The South African economy – Quo Vadis?*

In any assessment of the future of the South African economy there are in my view two main points that need to be stressed at this juncture. The first is that South Africa's *economic* future is inextricably linked with its *political* future. And the second is that, while the South African economy has performed well in recent years in achieving growth-oriented balance of payments adjustment and in servicing and repaying foreign debt, there is room for further improvement in the application of both short and long-term economic policies.

The link between future political and economic developments

Political reform a prerequisite for a sound economy

South Africa's economic future is inextricably entwined with its political future. Continued political and constitutional reform and the maintenance of law and order are preconditions for the attainment of such economic ideals as optimal real growth, low single-digit inflation, balance of payments equilibrium, a strong currency and, in general, economic prosperity and a rise in the standard of living.

Given the intensified stresses and strains in South Africa's political relationships with the rest of the world during the past four years, the accompanying deterioration in foreign perceptions of conditions in this country, and the resultant capital outflow, disinvestment and sanctions, one would have thought that this proposition was self-evident. But this does not seem to be the case.

The opposite view: "First get the economy right"

There are still those in South Africa who seem to be saying that, *irrespective of political realities and developments*, South Africa can achieve the economic ideals of high growth, low inflation and so on, simply by adjusting its *economic* policies. In their view the Government should therefore "first get the economy right", even if this means putting political and constitutional reform on the "back-burner" for the time being.

It is interesting that those who reason along these lines include members of two totally opposing schools of economic thought. The first group believes that South Africa can solve most of its problems, including those caused by capital outflow, disinvestment and sanctions, by turning itself into a "siege economy" through the imposition of draconian direct economic controls, such as quantitative import restrictions, exchange controls, bank credit ceilings, and price and wage controls. Such an approach, it is alleged, would promote domestic industrialisation, output growth and job creation via import substitution and a larger government share in the economy. And disinvestment, it is argued, will benefit the country by enabling South African companies to take over profitable foreign-controlled enterprises in South Africa at "fire-sale" or "bargain-basement" prices.

At the other end of the spectrum are those who believe that most of the country's economic problems are mainly if not entirely due to *too much* government intervention, *too many* direct controls, excessive levels of government spending and "financial mismanagement" in general. They therefore believe that the answer lies in abolishing all direct controls (including exchange control), reducing government spending and "leaving everything to free markets" (if not *à la* Von Hayek, then at least *à la* Milton Friedman). While the members of this school are not necessarily against more rapid political reform, some of them seem to be saying that, *independently of what happens on the political front,* such a change-over to completely free-market policies would by itself give South Africa a high growth rate, a low inflation rate, a strong balance of payments, and so on.

With the views of the "siege economy" school I differ utterly and completely. It is true that the South African economy has responded well to the challenge of sanctions and disinvestment. And it is also a fact that many South African companies have "bought back" foreign control of South African enterprises on extremely favourable terms. But economic theory, plain common sense and the experience in other countries all indicate that in the long run economic isolation and a siege economy would mean lower economic growth, a weaker currency, higher inflation and a lower standard of living than would otherwise have been the case. As a major trading nation with extensive international financial relations, South Africa would be unwise to turn its back on the world.

The views of the second group, namely the "free market" school, are to my way of thinking much closer to the truth. And under more normal political conditions, the Government would do well to take their advice seriously. Indeed, even under the present abnormal conditions, progress in the direction they favour would have many desirable effects on the economy. My main problem with their approach is that it gives inadequate weight to the prevailing stresses and strains in South Africa's political relationships with the rest of the world. These unpleasant realities place a limit on the extent to

*Address delivered by Dr Gerhard de Kock, Governor of the South African Reserve Bank, to the Institute of Life and Pension Advisers in Cape Town on 8 May 1989.

which South Africa can move further down the free market road. For the time being, therefore, we shall have to live with such necessary evils as exchange control and restrictions on foreign debt repayments.

The need to move forward simultaneously on both the political and economic fronts

For the purposes of this paper, however, my main argument is that whether one approaches the problem from the "siege economy" point of view or from the free market perspective, it is fallacious to think that, irrespective of what happens on the political front, South Africa can achieve optimal growth, low inflation, and so on, simply by adjusting its *economic* policies, and that it should therefore give a higher priority to "getting the economy right" than to political reform.

Why is this view fallacious? Would it not be easier to deal with our political problems in an environment of economic prosperity and growth? Of course, it would. *But the South African economy will not develop to anything like its full potential and the authorities will not "get the economy right" unless adequate progress is also made with political and constitutional reform. The close interrelationship between politics and economics in South Africa makes it imperative for the country to move forward on both these fronts simultaneously.*

The truth is that the political situation in which South Africa finds itself in the world today has had, and will continue to have, adverse effects on the economy. And while this state of affairs clearly calls for adjustments in economic policies, such adjustments can never "neutralise" or fully "compensate for" these harmful effects.

The costs of transformation from a capital-importing to a capital-exporting economy

The best example of this in recent years has been the behaviour of the capital account of South Africa's balance of payments. During most of the period between the end of the Second World War and 1984, South Africa normally recorded deficits on its balance of payments on current account equal to an average of between 2 and 3 per cent of gross domestic product. These deficits were financed by a healthy inflow of foreign capital in the form of equity investments, loan capital and trade finance. This was the ideal state of affairs for a rapidly developing economy with rich natural resources and a rapidly rising population. The foreign capital and technical know-how greatly assisted the country in developing its production and export potential and in raising the standard of living of all sections of the population.

Since 1985 this situation has changed dramatically. As a direct result of the marked deterioration in overseas perceptions of the political situation in South Africa, the country suffered a net capital outflow of about R25 billion during the four years from 1985 to 1988, of which more than half represented foreign debt repayments. This left South Africa no alternative but to achieve and maintain large surpluses on the current account of its balance of payments. In other words, *political* developments and perceptions forced South Africa to transform itself from a capital-importing to a capital-exporting economy.

It is now a matter of history that the South African economy brought about this transformation and made the necessary balance of payments adjustments with great success. Moreover, domestic economic confidence recovered and a new cyclical upswing commenced from about the middle of 1986 and gained substantial momentum during 1988 and into 1989. But, of course, this process of adjustment and debt repayment was not painless. The real economic growth rate was lower than it would otherwise have been, the exchange rate weaker and the rate of inflation higher. And real gross national product per head of the population declined by an average of about 2½ per cent per year in 1985 and 1986, before resuming an upward movement in 1987 and 1988.

Future capital account scenarios

What about the future? If adequate progress is *not* made in the field of political and constitutional reform, South Africa's relationships with the rest of the world are unlikely to improve to any significant extent. In that event South Africa will probably remain a capital-exporting and debt-repaying country for years to come. In consequence, large surpluses will have to be maintained on the current account of the balance of payments. That, in turn, means that the rate of real economic growth will be lower, the external value of the rand weaker, and the rate of inflation higher than would otherwise have been the case. In such circumstances the average standard of living in South Africa will at best rise only slowly.

On the other hand, if adequate progress *is* made on the political and constitutional fronts, with a resultant easing of the political stresses and strains in South Africa's relationships with other countries, a marked improvement is bound to occur in South Africa's balance of payments on capital account. Provided appropriate monetary and fiscal policies are applied, this should enable South Africa to combine a higher growth rate with a stronger currency and a lower inflation rate.

To quantify the precise effects on the South African economy of an improvement in the political situation, is obviously impossible. But to obtain some idea of the orders of magnitude involved, I asked the Economics Department of the Reserve Bank to see what light the Reserve Bank's econometric model of the South African economy could throw on the matter. The Department came up with the following results:

- If South Africa were to continue to experience a

net outflow of capital equal to about 4 per cent of gross domestic product during the next ten years, as it has done during the past four years, the *average* rate of growth of gross domestic product would be limited to about 2 per cent.

- If no net inflow or outflow of capital is experienced during the next ten years, so that the current account of the balance of payments only has to show a balance and not necessarily a surplus every year, real gross domestic product should be able to grow at an average rate of around 3 per cent per year.
- If the South African economy experiences a net capital *in*flow equal to about 4 per cent of gross domestic product – the exact opposite of the situation during the years 1985 to 1988 – an average growth rate of gross domestic product of between 4 and 5 per cent per year could be achieved.

Given the limitations of the econometric model and the many assumptions on which this exercise necessarily had to be based, the above estimates of the attainable real economic growth rates under the three different sets of assumptions regarding the capital account should not be taken too seriously. But they do illustrate the point that any progress on the political front that has the effect of reducing or reversing the net capital outflow will contribute greatly to a higher rate of real economic growth and the achievement of South Africa's other economic ideals. The favourable implications this would have for economic development in the rest of Sub-Saharan Africa cannot be emphasised enough.

The need for improved short and long-term economic policies

The second point about South Africa's economic future that I wish to underline is the need for improved and better co-ordinated short and long-term economic policies. This includes the need to clarify the differences and the interrelationships between the objectives and nature of short and long-term economic strategies.

Further improvement in policy implementation is desirable regardless of which of the three capital account scenarios set out earlier is realised in practice, i.e. irrespective of whether South Africa in the years ahead continues to experience a net capital *out*flow, a balance on the capital account, or a net capital *in*flow. In the case of a continued net outflow of capital, we must continue to make the best of a bad situation. And in the case of a cessation or reversal of the capital outflow, we must make the best of a good situation.

As illustrated once again by the short-term stabilisation measures announced by the Government and the Reserve Bank on 5 May 1989, South Africa does have a short-term economic strategy. It is also well known that the Government has accepted a Long-term Economic Strategy for South Africa, as drawn up by the Economic Advisory Council of the State President, and that as a supplementary aid to the implementation of this strategy a new Economic Development Programme is currently being prepared by the Central Economic Advisory Service.

The Long-term Economic Strategy has much to commend itself. It is fully reconcilable with South Africa's system of private initiative and effective competition, and is not to be confused with a socialist "master plan" of any kind. It sets out objectives, principles and policy instruments, and expresses a clear preference for market-oriented methods of economic policy over direct controls. Among other things, it provides for export promotion, import substitution and "inward industrialisation" as part and parcel of South Africa's long-term economic development.

Provided adequate progress is made with political reform in the years ahead, the long-term economic strategy, if properly implemented, should go a long way towards achieving its objectives, particularly that of raising the rate of economic growth and job creation.

Inadequate implementation of long-term economic strategy?

Here, I must confess, we do have a problem. The long-term strategy has not been adequately publicised and is not as well understood in either the public sector or the private sector as it should be. There is no shortage of official printed material on the subject. The paper work has been done. In addition to the long-term strategy document itself, comprehensive reports have been published in recent years by Commissions of Inquiry into such matters as monetary policy, taxation, export promotion and industrial strategy. Moreover, most of the recommendations made in these reports have been accepted by the Government in principle. But there is justifiable concern in many circles that the long-term economic strategy is, in fact, not yet being adequately implemented. Ways and means will therefore have to be found of ensuring more effective and co-ordinated application of official economic policies.

Distinction between short and long-term strategy

In pursuit of these objectives it is important to keep in mind the distinction between short and long-term economic policies.

Short-term economic policy is inherently *stabilisation* policy. The need for it arises from the fact that the critical variables in the long-term economic strategy – namely output, income, employment, exports, imports, the price level, the exchange rate, interest rates, etc – seldom move along straight lines but show *cyclical*, *seasonal* and *random* fluctuations. Short-term econ-

omic policy therefore aims at stabilising the economy as far as possible and at minimising the variance of key variables around their longer-term trend lines.

In South Africa, as in most other countries with basically free enterprise or "mixed" economies, short-term economic policy is largely concerned with *demand management* and relies mainly on *market-oriented* policy measures. If the total demand for goods and services in the economy outstrips the supply emanating from domestic production and imports, monetary and fiscal measures are normally employed to reduce such excess demand. If this is not done, the overspending will be reflected in a deficit on the current account of the balance of payments, the depreciation of the exchange rate and/or a rise in the general price level. The restrictive measures limit demand and growth in the short run, but help to correct the balance of payment deficit and the inflation, which would otherwise flatten the gradiant of the long-term trend line for growth and income. Conversely, short-term measures designed to stimulate demand are used when output and employment fall below their perceived current potential.

There are accordingly situations in which short-term economic stabilisation policy might appear to conflict with the objectives of the long-term economic strategy. The additional restrictive financial measures announced in May 1989 are the latest case in point. During 1988 the upturn in the South African economy became too vigorous. Real gross domestic expenditure, which had already increased by 4 per cent in 1987, increased by a further 7 per cent in 1988 and at an annual rate of around 6 per cent in the first quarter of 1989. This had the desirable effect of bringing about a substantial rise in output, employment and economic activity generally. But it was made possible by an excessive increase in bank credit and in the money supply, and resulted in a reduction in the surplus on the current account of the balance of payments, an increased capital outflow, a new depreciation of the rand, and new demand inflation. The monetary authorities therefore had no option but to apply a more restrictive policy in order to reduce the downward pressure on the exchange rate and the upward pressure on the inflation rate.

Some critics of this policy have suggested that instead of showing what they call "a doctrinaire obsession with excessive overheating and excess demand in the economy" the Treasury and the Reserve Bank should have "identified the problem as a structural deficiency" and should have "reduced the propensity to import, coupled ... with a raising of the export content of the GDP".

This view totally confuses *short-term stabilisation* policy with *long-term structural* policy. Of course, measures should be taken to promote exports, import substitution, inward industrialisation, etc. Of course, measures should be taken to increase productivity. And, of course, measures should be taken to improve South Africa's capital-output ratio. But this is all part of the *long-term* economic strategy. To achieve these objectives and to raise the attainable growth rate will take time. In the short term the Reserve Bank and the Treasury have to accept the situation as it is. They have to deal in realities. And if the rates of increase of the money supply and total spending become excessive, they have to be curbed. If this is not done, the result would be a decline in the foreign reserves, a further depreciation of the rand and a marked rise in the rate of inflation – all of which could have harmful consequences. Not the least important of these consequences would be the undermining of long-term economic growth.

More attention to long-term strategy

Of course, recognition of the importance of short-term policies in no way obviates the need to give more attention to the co-ordinated and consistent application of the long-term economic strategy. I have considerable sympathy with those who claim that the authorities in South Africa always seem to be so pre-occupied with short-term economic measures that they give inadequate attention to the implementation of the long-term strategy. It is true as Keynes said, that "in the long run we are all dead". But that reality is no excuse for not giving long-term economic policies the attention they deserve.

Conclusion

The two points I have tried to make today about South Africa's economic future are, of course, interrelated. If South Africa can achieve effective political reform coupled with the maintenance of law and order, and if this leads to a material improvement in the capital account of the balance of payments, the country should get much closer to the achievement of its ideals of rapid growth, low inflation, a strong currency and a rise in the standard of living. But even with an improvement in the political situation, these goals will only be reached if effective and co-ordinated short and long-term economic policies are applied.

Alternatively, if South Africa does *not* succeed in improving its political position in the world and in moving towards the normalisation of its relations with other countries, the resultant need to maintain large surpluses on the current account of the balance of payments in order to finance continuous capital outflows, would also underline the need for effective short and long-term economic policies.

The single most important conclusion reached in this paper, however, is that the ideals of optimal growth, low inflation, a strong currency and a rising standard of living will not be achieved in South Africa without adequate progress in the field of political and constitutional reform and a consequential easing of the stresses and strains in South Africa's relationships with other countries.