Inflation and growth in 1988 – After the "Crash" of '87 *

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Impact of collapse of share markets

The recent collapse of the world's main share markets has made the kind of "scenario sketching" that one indulges in at investment conferences more hazardous than usual. In my Annual Statement to Reserve Bank stockholders in August this year I contended that the South African economic situation was characterised by "high blood pressure" in the *financial* markets and "low blood pressure" in the *real* economy. Subsequent events have underlined the validity of that view. But that is history now. What was, was! The "blood pressure" of the South African Stock Exchange, like that of all other stock exchanges in the world, has gone down quite a bit during recent weeks. Medically speaking, some investors and stockbrokers may have had the opposite experience, but that is another matter!

The important question now is what the effects of the crash of the main stock exchanges will be on the *real* economies of the world. On this issue it is much too early to reach final conclusions. The recent share market collapse, like the preceding share market boom, has borne only a limited relationship to short-term developments in the *real* main industrial countries. The same strengths and weaknesses that exist today in production, income generation, employment and trade, were also evident during the preceding period when share prices were rising. Indeed, conditions in the real economies of the world today are little different from those of one, two or three months ago. A strong recovery in share markets in the months ahead therefore cannot be ruled out.

For the time being, however, it is only realistic to assume that the stock exchange developments of recent weeks will tend to exert at least some contractionary influence on real economic activity throughout the world.

The "optimistic" scenario for 1988

Two months ago at the SABC's Diagonal Street Banquet I set out a projection for the South African economy in 1988 which I called "the optimistic scenario". While expressing the view that this scenario was both internally consistent and feasible, I stated at the time that I did not expect it to be realised in practice. My purpose in doing this was to put the case for a new application of minds to the steps that have to be taken in the various fields of policy in order to bring us closer to the attainable ideal.

The "optimistic" scenario for 1988 I set out at that time provided among other things for the following:

- A rise in the growth rate of real gross domestic product (GDP) to around 4 per cent.
- A decline in the average rate of inflation (CPI) to about 12 per cent, as a prelude to a further decline to a single digit figure in 1989.
- A revival in both fixed and inventory investment as an active element in the generation of income and consumption.
- A decline in the surplus on the current account of the balance of payments to around R2 billion or R3 billion.
- A moderate rise in *nominal* interest rates resulting in most interest rates becoming positive in real terms.
- A fiscal policy of reducing tax rates while at the same time curbing the growth of government spending and preventing the deficit before borrowing from rising unduly.
- An increased use by South African importers and exporters of foreign trade and suppliers' credits, with a consequent improvement in the capital account of the balance of payments.
- The maintenance of the official gold and foreign exchange reserves at a satisfactory level and the further repayment of foreign debt to the extent required.
- A flexible and competitive exchange rate for the commercial rand likely to fluctuate between 45 and 50 US cents, depending, of course, on such imponderables as the exchange rate of the US dollar in terms of other currencies and the dollar price of gold.

This, then, was the "optimistic" scenario that I described two months ago as "feasible" but unlikely to be realised in practice.

Given the collapse of share markets during the past month, is this scenario still feasible? If, as most observers now assume, the events of recent weeks are bound to exert an adverse influence on real economic activity throughout the world, the answer must be in the negative. All "pre-crash" projections will then require at least some adjustment. In the case of the "optimistic" scenario, for example, the real growth rate for 1988 will have to be reduced to below 4 per cent. Other changes would include a *larger* current account surplus than the previously projected R2 billion or R3 billion (because imports would then rise less) and an even more moderate upward move-

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ment in nominal interest rates (because the demand for loanable funds would then rise less).

For the time being, however, I still do not believe that the "optimistic" scenario, even as adjusted, will in fact come to pass. This is mainly because the key to increased income generation, namely forward-looking fixed and inventory investment, is unlikely to show more than a moderate revival in the months ahead. The final outcome for 1988 is therefore unlikely to be quite as favourable as that set out in the "optimistic" scenario.

The "more realistic" scenario for 1988

What then, is a *more realistic* scenario for the South African economy in 1988? Let us focus on a few key variables.

A higher real growth rate

Real gross domestic product increased by about 5 per cent in 1984, declined by 1½ per cent in 1985 and rose by less than 1 per cent in 1986. Present indications are that this growth rate will amount to more than 2 per cent in 1987 and rise further to around 2½ per cent in 1988. Given the expected weakness in world economic conditions, this would be quite a reasonable achievement. However, I still believe that it should be possible to raise this rate to 3 per cent or more in 1988 and that every endeavour should be made to do so.

In an economy characterised by surplus capacity, unemployment, a large current account surplus, high liquidity and low interest rates, a real growth rate of over 3 per cent would cause many other things to fall into place. It would, for example, not only generate additional savings but also more tax revenue, thereby enabling the Treasury to reduce certain tax rates.

The latest (as yet unpublished) *quarterly* national accounts estimates should, as always, be interpreted with caution. After rising by revised annual rates of 2 per cent in the first quarter of 1987 and 1 per cent in the second quarter, real gross domestic product is estimated to have increased at an annual rate of only 1½ per cent during the third quarter. On closer examination, however, it transpires that this disappointing outcome was almost exclusively attributable to marked output declines in agriculture (mainly maize, sugar and citrus) and in mining (partly due to the labour strike during August). In the non-primary sectors of the economy, including manufacturing and commerce, real output growth reached the relatively high annualised rate of about 6 per cent during the third quarter. This is distinctly encouraging. Moreover, during the first three quarters as a whole, total real gross domestic product was some 2¾ per cent higher than in the first three quarters of 1986.

A lower rate of inflation

Recent econometric studies made by the Reserve Bank's Economics Department suggest that the average annual rate of increase of the consumer price index, which amounted to 18,6 per cent in 1986, should decline to about 16 per cent in 1987 and to around 15 per cent in 1988. Although this would represent progress in the fight against inflation, it would still leave the rate of inflation well above the 12 per cent provided for in the "optimistic" scenario. It remains my view that, unless an unexpected new politically induced capital outflow brings about another marked depreciation of the rand, it should be possible to reduce the rate of inflation to below 15 per cent in 1988.

This again raises the question why the Reserve Bank has during the past two years not applied a more restrictive monetary policy involving real positive rates of interest in order to curb inflation.

The answer is certainly not that the Reserve Bank has been "soft" on inflation. Far from it. The Bank remains deeply concerned about inflation. Moreover, it fully endorses the view that there is no long-run "trade-off" through which growth can be improved by a willingness to accept a higher rate of inflation. But the Reserve Bank has consistently held the view that the main cause of the temporary acceleration of the annualised quarterly rate of inflation from 12,8 per cent in the fourth quarter of 1984 to 26,0 per cent in the first quarter of 1986 was (exceptionally) not excess aggregate demand but the marked depreciation of the exchange rate between 1983 and 1986. This depreciation, in turn, was (exceptionally) not the consequence of excess money creation and spending but mainly of a politically induced capital outflow. This is borne out by the fact that, following the *ap*preciation of the rand during the past year, the rate of inflation has slowed down to around 15 per cent during the first two quarters of 1987, before rising to 16,9 per cent during the third quarter. Since the problem during the 1985-87 period was therefore one of *under*spending and *not over*spending, the Reserve Bank deemed it undesirable to attempt to reduce the rate of price increases by applying a severely restrictive monetary policy.

A rise in both real wages and salaries and in real profits and dividends

If the growth rate rises and the inflation rate falls as anticipated, it follows that *real* wages and salaries and *real* profits and dividends will tend to rise in 1988. This implies an increase in the average standard of living per head of the population. This would represent a welcome change. In 1985 and 1986 real gross national product per head of the population declined by an average of about 2,2 per cent per year, real personal

disposable (after tax) income per head by an average of 5,6 per cent per year, and real private consumption per head by an average of 4,2 per cent per year. The expected reversal of these tendencies is therefore something to look forward to.

A revival in fixed and inventory investment

At present it does not look as if South Africa's exports will rise enough in 1988 to raise the real economic growth rate to around 2½ or 3 per cent. For such a growth rate to be realised there must accordingly be a marked increase in *gross domestic expenditure*. And in present circumstances such a rise is unlikely to occur unless there is a significant revival in capital outlays on plant, equipment and construction, as well as a considerable build-up of inventories. A marked upturn in fixed and inventory investment is therefore necessary to boost the real GDP growth rate by generating additional income and, via the familiar "multiplier" process, also additional consumption spending.

Thus far in 1987 this has not yet happened. A further rise in real gross domestic expenditure at an annual rate of about 8 per cent during the third quarter was accounted for mainly by a rise of about 3 per cent in real private consumption and some further build-up of industrial and commercial inventories.

In more normal circumstances the favourable developments in South Africa's balance of payments and monetary and banking situation since June 1986 would by now have brought about a strong upturn in both fixed and inventory investment. It is useful to recall that after the Sharpeville riots in 1961 there was also a period in which confidence waned and capital spending declined. But when confidence subsequently returned, fixed investment increased in *real terms* by as much as 18 per cent in 1963, 20 per cent in 1964 and 17,5 per cent in 1965. This generated additional income and therefore, via the multiplier, additional consumption. The end result was a strong cumulative upswing.

Decline in current account surplus and improved capital account

The surplus on the current account of the balance of payments remains large despite the recent rise in imports. According to provisional estimates it still exceeded an annual rate of R5 billion in the third quarter of 1987. The latest indications are that for 1987 as a whole the surplus will amount to nearly R6 billion -- equal to about 3½ per cent of gross domestic product. However, if real gross domestic product rises by a further 2½ per cent in 1988 as expected, the current account surplus will probably decline to between R3 billion and R4 billion in that year -- a development which should be welcomed as an integral part of more rapid economic expansion.

This expected decline in the current account surplus should not create problems for the *overall* balance of payments, the gold and foreign exchange reserves or the interim debt arrangements. If there is enough confidence in 1988 to produce the rise in investment and consumption required to generate a real GDP growth rate of 2½ per cent or higher, it is reasonable to assume that adequate foreign trade-related and suppliers' credits will then also be available to South Africa if and when the demand for such funds increases. In other words, the decline in the current account surplus should then be offset by a corresponding improvement in the capital account of the balance of payments.

Implications for monetary policy in 1988

What are the implications of this scenario for monetary policy?

Money supply and interest rates

Nothing has happened recently to change the Reserve Bank's view that monetary policy should remain expansionary for the time being. Indeed, it will not have gone unnoticed that the Bank has responded to the October share market collapse by making monetary policy even more accommodative in two ways:

Firstly, the Bank has at its own initiative provided substantial amounts of cash reserves to the banks and discount houses through repurchase agreements and placements (via a tender system) of funds of the Corporation for Public Deposits (CPD). In this way the Bank has not only limited the "money market shortages" that have to be accommodated at its discount window but at times even produced "money market surpluses". This action achieved the intended result of keeping interest rates on call funds and money market paper low and preventing any undue rise in long-term interest rates.

Secondly, in applying its exchange rate policy of managed floating the Reserve Bank has moderated the appreciation of the rand in terms of the US dollar in order to ensure the continued competitiveness of South African enterprises and to support the rand price of the country's main exports, including gold.

In these two ways the Reserve Bank has helped to create a monetary climate conducive to the restoration of more normal conditions on the Stock Exchange.

Looking ahead, the Reserve Bank will continue to encourage reasonable growth in bank credit and in the money supply. Initially, both short and long-term interest rates are likely to remain at their present

exceptionally low levels, which in most cases are negative in real terms. At a later stage, if the real GDP growth rate increases to 2½ per cent or higher as provided for in the "more realistic" scenario, the accompanying rise in the demand for loanable funds might well bring about a gradual upward movement in interest rates. At some stage most interest rates would then presumably become positive in real terms, i.e. after correction for inflation. Naturally, if the expected further decline in the rate of inflation occurs, *nominal* interest rates would not have to rise very much before *real* rates became positive.

The Reserve Bank would, of course, be able to moderate the upward movement in interest rates by keeping its own Bank rate relatively low and by creating additional central bank credit through discount window accommodation, open-market operations and in other ways. But in the growth scenario under discussion this could be inflationary and would almost certainly conflict with the policy of keeping the increase of the broad money supply, M3, within predetermined limits.

The present target range for the rate of increase of M3 is 14 to 18 per cent between the fourth quarter of 1986 and the fourth quarter of 1987. From the beginning of the targeting period up to the end of September 1987 the annual rate of increase of M3 amounted to 14,4 per cent. In the meantime, however, there has been a further increase in the velocity of circulation of M3. If this is taken into account, the rate of increase of the "effective" broad money supply over this period amounted to 15,8 per cent, which still falls well within the target range.

The new range to be determined in February 1988 for the period between the fourth quarter of 1987 and that of 1988 is unlikely to be higher, and might well be lower than 14 to 18 per cent, given the need to reduce the rate of inflation still further. If, in these circumstances, the banks expand their credit substantially in response to a rising demand for loanable funds, M3 might tend to overshoot the target range, and it would then be incumbent upon the Reserve Bank to adopt a less accommodative policy stance. In practice this would imply a gradual rise in Bank rate and in most market-oriented interest rates. If such an increase occurs, it should be welcomed as both a symptom of increased prosperity and an indication of the determination of the authorities to avoid any re-emergence of demand inflation.

The "mix" of fiscal and monetary policy

The behaviour of interest rates in 1988 would, of course, also depend on the "mix" of fiscal and monetary policy. It is therefore important to prevent Government spending and the Budget deficit before borrowing from rising excessively. If the public sector borrowing requirement becomes inordinately large at a time when the private sector is also expanding, upward pressure would naturally be exerted on interest rates. However, if fiscal policy plays its proper role, the upward movement in nominal interest rates should be fairly limited.

Exchange rates

Another crucially important variable in any scenario for 1988 is the exchange rate of the commercial rand. The lower the exchange value of the rand, the better the prospects of reconciling a higher GDP growth rate with a large current account surplus in 1988, but the smaller the chances of simultaneously reducing the rate of inflation.

Of course, the setting of a target for money supply growth rules out the setting of an independent target for the exchange rate. But since the South African monetary authorities have from the beginning opted for "low-profile" monetary targeting rather than the application of a rigid and overriding "money rule", the Reserve Bank does enjoy some (constrained) discretion in applying its exchange rate policy of managed floating. How will it exercise this discretion in the months ahead and how will exchange rate movements fit into the scenario under discussion?

To begin with, the official exchange rate policy remains one of managed floating. The Reserve Bank has no fixed target or target range for the exchange rate of the rand in terms of either the US dollar or any other foreign currency or "basket" of foreign currencies. In particular, as the recent exchange rate movements have shown, the level of 50 US cents is neither a floor nor a ceiling for the rand. Thus, when the US dollar recently depreciated further against most other major currencies, the rand moved up to over 51 US cents.

This does not, however, mean that the Reserve Bank is indifferent towards movements of the exchange rate. On the contrary, in "managing" the exchange rate through market "intervention", it fully recognises that an appreciation of the rand is not always good and a depreciation not always bad for South Africa. For an open economy such as that of South Africa there are always important advantages and disadvantages attached to any appreciation or depreciation of its currency. And these advantages and disadvantages have to be weighed up carefully to determine whether the net effect of any given change in the exchange rate would be favourable or unfavourable.

If, for example, the gold price were to remain high or to increase further without any significant further depreciation of the US dollar against other currencies, the Reserve Bank will tend to buy dollars in the market in order to prevent an excessive appre-

ciation of the rand. It is true that such an appreciation would help to curb the rate of inflation. But it would also undermine the present policy of promoting growth and creating employment. This is because it would reduce the rand value of exports and expose domestic manufacturers to increased foreign competition.

At the same time, owing to the improvement in the balance of payments and the large increase in the official gold and foreign exchange reserves during the past eighteen months, the Reserve Bank is at present also in a better position than it has been for some years to prevent an undesirable *de*preciation of the rand by selling dollars for rand in the market. It will use this power in the period ahead, as it has done during the past year, to iron out unnecessary exchange rate fluctuations.

In accordance with the official exchange rate policy of managed floating this, of course, in no way implies that the exchange rate of the rand in terms of the dollar or any other currency will or should remain "fixed" in the months ahead. But it does mean that the movements of the various rand exchange rates are capable of being properly integrated with the present monetary and fiscal policy, which continues to aim at maintaining a balance between the promotion of growth and the curbing of inflation.

South Africa in a relatively favourable position

In the course of putting together the scenario I have presented today, I have been struck by the relatively favourable economic position in which South Africa finds itself in the world today -- in the aftermath of the recent collapse of share markets. It is true that if real growth rates in the industrial countries *are* significantly reduced in 1988 as most observers now expect, commodity markets will almost certainly be adversely affected. This, in turn, is bound to have unfavourable effects on primary producing countries and to exacerbate the existing international debt problems. In such circumstances it stands to reason that the South African economy would not emerge unscathed.

This time around, however, South Africa is clearly in a better position to weather the storm than most other countries. Call it irony, call it fate, call it justice, but the very fact that the South African economy was forced to adjust to a unique combination of adverse extraneous economic and political developments after 1981 and again from 1984 onwards, has placed it in a relatively favourable position to cope with possible adverse developments in the world economy in 1988.

The remarkable balance of payments and foreign debt servicing performance of the South African economy during the past two years has been well documented. The maintenance of current payments surpluses equal to around 4 or 5 per cent of gross domestic product for three consecutive calendar years, the net repayment of about US$4,8 billion of foreign debt in three years, the more than doubling of the gold and foreign exchange reserves, and the appreciation of the rand since June 1986, are now a matter of history and need no further elaboration. It is sufficient to note that these developments have laid a sound foundation for the upswing now in progress in South Africa and for the current steady, if unspectacular, real economic growth.

Despite the likely adverse effects of the recent collapse of share markets, the prospects for the South African economy in 1988 are therefore relatively much better than those for most other countries. Whereas many other countries now face some combination of lower growth and higher inflation, South Africa has it within its grasp to achieve both a higher growth rate and lower inflation in 1988.