used to full advantage?

I believe the answer lies in the extent to which we succeed in meeting the four requirements to which I have referred. The challenge is to demonstrate to ourselves and to the outside world that we have both the will and the ability to apply sound short-term monetary and fiscal policy, to implement an appropriate long-term economic strategy, to maintain law and order, and to proceed with further peaceful, evolutionary political reform.

Meaningful progress on these four fronts will contribute greatly to the normalisation of South Africa's relationships with foreign banks and capital markets. More fundamentally, it will help to achieve what must now be a major objective for all who are genuinely interested in the welfare of the people of Southern Africa: a positive vision of economic growth and prosperity in the period ahead.