The balance of payments constraint on economic growth in South Africa

Address by Dr Chris Stals, Governor of the South African Reserve Bank, at the "Tomorrow's Leaders Awards Banquet" arranged by Fringecor and the Sunday Star, Tuesday, 11 May 1993.

1. Introduction

This special occasion this evening is dedicated to "Tomorrow's Leaders". The six finalists in the competition sponsored by Fringecor in conjunction with Sunday Money are honoured for their contributions to the timely debate now taking place in South Africa on macro-economic policy issues, and on how to create a better future for all South Africans.

When I started my career in the Reserve Bank in 1955, I was appointed to the Exchange Control Department as a junior clerk. My introduction to central banking therefore started off with the challenge of managing one of the major constraints on economic growth in this country, and that is the constraint of the balance of payments.

Granted, in those days exchange controls as applied by South Africa formed an adjunct to our membership of the Sterling Area, and were intended mainly to prevent Sterling Area capital funds from flowing out of the Sterling Area to the "hard currency" countries. Over time, the Sterling Area disappeared and the distinction between "hard" and "soft" currencies faded away, but recurrent balance of payments crises in South Africa demanded the retention, and the extension, of our exchange controls.

On more than one occasion over the past thirty years, the external problem was triggered by non-economic events, such as the Sharpeville incident in the early 1960's, unrest in Black schools in 1976, and the politically motivated boycotts and sanctions of the 1980's. Throughout this period, however, the underlying weaknesses of the South African balance of payments surfaced from time to time, even on the rare occasion when South Africa did experience relative political and social stability.

The recent decline in the country's official gold and foreign exchange reserves served as a stark reminder of the vulnerability of the balance of payments. From the end of August 1992 to the end of March 1993, that is over a period of just seven months, we lost more than R6 billion, or almost half of the total official foreign reserves. The shock about this decline is that it happened during a period of severe recession in the domestic economy and with imports at a relatively low level. A combination of the after-effects of the drought of last year, an appreciation of the US dollar, relatively high real rates of interest in certain overseas financial centres and a deterioration in the domestic political situation contributed to the adverse balance of payments. The magnitude of the decline in the reserves, however, substantiated the notion that a much higher level of reserves will be required in future to support and sustain any new economic upswing.

South Africa has learned from the bitter experience of August 1985 that a country that allows a balance of payments problem to develop to a point where it can no longer be managed, pays a high price in terms of lost international credibility for its failure. Corrective action is therefore necessary at an early stage, which may even at times require the abortion of an economic upswing in its infancy.

2. Causes of the balance of payments problem

In some respects, in an open economy like we have in South Africa, the balance of payments reflects the net result of equilibrium, or disequilibrium, in the domestic economy. If there is a savings gap, that is, if domestic saving is not sufficient to cover domestic investment, the economy needs a net inflow of capital to cover the shortfall. Likewise, a trade gap with the domestic demand for goods and services exceeding domestic production, can only be covered by a trade deficit with the outside world. Such a trade deficit, however, must be financed with foreign exchange and a country with a trade deficit therefore needs a net inflow of capital from the rest of the world or, alternatively, a sufficiently high level of foreign reserves.

Reducing South Africa's vulnerability for the balance of payments problem therefore begins at home. It is domestic saving and investment that must in the long run be in equilibrium; it is domestic production and expenditure that must be aligned; it is the efficiency of our domestic industries that must be improved to make us more competitive in world markets.

Structural economic adjustment programmes initiated and supported by the International Monetary Fund and the World Bank normally are intended to improve the long-term balance of payments situation of the participating countries. The IMF has long learned the lesson that the continuous financing of a balance of payments deficit, without a well-structured adjustment programme, only perpetuates the problem. The Fund's conditionalities attached to its loan arrangements are therefore intended to restore equilibrium in the domestic economy, and thus to obviate future balance of payments deficits.

Efforts to address a balance of payments problem more directly, that is by manipulating imports, exports or capital movements, do not rectify the basic causes of the problem, and therefore often lead to even more controls. Such direct controls, like the borrowing of foreign funds to finance a deficit, can only alleviate the problem in the short run — real structural adjustment can be postponed for some time but cannot be avoided. What is even of greater concern is that the magnitude of an underlying disequilibrium situation increases with time, and the delay of adjustment usually necessitates even more painful corrective action at a later stage.

3. The South African balance of payments problem

On the surface and from a first and cursory analysis of the developments in the South African balance of payments in recent years, a deduction may be made that our external economic problem is mainly confined to the capital account. Ever since 1985, total exports of goods and services in each year exceeded total imports by a comfortable margin, ranging in total from R2,7 billion in 1988 to R7,4 billion in 1991. Over the period of eight years as a whole, the cumulative current account surplus amounted to more than R40 billion.

Exports of merchandise did extremely well over this period, having increased in real terms by 8,5 per cent per annum over the eight years. It should, however, be taken into account that the domestic economy remained fairly depressed, and that imports therefore stayed relatively low. Imports as a percentage of gross domestic expenditure indeed increased from 20,8 per cent in 1985 to 24,6 per cent in 1992, indicating that the so-called import penetration ratio increased in recent years. We can therefore expect our imports to rise quite sharply once our domestic economy moves into the next upward phase of the business cycle. The current account could then very easily move into deficit again.

Large net outflows of capital since 1985 not only absorbed all the surpluses on the current account, but also depleted the country's net gold and foreign exchange reserves to almost zero in the middle of 1989. Since then, the Reserve Bank's net gold and other foreign assets increased again to R11,5 billion in August last year, before declining to R5,3 billion at the end of March 1993.

The total cumulative net outflow of capital from 1985 to 1992 amounted to R42,2 billion, thereby exceeding the total surplus on the current account by a small margin which had to be financed from the foreign reserves. These large capital outflows were partly politically motivated, and partly reflected the changing trends in capital flows in the global system.

At this juncture, we must ask ourselves what the possibilities are of changing the historical pattern of the South African balance of payments. Can we do something to avoid a rapid deterioration in the current account even in the early stages of every upswing in domestic expenditure, and can we reduce the capital outflows and even look forward to some capital inflows to finance future current deficits? Such capital inflows will, at the same time, supplement the limited amount of domestic saving. These represent crucial questions in any programme for economic restructuring, and for the attainment of a higher rate of economic growth in the new South Africa.

4. The solution for the balance of payments problem

For many years, South Africa relied heavily on exchange controls to constrain the net capital outflows, and on tariffs, subsidies and other protective measures to influence imports and exports. Within these constraints, deflationary domestic demand management measures intended to depress domestic expenditure and thus also imports, were used from time to time with the objective of improving the balance of payments situation. The exchange rate of the rand, also within the framework of direct controls and the overall demand management system, played some further part in the quest for balance of payments equilibrium.

This mixture of policy measures sometimes worked against each other, distorted the allocation of resources, and contributed to a rather complex and intransparent policy framework. Measures were often introduced as a defensive action taken in reaction to politically motivated actions, with the intention to remove them again once the offensive political actions were terminated.

Now that South Africa is moving towards a new political dispensation, we may soon have the opportunity of reviewing our balance of payments policies as part of a major restructuring of the total economy. In the final situation, balance of payments equilibrium will be established in a market-oriented system only in a situation where market forces will be relatively free and will be allowed to establish realistic prices for imported and for domestically produced goods. This is, of course, not the case in the present environment where prices, including interest and exchange rates, are grossly distorted by the existing exchange controls, restrictive trade measures and export subsidies.

A revision of the various measures affecting the balance of payments, without a simultaneous programme for an improvement of the domestic economic structure, will of course be of no avail. As previously stated, the balance of payments of a country can be regarded as a symptom of the domestic economy, and serious balance of payments disequilibrium as a reflection of deficiencies in the domestic structure. To treat the symptoms without curing the causes will not provide any sustainable solution.

A reduction in the existing exchange controls at this stage without making the country more attractive to foreign investors, or a depreciation of the currency while the cost of domestic production is continuously increasing and is pricing us out of the market place in any case, will present no real solution to the balance of payments problem. The recommended sequence of actions is clear — first eliminate the many deficiencies in the domestic economy, and then tackle the balance of payments problem.

Against this background, a balance of payments programme as part of the gradual improvement of the overall structure of the South African economy and implemented mostly in the later stages of the restructuring programme, should include the following:

* a removal of the present import surcharges which were introduced in 1988 as a special balance of payments protective measure;
* a simplification, reduction and stabilisation of the existing import tariff structure;
* a major revision of the export promotion system (GEIS), with the objective of making it more efficient and, where possible, less costly;
* a gradual phasing out of the exchange controls, particularly those applicable to non-residents;
* the encouragement of foreign investment in South Africa, especially direct investment in the form of equity ownership and participation; and
* the acceptance of relatively free exchange rates determined by market forces. Intervention should be intended to "lean against the wind" only, and to avoid disorderly adjustments, but should not fix an unrealistic level for the exchange rate, neither in the form of an undervalued or an overvalued rand.

It is, of course, also assumed that in the future situation, South Africa will again have normal access to the facilities of the International Monetary Fund and the World Bank. The IMF, however, does not provide a country with development funds for application within the domestic economy, but only with foreign exchange assistance to bridge temporary balance of payments deficits of a current account origin. It is normally expected of members to repay loans from the IMF within a three to five year period, that is, after the balance of payments disequilibrium has been corrected. The availability of this type of assistance could nevertheless play an important part in easing the balance of payments constraint on economic growth, particularly to the extent that it now restricts the scope for any stimulation of the domestic economy out of fear that it could easily lead us into a balance of payments crisis.

Loans from the World Bank, on the other hand, are normally directly linked to development programmes and will undoubtedly make an important contribution towards raising the growth potential of South Africa to a higher level. The readiness of these two multinational institutions to participate again in financing arrangements for South Africa, will also have an important effect on private sector investors, and even on the governments of other countries. We therefore look forward to the imminent return of these two international institutions to the South African financial and economic development scene.

South Africa should, nevertheless, remain modest in its expectations on the amount of foreign finance that may be available for its future development. There is fierce competition in the world today for the scarce amount of savings available, and many other developing countries, for example in South America, are a few steps ahead of us in this contest. Even if funds should be available in unlimited amounts, the absorption capacity of any country for foreign loans is limited. The servicing of the foreign debt in the form of interest payments and capital redemptions requires foreign exchange that must be earned in the hard way through current account surpluses, unless existing loans can always be rolled over at maturity. As South Africa has learned from the experience of 1985, this is not always possible.

5. Conclusion

The balance of payments problem normally begins at home. Any improvement in the efficiency of the domestic economic structure will also benefit the balance of payments in the longer run.

South Africa has a wonderful opportunity together with the political and social reforms that are now being introduced, also to review its macro-economic policies. As part of an economic adjustment programme, a number of things must be done to improve the balance of payments situation. It will be of no avail, however, to introduce such changes before attention has been given to the minimum corrections required for an improvement of the domestic economic structure. Our own industries must first become more productive and efficient, for then the balance of payments problem will at least partly recede by itself.

In the final situation, the balance of payments remains a sensitive regulator that will always serve as a reminder to ourselves of our own economic limitations. No nation can live beyond its means for any lengthy period of time without running into an external economic problem. The balance of payments therefore serves as a sensitive disciplinary force on all countries and as a constant reminder that there is no alternative for hard work. Provided we can motivate ourselves and provided we can enable all the people of this country to become more productive, it is possible to shift the balance of payments constraint upwards to make a higher growth rate possible on a sustainable basis. Only then will the dream of greater prosperity for all the people of South Africa become a reality.

This, I believe, is the message I read in the contributions of the majority of the participants in this competition.