Short versus long-term economic policy*

By Dr Gerhard de Kock, Governor of the South African Reserve Bank

Need to distinguish between short and long-term economic strategy

This paper deals mainly with short-term economic policy in South Africa in 1988/89. But it does so against the background of the *Long-Term Economic Strategy* for South Africa drawn up by the Economic Advisory Council of the State President in 1986 and subsequently accepted, with minor qualifications, by the Government. This approach is adopted because of a perceived need to clarify some of the differences and the interrelationships between the *objectives* and *nature* of short and long-term economic policies.

South Africa's long-term economic strategy

South Africa's accepted long-term economic strategy has as its *overriding purpose* the following:

> "The establishment and expansion of a soundly functioning economic order aimed at achieving the greatest possible economic growth and prosperity brought about by individual achievement and ability, with equal opportunities and acceptable circumstances for all individuals. This must take place within the framework of a market system in which private initiative and effective competition are actively promoted and State involvement is intended to support these objectives."

This strategy lays down policy guidelines to achieve the following *objectives* within five to ten years:

"(a) An increase in the long-term economic growth potential and the actual growth performance, as well as in the job creation ability of the economy, to such an extent as to reduce the unemployment rate significantly from the 1986 levels. In the past this appeared to be possible only when the economy grew at a rate of more than four to five per cent per year.

"(b) A reduction in the inflation rate to below the 10 to 15 per cent range within which it has fluctuated for large parts of the past one and a half decades."

The detailed policy proposals in the strategy were formulated on the basis of certain *general points of departure*. These include the following:

- "Domestic law and order will be restored and processes of political reform will become established in such a way that they gain wide support from most population groups in the RSA.
- "It is accepted that the Government ... will continue to follow a market-orientated approach to economic policy. This does not, however, imply that the free market should be elevated to the status of dogma or that the results of market forces should be accepted unquestioningly. The unique circumstances prevailing in South Africa will certainly require that market forces be influenced in the desired direction from time to time. When this type of intervention is justified ... it is preferable that the intervention should take place in an indirect manner.
- "It follows ... that when it is necessary for the Government to take corrective steps, it would choose its policy measures in such a way that the identified problem is addressed at source, i.e. at the point of origin of the problem ... The inflationary and other adverse consequences of overspending by government cannot, for example, be rectified by measures to curtail private consumption expenditure without causing other adverse effects. By the same token, the problem should be rectified at its point of origin if a problem of domestic overspending arises and has negative implications for the balance of payments, rather than by the introduction of measures such as an exchange rate adjustment or a general surcharge on imports."

The strategy is then set out in some detail under the headings of financial policy measures, manpower measures, measures directed at the increased provision and better utilisation of capital, export promotion and industrial protection measures, measures directed towards the promotion of orderly urbanisation, and rural development policy measures.

Of particular interest are the following prescriptions:

- "The average level of interest rates must be positive in real terms.
- "The part of gross domestic expenditure accounted for by government consumption and the public sector's claim on scarce capital and manpower must be structurally reduced ...
- "The Government's responsibility in the economy must be adapted and curtailed by ... implementing a purposeful programme of privatisation and deregulation.
- "A budget deficit, before borrowing, of at most three per cent of the GDP must be set as a general target ..."

As far as *monetary policy* is concerned the strategy prescribes:

* Address delivered at the Twelfth Annual Investment Conference of Frankel, Kruger, Vinderine Inc in Johannesburg on 14 February 1989

- "Monetary targets must be based on the long-term growth target that is being pursued as well as on the curbing of inflation with due regard to short-term considerations.
- "It is accepted that the setting of monetary targets will mean that interest rates (and also exchange rates) will have to be flexible enough to be able to be adapted to changing business cycle conditions with the object of exercising a stabilising effect on business cycle fluctuations."

As far as *exchange rate policy* is concerned the strategy accepts that –

"(a) it cannot be determined independently of monetary and fiscal policy, which therefore implies that a predetermined target cannot be set for the exchange rate between the rand and any other major monetary unit, especially not in a world of fluctuating exchange rates;

"(b) although a more stable exchange rate is obviously preferable to a less stable one, priority must be given to sustained domestic economic growth rather than to exchange rate stability ..."

New Economic Development Programme

As a supplementary aid to the implementation of this long-term strategy a new Economic Development Programme (EDP) is currently being drawn up by the Central Economic Advisory Service. In the nature of the case this will involve the quantification of some of the key variables in South Africa's economic future.

While this quantification exercise is to be welcomed, care should be taken from the outset to interpret it correctly. The mistake must not be made of viewing quantified projections for such variables as gross domestic product, consumption, investment, exports, imports, exchange rates, interest rates, the balance of payments and the rate of inflation as either *predictions* or overriding *targets* to be achieved "come hell or high water". Instead, these figures should be viewed as part of an internally consistent scenario or set of projections based upon a number of assumptions regarding such variables as the gold price, the exchange rates between the major currencies, commodity prices, the course of the international business cycle, political developments, etc.

It must be stressed that there can be no question of simultaneously setting independent *targets* for a variety of key variables. If, for example, a target is set for money supply growth, targets cannot also be set for either the exchange rate or interest rates. The interrelationship between these variables rules that out completely. Similarly, if priority is attached to setting and achieving a target for the rate of growth of real gross domestic product, it is logically inconsistent also to set specific targets, i.e. overriding aims which appear to be capable of realisation by the policy instruments available to the authorities, for the rate of inflation and the balance of payments.

Is the long-term strategy being adequately implemented?

The long-term economic strategy has much to commend itself. It is a strategy that 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 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.

If correctly and consistently applied, *and if the precondition of acceptable political reform coupled with the maintenance of law and order is met,* the long-term strategy should go a long way towards achieving its objectives, particularly that of raising the rate of economic growth and job creation. There is, however, widespread concern at the moment that the strategy is, in fact, not being adequately implemented. Ways and means of ensuring more effective and co-ordinated implementation of the strategy are accordingly being considered at present, and hopefully progress will be made in this direction in the near future.

Hands-on management involving direct controls?

There is, however, one approach to the implementation of the strategy which I for one cannot support. That is the proposal that the South African economy should be treated like a large private company – a kind of "South Africa Incorporated" – and subjected to so-called "hands-on management" involving direct controls such as quantitative import quotas, selective bank credit ceilings, exchange rate pegging, and some form of "incomes policy", i.e. wage and price controls.

Some proponents of such "hands-on management" claim that their approach can be reconciled with free enterprise and a market economy. They are wrong. They are sailing under false colours. If they are consistent they will recognise that what they propose is in fact a system of central planning and direct economic control. It is dirigism. Proponents of such a system are, of course, entitled to their views. But then they should hoist the correct flag. They cannot claim that the system they propagate is reconcilable with free enterprise and the operation of a market economy. It is not.

"Hands-on management" *involving extensive direct controls* is unthinkable without a socialistic "master plan" for the economy. Without such a plan the import controller, for example, might give import permits to enterprises A, B and C and deny such permits to D, E and F, while at the same time the credit controllers might, through their direct and selective quantitative credit ceilings, create a situation in which the banks refuse additional credit to A, B and C but extend it to D, E and F – a case of the right hand not knowing what the left hand is doing. Or think of the implications if the Board of Trade and Industries, in the absence of a master plan, were to select industries G, H and I for growth and to grant them tariff and import control protection, while at the same time the price controller inadvertently discouraged the expansion of these enterprises by fixing their prices too low and simultaneously stimulated industries J, K and L by fixing their prices too high. To avoid such unco-ordinated bureaucratic action, there would have to be a central plan.

Moreover, such a central plan would have to be *enforceable*. The person or persons responsible for the hands-on management of the economy would have to be given the power to *compel* private enterprises to act in accordance with the master plan. In the end, many private firms would therefore in large measure be told, "what", "how", "where" and "for whom" they should produce.

All of this would conflict directly with South Africa's accepted economic system. In South Africa's so-called "mixed" economy the Government determines the broad economic framework and strategy, and is itself responsible for certain important economic activities. But for the rest the system rests on private initiative, effective competition and the operation of free markets.

This system has never been one in which the Government "leaves everything to the working of free markets", as is sometimes alleged. The Government "manages" the economy in accordance with the economic strategy it has laid down. But in doing so it prefers to use market-oriented policy measures rather than direct controls which are usually accompanied by masses of bureaucratic "red tape" and which can often be circumvented quite easily. In other words, the Government recognises the existence of markets, appreciates their value to the economy and accepts that it can attain its economic objectives better by operating *via these markets* than by using direct controls. When, for example, it is considered desirable to protect certain sectors of manufacturing against foreign competition, this is done mainly by means of tariff protection and tax measures, rather than through quantitative import quotas.

Short-term economic policy

How does South Africa's present short-term economic policy relate to its long-term strategy?

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. In addition, in an open economy like that of South Africa, the balance of payments can be materially affected not only by cyclical variations in both the domestic and the world economy but also by a variety of exogenous economic and political developments. Short-term economic policy is therefore essential to stabilise as far as possible a host of inherently unstable variables in both the domestic economy and the balance of payments. This stabilisation can be viewed as the minimisation of the variance around the 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. Its theoretical underpinning is in essence a blend of "monetarism" and conservative Keynesian demand management.

If the total demand for goods and services in the economy outstrips the ability of the means of production to produce a comparable output, monetary and/or fiscal measures are employed to suppress the demand to the level of the output obtainable *at that time*. If this is not done, the overspending will be reflected in a deficit on the current account of the balance of payments, a shortfall of saving relative to investment, a 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 payments 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 the perceived current potential.

It follows that there are situations in which short-term economic stabilisation policy might appear to conflict with the objectives of the long-term economic strategy. Take the example of 1988. The upturn in the South African economy turned out to be much more vigorous than had been anticipated. *Real* gross domestic expenditure, which had already increased by 5 per cent in 1987, increased by a further 7 per cent in 1988. 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, a depreciation of the rand, a decline in the gold and foreign exchange reserves and new demand inflation. The monetary authorities therefore had no option but to apply a less accommodative or more restrictive monetary and fiscal policy in order to reduce the downward pressure on both the exchange rate and the foreign reserves 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 improve 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.

Recent economic developments

Against this background I would now like to comment briefly on recent and prospective economic developments and policy in South Africa.

If account is taken of the sombre background of political tension, sanctions and disinvestment against which the South African economy has had to operate since the end of 1984 - and particularly of the resultant net (non-reserve-related) capital outflow of roughly R25 billion since that time - the performance of the economy in recent years has been gratifying. South Africa has not only survived the economic warfare but has combined balance of payments adjustment with real economic growth.

Compared with ½ per cent in 1986 and 2½ per cent in 1987, the rate of growth of real gross *domestic* product is now estimated to have amounted to about 3 per cent in 1988. Real gross *national* product increased between the second quarter of 1986 and the fourth quarter of 1988 at an average annual rate of about 4 per cent.

The main driving force behind this forward surge was a rise in consumer and investment spending so steep that it lifted *real* gross domestic expenditure in 1988 to a level about 7 per cent higher than in 1987 and 12½ per cent higher than in 1986. It is particularly encouraging that total real gross domestic fixed investment increased by about 6½ per cent in 1988.

Further good news is that the acceleration of the growth rate over the past three years was accompanied by a marked decline in the rate of inflation. The twelve-month rate of increase in consumer prices slowed down from 20,8 per cent in January 1986 to a lower turning-point of 12,3 per cent in August 1988, and subsequently increased only marginally to 12,5 per cent in December 1988. Even more dramatic was the decline in the quarter-to-quarter increase in the consumer price index at seasonally adjusted annual rates, from 24,9 per cent in the first quarter of 1986 to 9,2 per cent in the first quarter of 1988. However, it then increased again to 13,9 per cent and 13,6 per cent in the third and fourth quarters of 1988, respectively.

Naturally the upsurge in domestic spending in 1988 brought about a reduction in the surplus on the current account of the balance of payments. According to the latest estimates, however, the current surplus recovered to a seasonally adjusted annual rate of about R5 billion during the fourth quarter of 1988. For the year 1988 as a whole, the surplus is now estimated at about R2,8 billion, which is considerably higher than most estimates made during the course of the year.

In addition, South African banks, other private enterprises and public entities continued to make substantial net repayments of foreign debt both inside and outside the "standstill net" in 1988. All in all the South African economy has now repaid about US$6 billion (close to R13,0 billion) of foreign debt since the end of 1984 – equivalent to about 6½ per cent of exports of goods and services during this period. Of this amount, about US$1,5 billion (just more than R3 billion) represented payments "inside the net". The remaining amount of US$4,5 billion (about R10 billion) included net repayments "outside the net" of bearer bonds and notes, credits of the International Monetary Fund, Reserve Bank credits and ordinary trade credits.

South Africa's ratio of foreign interest payments to exports of goods and services, which amounted to only 10,7 per cent in 1985, compared with an average of 30,2 per cent for Western Hemisphere developing countries, declined to about 6½ per cent in 1988. Similarly, South Africa's ratio of foreign debt to total exports of goods and services declined from a peak level of 171 per cent in 1984, which was not inordinately high, to an estimated 85 per cent in 1988. In contrast, the comparable ratio for Western Hemisphere developing countries deteriorated from an average of 273 per cent in 1984 to an estimated 322 per cent in 1988.

Against these favourable developments has to be set, however, the fact that South Africa experienced another large outflow of capital provisionally estimated at about R6 billion during 1988, most of which occurred during the period June to October. While this outflow included debt repayments, it also reflected substantial unfavourable "leads and lags" in current foreign payments, partly due to large-scale switching of trade financing from foreign to domestic sources of finance following the appreciation of the US dollar and the rise in overseas interest rates from June onwards. This short-term outflow was, however, arrested after the 2 per cent rise in the Reserve Bank's rediscount rates on 2 November 1988.

Since the net outflow of capital exceeded the current account surplus during 1988, South Africa's total gold and foreign exchange reserves (including those held by the banks) declined from R7,9 billion (US$4,1 billion) at the end of 1987 to R6,7 billion (US$2,8 billion) at the end of 1988. Judging by the behaviour of the Reserve Bank's foreign reserves, however, the downward tendency was arrested from November onwards.

Similar tendencies were shown by the exchange rate. During 1988 the commercial rand depreciated against the trade-weighted basket of currencies by 13,1 per cent. Since October 1988, however, it has shown an appreciation of about 2,5 per cent.

Implications for monetary and fiscal policy

What are the implications of these developments for monetary and fiscal policy in the months ahead?

In retrospect, it is clear that the monetary authorities, in common with most other observers, underestimated both the vigour and the duration of the economic upswing during 1988. Accordingly, although monetary policy was progressively tightened during the course of 1988, resulting in the prime overdraft rate rising from 12½ per cent in January to 18 per cent in November, the "mix" of monetary and fiscal policy on balance remained too accommodative and expansionary during most of the year.

This is evident from the behaviour of the broad money supply, M3, which increased by 26,5 per cent between the fourth quarter of 1987 and the fourth quarter of 1988, thereby overshooting the upper limit of the target range of 12 to 16 per cent by 10,5 percentage points. It is true that the velocity of circulation of M3, i.e. the ratio between nominal gross domestic product and M3, declined by about 7 per cent over this period. The result was that the *effective* broad money supply or MV, i.e. *M3 adjusted for changes in its velocity of circulation,* increased by about 17 per cent, compared with the 26,5 per cent increase of M3 itself. Even with this qualification, however, the rate of monetary expansion was still excessive and contributed to the undue pressure on both domestic resources and imports.

As far as fiscal policy is concerned, it now appears likely that during the fiscal year 1988/89 both government spending and revenue will greatly exceed the Budget estimates. The net outcome will probably be a "deficit before borrowing" close to, or even below, the Budget estimate of R9,9 billion, equal to 4,9 per cent of gross domestic product. The monetary authorities have also been successful in financing this deficit by appropriate "non-money-creating" means, i.e. by borrowing on the capital market and avoiding excessive use of bank credit. Gratifying as all of this is, however, the conclusion must be drawn that, like monetary policy, fiscal policy did not do enough to restrain the excessive rise in total demand during 1988.

Account must also be taken of the increase of some R6 billion in the Reserve Bank's claim on the Treasury arising out of the "losses" sustained by the Bank during the fiscal year 1988/89 in the performance of its assigned function of providing forward exchange cover, for the account of the Treasury, to authorised exchange dealers. While the Reserve Bank Act does not require this particular form of government debt to be repaid in the year in which it is incurred, the matter needs to be addressed as part and parcel of fiscal policy.

The main implication of all of this is that there can be no question of any relaxation of either monetary or fiscal policy in the months ahead. It is imperative that an appropriately restrictive mix of monetary and fiscal policy be applied.

It is true that there are some indications that the economic upswing is levelling off and that, in a technical sense an upper turning-point of the business cycle has either already been passed or is about to be reached. But we believed that to be the case six months ago, and we were wrong. Are we right this time? Is the rate of increase of general economic activity really slowing down? The answer appears to be – yes. But for the time being total spending, the demand for credit and the rate of increase of the money supply are all still excessive and must be curbed. The need for this has also been underlined by the recent decline in the dollar price of gold to levels well below $400 per ounce.

The fact is that the South African economy may be called upon to make debt repayments of anything up to US$1,7 billion or R4,2 billion in 1989, and that this figure could rise to a maximum of US$2,1 billion in 1990 followed by US$1,5 in 1991. Admittedly this is a "worst-case scenario", and in reality the required debt repayments will almost certainly be less. But the only prudent course for the monetary authorities to follow is to provide for current account surpluses in the next three years that will be large enough to finance whatever debt repayments may be required. Such surpluses are well within reach, *but only if the mix of monetary and fiscal policy is adequately restrictive in the period ahead.*

Likely scenario for 1989: assuming proper monetary and fiscal policy

What then lies ahead for the South African economy in 1989?

At this stage the most likely scenario for the South African economy in 1989 is one that provides for

- a growth rate of real gross domestic product of about 2 per cent;
- an *average* inflation rate of around 15 per cent, with the rate first rising to above that level but then resuming a downward tendency later in the year;
- a surplus on the current account of the balance of payments of R4 billion or higher;
- the further repayment of foreign debt to the full extent required, which is likely to amount to between \$1 billion and \$1,7 billion (R2,5 billion and R4,2 billion at the current exchange rate) in 1989 as a whole;
- the gradual rebuilding of the official gold and foreign exchange reserves to a more satisfactory level.

Such a scenario would, of course, fall short of the objectives set out in the long-term economic strategy, particularly those of a growth rate of 4 to 5 per cent and an inflation rate below the 10 to 15 per cent range of the past fifteen years. But in the existing circumstances it would nevertheless represent a satisfactory short-term outcome.

This serves as another illustration of the need to distinguish between short-term "stabilisation" policy and long-term "structural" policy. The long-term strategy needs to be applied with vigour and consistency. This includes above all else further political reform and steps to normalise South Africa's financial and general economic relationships with other countries. But in the meantime the authorities have no choice but to recognise the existing short-term constraints in applying their monetary and fiscal policies.

The scenario I have sketched for 1989 will, however, only come to pass if fiscal policy is less expansionary during 1989/90 than during the current fiscal year, and if the rate of increase of M3 is reduced to within the 12 to 16 per cent target range. If these conditions are not met, severe downward pressure could be exerted on the gold and foreign exchange reserves in the course of 1989, leading to a new depreciation of the rand and a rise in the average inflation rate to above the expected 15 per cent.

The challenge now confronting the Treasury and the Reserve Bank is therefore clear. The mix of monetary and fiscal policy in the months ahead must be restrictive enough to bring about the required decline in the rate of increase of total demand in the economy – otherwise the desired scenario for 1989 will not be realised.