More growth and less inflation in 1988 – why not?*

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Traumatic impact of capital outflow and other extraneous developments

It is old hat that the South African economy has in recent years been hard hit by a unique combination of extraneous economic and political developments. What is perhaps not fully appreciated, is just how traumatic this experience was for the economy and how far-reaching the economic adjustments were that inevitably had to be made.

The consequences of the sharp gold price declines between January 1980 and June 1982, and then again between February 1983 and February 1985, the weak commodity markets in general and the drought were serious enough. But particularly devastating were the effects of the largely politically induced capital outflow of R15,5 billion during the two years 1985 and 1986. This outflow, which included changes in so-called "reserve-related liabilities" and debt repayments in general, were equivalent to 6 per cent of gross domestic product – an exceptionally large figure. Moreover, of this amount, more than R11,5 billion occurred *after* the imposition of the debt standstill at the end of August 1985 and the simultaneous re-introduction of exchange control over non-resident equity capital – to supplement the long-standing exchange control over capital transfers by residents. This demonstrated once again that, while exchange control has a role to play in South Africa's unique political and economic circumstances, it has at best a limited effect in protecting the economy against an outflow of capital if the inducement to move such funds out of the country is strong enough.

Inevitability of balance of payments adjustment

The inevitable result of these developments was a massive balance of payments adjustment. Since the South African economy was, for political reasons, denied access to bridging finance in the form of credits or capital from the International Monetary Fund, the World Bank, central banks or other comparable international institutions, it had no option but to produce and maintain a large surplus on the current account of its balance of payments, in order to finance the debt repayments and other capital outflows. This meant that it had to transfer real resources to the outside world – something that is unnatural for a developing country with considerable growth potential and a rapidly growing population. More goods and services had to be exported to the rest of the world than were received back in the form of imports. This meant that a significant portion of the economy's production was not available for domestic consumption and investment.

By the second half of 1984 it was clear that the inevitable adjustment process in South Africa would entail some or other combination of slower economic growth, exchange rate depreciation and higher "inflation", and therefore a lower average standard of living per head of the total population. The only options open to the authorities were between different methods of adjustment and between different ways of sharing the adjustment burden.

It is amazing how many articles have been written and speeches made about subjects like inflation, growth and economic policy in South Africa during recent years with hardly any reference to these realities, and specifically without any recognition of the impact of the huge net capital outflow. Even more astonishing was the view held in some circles at one stage that "economic policy" (and specifically the use of more direct bureaucratic controls) could have "compensated" for the adverse extraneous developments or could have "immunised" the economy against these shocks. For a developing country that suddenly experiences a net capital *out*flow equal to 6 per cent of gross domestic product over a two-year period, the key word is "adjustment", not "compensation" or "immunisation".

Effective adjustment and debt repayment performance

There is now growing recognition, both inside and outside the country, that the South African economy has adjusted well to the economic realities of recent years. After some procrastination, effective policies of monetary and fiscal discipline were in the end applied, even though they were painful and unpopular, and the country is now reaping the benefits.

The effective adjustment performance of the South African economy is evident from:

- The achievement of large surpluses on the current account of the balance of payments equal to between 4 and 5 per cent of gross domestic product for three consecutive years, namely 1985, 1986 and 1987.
- The net repayment of US$4,3 billion (close to R9 billion) of foreign debt since the end of 1984 – a figure that is estimated to rise to US$4,8 billion (nearly R10 billion) by the end of 1987.
- The dramatic improvement in all South Africa's "foreign debt ratios". Thus, the country's ratio of foreign interest payments to exports of goods and services amounted to only 10,7 per cent in 1985, compared with an average of 27,6 per cent (and over 40 per cent in some cases) for Western Hemisphere countries. It then declined to 9,5 per cent in 1986 and to an estimated 7,5 per cent in 1987. Similarly, South Africa's ratio of foreign debt to total exports of goods and services declined from a

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peak level of 171 per cent in 1984, which was not inordinately high, to 108 per cent in 1986 and to an estimated 90 per cent in 1987. In contrast, the comparable ratio for Western Hemisphere developing countries deteriorated from an average of 277 per cent in 1984 to 355 per cent in 1986 and an estimated 368 per cent in 1987.

- The rise in South Africa's total gold and foreign exchange reserves from R3,9 billion (US$1,9 billion) at the end of April 1986 to R8,5 billion (US$4,2 billion) at the end of July 1987. The latter figure was equal to about three and a half months' imports of goods.
- The appreciation of the commercial rand from a low point of 36 US cents on 12 June 1986 to its present level of around 48 US cents. Against a trade weighted "basket" of currencies the rand at present stands about 28 per cent higher than on 12 June 1986. The financial rand also moved up from about 18 US cents at one point in June 1986 to a peak of 35 US cents on 30 March 1987, before receding to its present level of around 30 US cents.

Cost of balance of payments adjustment: low growth and unemployment

Of course, while all of this adds up to an outstanding achievement by the South African economy, it is a "balance-of-payments-adjustment success story", not a "growth success story". A heavy price had to be paid for the external economic adjustment. Belts had to be tightened. The rate of real economic growth slowed down. Unemployment increased. The quarterly rate of inflation increased from 12,8 per cent in the fourth quarter of 1984 to 26,0 per cent in the first quarter of 1986, before declining again to about 15 per cent to both the first and second quarters of 1987. 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.

In the final analysis, however, nothing can detract from the fact that the South African economy met the daunting challenges it faced with quite astonishing success. Priority had to be given to the protection and strengthening of the balance of payments, and this was done rapidly and effectively.

A more vigorous upswing – so near and yet so far?

Against this background of effective adjustment the stage is now set for a more vigorous upswing and a period of more rapid real economic growth. Admittedly, business and consumer confidence is still inadequate. But we are probably closer to real economic prosperity than is generally realised. It is a case of "so near and yet so far". Only a spark of confidence is needed to trigger a strong upturn in fixed and inventory investment. Without that spark the present upswing will remain sluggish. But with it, the economic prospects are excellent.

The "Optimistic Scenario" for 1988

This trend of thought has prompted me to set down a number of economic developments I would like to see in 1988. Call it wishful thinking. Call it "the optimistic scenario" if you like. I am not predicting that this scenario will, in fact, come to pass. Certainly, the monetary authorities do not have the power to ensure that it does. To a large extent the outcome in the period ahead depends on developments over which the monetary authorities have little if any control. But given even a modest improvement in overseas perceptions and in our strained foreign relations, the "optimistic scenario" cannot be ruled out.

The developments I would like to see in 1988 include the following:

A higher real growth rate

First on the list is a significantly higher real rate of economic growth and a marked decline in the rate of unemployment. The Reserve Bank's econometricians inform me that, on present indications, the rate of growth of real gross domestic product should be in the vicinity of 2½ per cent in both 1987 and 1988. I would like to see it much higher in 1988, namely at about 4 per cent. Such a real growth rate would make some dent in unemployment. It would also generate additional savings. At the same time it would enable the Treasury to reduce certain tax rates and yet generate more tax revenue. Such a reduction in tax rates constitutes an essential part of the optimistic scenario.

A lower rate of inflation

Simultaneously with the rise in the growth rate to around 4 per cent, I would like to see a substantial further reduction in the rate of inflation in 1988. My econometricians tell me that, on present indications, 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 about 14½ per cent in 1988. In my optimistic scenario I would like to see it lower still, namely at about 12 per cent. And I would wish to see it show a declining tendency *during the course* of 1988, so that the average rate for 1989 might become a single digit figure.

Is this an impossible dream? Is it at all reasonable to expect both a higher growth rate and a lower inflation rate in 1988? Historically it is true that rising growth rates and accelerating inflation rates have often gone together. But in the abnormal circumstances currently prevailing in South Africa a scenario for 1988 which provides for both a higher growth rate and a lower inflation rate is, in my view, not out of the question.

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

It follows that, with the growth rate rising and the inflation rate falling, the optimistic scenario would provide for a rise in 1988 in both *real* wages and salaries and *real* profits and dividends, and therefore an increase in the average standard of living per head of the population.

A revival in fixed and inventory investment

An essential requirement for the optimistic scenario for 1988 is a distinct revival in real fixed and inventory investment. Given the expected relatively moderate growth in world output and trade, South Africa's exports are not likely to rise enough to produce anything like a 4 per cent real economic growth rate. Such a growth rate will therefore only be realised if there is a marked increase in *gross domestic expenditure.* And in present circumstances such a rise in total spending is unlikely to occur unless there is a strong revival in capital outlays on plant, equipment and construction, as well as a considerable build-up of inventories. A strong upturn in such fixed and inventory investment will boost the real GDP growth rate by generating additional income and, via the familiar "multiplier" process, also additional consumption spending.

The notion that fixed and inventory investment can only be expected to rise *after* consumption has increased enough to absorb virtually all existing surplus productive capacity, is incorrect. While private consumption can at times rise "autonomously", it more often than not increases as a function of additional income generated by prior increases in exports, government spending and/or investment spending. Investment decisions, on the other hand, are normally *forward-looking* and based on the *expected* profit rate or what Keynes called the "marginal efficiency of capital".

Investment in plant, equipment and construction is an act of faith in the future. When entrepreneurs make such investments at any given juncture they normally do so with a view to meeting an *anticipated* demand and making profits three, five and ten years later. The timid entrepreneur who waits until virtually all his existing surplus capacity is absorbed before he invests in additional plant, equipment and construction, usually misses the boat. The successful entrepreneur is the innovator or the one with vision and courage who correctly anticipates future increases in consumption.

It is in this crucial respect that the present economic situation in South Africa is abnormal and paradoxical: "high blood pressure" in the financial markets and "low blood pressure" in the "real" economy, i.e. in the spheres of spending, output, trade and employment. Given the favourable developments in South Africa's balance of payments and domestic financial markets in recent years, both fixed and inventory investment would in more normal circumstances already have started rising strongly between one and two years ago. The fact that it has not done so reflects inadequate business confidence. With the return of confidence implied by the optimistic scenario this obstacle would naturally fall away and a sharp rise in investment would then be indicated. 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 result was a strong cumulative upswing.

Is the optimistic scenario feasible?

Quite apart from the question whether the optimistic scenario I have described will, in fact, come to pass, is it at all feasible? The answer, I believe, is yes. Look at the facts:

The balance of payments on current account continues to show a large surplus; the gold and foreign exchange reserves have doubled over the past year; the foreign debt situation is under control; the exchange rate policy encourages exports and import substitution; the money supply is not rising too rapidly; interest rates are not only low but, in most cases, negative in real terms; the banks and building societies are ready, able and willing to expand their credit; the Reserve Bank supports them actively through its low Bank rate and open-market operations; share prices and stock exchange turnover have set one record after another during recent months; fiscal policy is expansionary; surplus capacity exists in many sectors of the economy, including most of the infrastructure; unemployment is relatively high; and the population is rising at well over 2 per cent per year in total and at a much higher rate in urban areas.

In circumstances such as these, a scenario involving faster growth and at the same time lower inflation appears to be quite feasible.

Assuming, then, that the optimistic scenario does come to pass in 1988, what other changes must we expect?

Decline in current account surplus

To begin with, the current account surplus on the balance of payments is likely to decline. This will be largely because of the rise in imports that will almost certainly result from the higher growth rate and the accompanying rise in real fixed and inventory investment.

At a real GDP growth rate of 4 per cent, the *value* of imports could easily rise by between 20 and 24 per cent in 1988 and the real *volume* by between 12 and 14 per cent. The value of the gold output and other exports will probably also rise substantially, but by considerably less than that of imports. The precise behaviour of imports and exports and of the current account as a whole will, of course, depend on a host of factors, including not only the movements of the dollar price of gold, oil and other world commodities but also the movements of exchange and interest rates both inside and outside South Africa. In economics it is still true that "everything depends on everything else". However, in broad terms and without setting out in detail all the underlying assumptions, a 4 per cent growth rate could imply a decline in the current account surplus from an expected figure of between R5 billion and R6 billion in 1987 to a figure of around R2 billion or R3 billion in 1988. In the circumstances such a decline should be welcomed as an indication of more rapid economic expansion.

Rise in interest rates

A further development that would probably form part of the optimistic scenario for 1988 is a gradual rise in both short and long-term interest rates. At some stage most interest rates would then presumably become positive in real terms, i.e. after correcting for inflation. Since the scenario provides for a gradual decline in the rate of inflation, *nominal* interest rates would not have to rise very much before *real* rates became positive. But they would almost certainly tend to rise to some extent if the GDP growth rate increases to the vicinity of 4 per cent.

The tendency for interest rates to rise will reflect the strong increase that must be expected in the demand for bank credit and other loanable funds in the optimistic scenario. The Reserve Bank would be able to moderate the upward movement in interest rates by keeping its own Bank rate relatively low and creating additional central bank credit through open-market operations and in other ways. But this would almost certainly conflict with its policy of keeping the growth 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. 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. But if the banks expand their credit substantially in response to the rising demand for loanable funds, M3 might well tend to overshoot the target range, and the Reserve Bank would accordingly have to adopt a less accommodative policy stance. In practice this would imply a gradual rise in Bank rate and in most market-related interest rates. Such an increase should be welcomed as a symptom of increased growth and prosperity.

"Mix" of fiscal and monetary policy

How far the upward movement in interest rates would have to go would, of course, depend not only on the "imponderables" but also on the "mix" of fiscal and monetary policy in 1988. In this regard, it is important to prevent government spending and the deficit before borrowing in the Budget from rising excessively. If the public sector borrowing requirement becomes inordinately large at a time when the private sector is also expanding, it would, of course, tend to exert upward pressure on interest rates. However, if fiscal policy plays its proper role, the upward movement in nominal interest rates would probably be fairly limited.

Capital account, gold and foreign exchange reserves and debt repayments

Against the background of the successful maintenance of law and order in South Africa and the economy's impressive balance of payments adjustment, foreign perceptions of the political and economic situation in South Africa have improved perceptibly during the past fifteen months. Accordingly, if there is enough business confidence to produce the rise in investment required to generate a real GDP growth rate of about 4 per cent in 1988, it appears reasonable to assume that additional foreign trade-related, gold-related and suppliers' credits will be available to South Africa if and when the demand for such funds increases.

If this is so, the 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. On the contrary, the maintenance of adequate foreign reserves and the continued repayment of foreign debt, if still required, would then be fully compatible with the optimistic scenario as a whole.

Exchange rates

A crucially important variable in the scenario is, of course, the exchange rate of the commercial rand. The lower the exchange value of the rand, the larger the current account surplus that can be reconciled with a real growth rate of around 4 per cent in 1988, but the smaller the chances of simultaneously reducing the rate of inflation.

Given the likely other developments that form part of the optimistic scenario, including the higher interest rates and improved capital account, the rand-dollar exchange rate could conceivably fluctuate within a limited range reasonably close to that of recent months, i.e. between 45 and 50 US cents. Whether it does or not would, of course, also depend on many other developments, including the behaviour of the US dollar itself, the dollar price of gold and many other imponderables.

Concluding remarks

Central bankers rarely make quantitative economic predictions. True to that tradition, I have made no prediction of any kind tonight. Nor have I set any precise new quantitative targets for economic policy. I have merely described one possible scenario for the South African economy in 1988 – "the optimistic scenario" – which includes among other things the following:

- A rise in the real GDP growth rate 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 rise in both *real* wages and salaries and in *real* profits and dividends, and therefore in the average standard of living per head of the population.
- 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 rate of increase of the broad money supply, M3, within the target range to be laid down for 1988, which is likely to be equal to or lower than the present 14 to 18 per cent.
- 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 government spending to such an extent that the deficit before borrowing, while rising in nominal terms, does not become so large as to exert undue upward pressure on interest rates.
- 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.

Will this optimistic scenario be realised? As matters stand at present, I doubt it. On any realistic assessment some of the assumptions underlying this scenario are clearly too optimistic. The key variable is forward-looking investment spending, and unless foreign and domestic business confidence in South Africa's economic future improves further in the months ahead, it is unrealistic to expect more than a moderate revival in this important component of gross domestic expenditure. Although the overall economic situation should continue to improve as the upswing develops more momentum, we shall probably have to settle for something less than the favourable scenario I have sketched. This means, among other things, a lower growth rate than 4 per cent, a higher inflation rate than 12 per cent, a larger current account surplus than R2 billion or R3 billion, and little if any upward movement in interest rates.

But let us not leave the matter there. Let us not resign ourselves to second best. If there is any validity in the reasoning that the 4 per cent growth scenario is both internally consistent and feasible, then we should re-examine carefully the reasons why we do not expect it to be realised in practice. And we should apply our minds anew to the steps that need to be taken in the various fields of policy to bring us closer to the ideal. More growth and less inflation in 1988 is well within our grasp. Let us go for it.