Mr Stals looks at South Africa's financial and economic prospects for the next five years

Address by the Governor of the South African Reserve Bank, Dr Chris Stals, at conferences organised by Omega Investment Research (Pty) Ltd held in Frankfurt on 25/1/99 and Zurich on 27/1/99.

This overview of the South African economy is presented in three parts. Firstly, recent developments in the economy and the current situation are summarised to provide a background for possible future developments. Secondly, the more important structural economic adjustments that are now in progress and that will have an important influence on the course of future developments are referred to. Thirdly, a longer-term view is taken of developments over the most recent past two five-year periods, supplemented with a forecast for the next five years.

1. Recent developments and the current situation

The year 1998 turned out to be a very frustrating one for the South African economy. During the first quarter, encouraging signals of an imminent improvement in underlying conditions emerged. Substantial amounts of foreign capital flowed into the country, mainly in the form of portfolio investments in South African bonds and equities. The country's foreign reserves increased sharply; there was upward pressure on the exchange rate of the rand; domestic liquidity increased; and interest rates declined.

At that stage, there was some optimism that the fairly depressed conditions in real economic activity since the second half of 1997 would be turned into a new upswing during the course of 1998. Growth in real gross domestic product, which had declined from a level of about 3½ per cent per year in 1995 and 1996 to below 2 per cent in 1997, was predicted to rise again in 1998.

However, the South African economy was severely shocked when the large inflows of foreign funds in the form of portfolio investment in South African bonds were suddenly reversed in May 1998. Non-residents increased their holdings of South African bonds by R16 billion during the first four months, but then became net sellers, and reduced their holdings of South African bonds by R26 billion over the next eight months. It is interesting to note that, throughout last year, non-residents remained more positive about investment in South African equities and increased their holdings of shares acquired through the Johannesburg Stock Exchange by R42 billion over the year as a whole. Despite the large disinvestment in bonds, non-residents still increased their overall holdings of South African securities by R32 billion.

The abrupt change that took place in May in the Bond Exchange nevertheless had far-reaching effects for the South African financial situation. The yield on long-term government bonds, for example, rose from a monthly average of 12.9 per cent in April to over 18 per cent in September, and fluctuated widely on a daily basis to peak at over 21 per cent at one stage. The adverse effects of the net selling of bonds by non-residents quickly spilled over into the market for foreign exchange. Pressures in this market led to an eventual devaluation in the nominal effective exchange rate of the rand of 16.4 per cent from the end of April 1998 to 31 December 1998. The country's net gold and foreign exchange reserves, which increased by almost R19 billion over the fifteen months that ended in March 1998, then declined again by R12½ billion over the last three quarters of last year. At the end of 1998, the total official reserves of the country amounted to about R31.6 billion, the equivalent of about two months' imports.

These changes in the capital account of the balance of payments, which were obviously directly linked to the worldwide dispersion of the East Asian crisis, forced the Reserve Bank to switch to a more restrictive monetary policy. The interest rate on the Reserve Bank's daily repurchase transactions with banking institutions increased from below 15 per cent in early April 1998 to almost 22 per cent in August. In light of the declining amount of liquidity in the banking sector, and the rising rate for Reserve Bank accommodation, banking institutions raised their prime lending rate from 18 per cent in April 1998 to over 25 per cent in August.

With these adverse developments in the financial markets, the outlook for an early improvement in real economic activity faded. On the contrary, overall economic activity slowed down further. In the third quarter, total real gross domestic product indeed showed an annualised rate of decline of 2½ per cent. It is estimated that, on balance, total gross domestic product in 1998 was not much different from that of 1997.

The negative developments in the global financial and commodity markets had some adverse effects also on the current account of the balance of payments. The deficit indeed increased from a level of about R7 billion in the first half of the year to a level of about R18 billion in the second half. Special imports, however, contributed to this increase in the negative balance, and indications are that the growth in imports is now slowing down in line with the more depressed domestic demand, whereas certain exports are beginning to react positively to the depreciation of the rand last year.

Short-term developments in the South African economy were therefore very much affected by the turmoil of the past year in the global financial markets, and by negative developments in international commodity markets. The current situation creates frustration for the monetary authorities, who have an understanding of the need for some stimulation of domestic demand, but also an obligation to protect overall financial stability in an unfriendly and volatile international financial environment.

The strong link between internal economic developments in South Africa and changes in the international situation was illustrated clearly when global financial markets became more stable towards the end of last year and in the early weeks of 1999. The strained South African financial situation simultaneously eased to such an extent that the exchange rate of the rand appreciated from about R6.30 to the United States dollar in August 1998 to R5.70 early in January 1999. Domestic interest rates declined by about 3 full percentage points from the extremely high levels reached last year.

In the past ten days, however, negative developments in the Brazilian situation once again created new pressures in the South African market for foreign exchange, and put some brakes on the declining trend in interest rates. In the short term, the fate of the South African economy is now to an important extent determined outside of the country. Should the international situation stabilise and improve during the course of 1999, the South African economy will be sure to follow.

2. Structural economic adjustment

As already explained, cyclical developments in the South African economy turned negative in 1997 and remained depressed throughout 1998. The business cycle will hopefully swing more positive again as the international financial situation becomes more stable (in the second half of this year?). There are, however, a number of fundamental or more basic deficiencies in the economy which were identified by Government in its Macroeconomic Strategy for Growth, Employment and Redistribution (GEAR), published in June 1996, and which also needs attention.

In the GEAR document, Government recognised that the most important economic problem facing South Africa at this juncture is the large and growing unemployment in the country. This problem not only provides a serious economic challenge for macroeconomic policy, but also contributes to adverse socio-political developments. For example, the seriously disrupting crime and violence situation in the country can be linked directly to growing unemployment. In its turn, the crime and violence makes economic recovery more difficult. The country is therefore trapped in a vicious circle of growing unemployment, more crime and violence, lower economic growth, and, therefore, more unemployment.

The Government's GEAR programme supports its earlier Reconstruction and Development Programme (RDP), providing for the social upliftment of the South African community, particularly of the disadvantaged groups of the past. The RDP focused the attention on the demand side of the economy, that is on the huge and legitimate needs of millions of South Africans that still live in poverty. It is understood by Government, however, that the means to provide for RDP can only come from increases in the production of goods and services. The disappointing past performances of the supply side of the economy must therefore be addressed in order to make it possible to meet the accumulated pent-up demand by producing more goods and services in the country.

The main strategies in the GEAR programme provide for the following:

- a fiscal deficit reduction programme to contain debt service obligations, counter inflation and free resources for investment;
- a reduction in tariffs to contain input prices and facilitate industrial restructuring;
- a commitment to moderate wage demands, supported by an appropriately structured flexibility within the collective bargaining system;
- an exchange rate policy to keep the real effective rate stable at a competitive level;
- a consistent monetary policy to prevent a resurgence of inflation;
- the gradual relaxation of exchange controls;
- the restructuring of state assets (privatisation);
- tax incentives to stimulate new investment in competitive and labour-absorbing projects; and
- a strengthened levy system to fund training on a scale commensurate with needs.

South Africa is in a process of gradually implementing the GEAR strategy, although Government is often criticised for moving too slowly, particularly with the privatisation programme, and with the introduction of more flexibility in the labour market. The adverse cyclical developments of the past eighteen months, and the dismal performance of the economy in the short term, encouraged the critics of GEAR to condemn it as a failure. There are therefore strong pressures within the country for Government to relinquish the strategy and to replace it with a more populist approach.

Government, however, remains committed to the gradual restructuring of the economy with the objective of raising the economic growth potential to at least 5 per cent over a six-year period. It is admitted that some of the strategies provided for in the 1996 GEAR document may need some revision in light of recent economic developments, but the essence of the strategy must be retained and must be pursued and implemented with determination.

In a recent study of the South African economy, economists from Goldman Sachs of New York concluded as follows: “The GNU (Government of National Unity) successfully led the country through the first phase of the transition (1994-98) from the apartheid era. The GNU completed a program of structural reforms, including progressive current and capital account liberalization, committed to respect the independence of the SARB (South African Reserve Bank), and announced a development strategy emphasizing gradual fiscal consolidation.

However, a second round of structural reforms to address structural rigidities on the supply-side of the economy are required if real GDP growth and employment are to be boosted in a significant and sustainable way. These reforms include liberalization of labor markets, completion of the trade reforms, completion of capital account liberalization, and further public sector reform -- including an aggressive privatization program”.

3. Longer-term developments in the South African economy

Turning to the longer-term developments in the South African economy, it is interesting to note that some remarkable improvements did take place in parts of the economy over the past five years. An analysis of a few selected key economic indicators of developments over the past ten years (see Table 1 attached to this document) reveals the following:

- The rate of growth in real economic activity as reflected in changes in gross domestic product increased from a yearly average of 0 per cent in the first period (1989 to 1993) to 2 per cent in the second period (1994 to 1998). Similarly, the rate of growth in real gross domestic expenditure changed from minus ½ per cent to positive growth of 3 per cent per annum. Greater confidence was also reflected in a substantial improvement in gross domestic fixed investment, which declined by 2½ per cent per year from 1989 to 1993, but then increased by 7 per cent per year from 1994 to 1998. One of the emerging weaknesses in the economy is reflected in the decline over these two periods in gross domestic saving as a percentage of gross domestic product, from an annual average of 19 per cent in the first, to 16 per cent in the second period.

- Where the economy failed most was in the creation of jobs. Total employment indeed declined by an average annual rate of 2 per cent from 1994 to 1998, which was even worse than the average decline of 1.3 per cent in the preceding period of five years. Despite the further increase in unemployment, the annual rate of increase in average real wages and salaries more than doubled, from 1.7 per cent in the first, to 3.9 per cent in the second period.

- A further positive development was a dramatic switch-around in the net capital flows from abroad -- from persistent outflows before 1994 to a cumulative net inflow of more than R50 billion over the next five years. The relatively large capital inflows made it possible to tolerate a deterioration in the current account of the balance of payments -- from forced surpluses in the first, to continuous deficits in the second period, reflecting a substantial increase in total domestic expenditure at a rate that outpaced the rate of growth in gross domestic product. It should also be noted that, with the removal of international boycotts and sanctions against South Africa after 1993, both merchandise imports and exports started expanding at a much higher rate.

- A further important improvement in the economy is reflected in the decline in the average annual rate of inflation, which was still in double digit territory during the first period, but stayed comfortably below the 10 per cent level in the second.

It is obvious from an analysis of the macroeconomic statistics that, in the process of structural adjustment, South Africa must, over the next five years, succeed in its stated objective to turn around the trend of the past ten years for total employment to decline consistently. This remains the most daunting challenge for the South African economy.

The forecast for possible developments over the next five years provided in Table 1 is, like all economic forecasts, based on past trends, and on discretionary assumptions about possible future developments. For the purpose of this forecast, it was assumed that Government will continue to implement the GEAR strategy and will retain disciplined fiscal and monetary policies. It was also assumed that South Africa will be able to attract a fairly substantial amount of foreign investment funds over the next five years -- an amount at least equal to the total net inflows of the past five years, with hopefully a greater part of it in direct instead of portfolio investment.

A further requirement for the strategy to succeed is that monetary policy will remain fairly restrictive, and interest rates will be retained at a relatively high level. It also requires some further reduction in the deficit on the Budget of central government from about 4½ per cent of gross domestic product this year to 2½ per cent in the near future.

It should, furthermore, be remembered that, apart from the shortcomings of the economy referred to above, South Africa also offers many advantages that provide a strong basis for future economic development. These include a well-developed infrastructure, sound and well-managed financial institutions, sophisticated and modern financial markets, and highly-developed skills and experience in areas such as engineering, architecture, the legal professions, medical care, and business management. Add to this the possibilities that are being opened up for an expansion of South Africa’s economic relations with the rest of Africa, and there are many reasons for being optimistic about the economic potential of the country.

On the assumptions made about the implementation of macroeconomic policy, and on condition that the existing advantages present in the South African economy will be protected and further expanded, the following forecast for possible developments in the South African economy over the next five years does not seem to be unrealistic.

- The capacity of the economy to produce goods and services will be raised gradually to reach a level of 5 per cent by the year 2004. This will give an average annual rate of growth in gross domestic product of about 3 per cent over the next five years.

- Net capital inflows into the country at a rate of more than R10 billion per annum will make it possible to maintain growth of at least 3 per cent per annum in gross domestic expenditure, also rising gradually to about 6 per cent per year by 2004.

- This will include a continuous growth in gross domestic fixed investment at an average rate of 4 per cent per annum.

- The current account of the balance of payments will remain under pressure, and a rising deficit will require more capital inflows. Positive steps will have to be taken (in line with the GEAR strategy) to attract more direct foreign investment into the country.

- Inflation will decline gradually and will come in line with the level of inflation in the major industrial countries of the world.

- The process of gradually removing exchange controls will be completed, and South Africa will become even more integrated in the world economy.

- South Africa’s leading economic role in Southern Africa will be firmly established through SADC, and will gradually expand beyond the Southern Africa region.

It must be expected that the path of economic development in South Africa over the next five years will not be a smooth one. The structural economic reforms, further integration in the world economy, and the continuing socio-political reforms in the country will all at times have a destabilising effect on the domestic economy. It will be extremely difficult at this stage to provide any sensible year-to-year forecast of possible developments in the economy. The attempt to take a longer-term perspective covering the next five years, therefore, makes more sense.

The forecast also indicates that total employment in the country should soon start rising, although it will still require a major effort to make up for existing backlogs.

4. Conclusion

Based on a short-term analysis, the South African economy is rather depressed at this stage, and is very dependent on some improvement in the international economic environment for sustainable recovery.

An analysis of developments in a few important macroeconomic aggregates reveals significant improvements in the performance of the overall economy over the past five years, but also exposes a few structural weaknesses that must be addressed urgently in order to raise the total production capacity.

Finally, if well-managed, the South African economy has the potential of making further steady progress over the next five years to reach the objective of at least 5 per cent growth per annum, and of creating more jobs.

Should the country want to achieve more ambitious targets in the next five years, and I believe even that would be possible, we shall, in the words of the Goldman Sachs economists, have to apply the same strategies, but with less timidity, and more aggression.

Table l: Selected Key Economic Indicators

(Average annual percentage changes, unless otherwise indicated)

	1989 to 1993	1994 to 1998	1999 to 2003*
1. Real gross domestic product	0	+2	+3
2. Real gross domestic expenditure	-½	+3	+3
3. Real gross domestic fixed investment	-2½	+7	+4
4. Ratio of gross domestic saving to gdp	19	16	...
5. Employment	-1.3	-2.0	+1
6. Real salaries and wages per worker	+1.7	+3.9	1.5
7. Balance of payments (R billions)			
	+R 5.2b	-R 7.9b	-R 9b
* Current account (average)	-R26.6b	+R50.9b	...
* Capital account (cumulative total)			
8. Merchandise			
* Imports	+2.2	+9.2	+7
* Exports (including gold)	+2.9	+6.4	+5
9. Consumer prices	+13.6	+8.1	5.5
10. Prime overdraft rate of banks (level)	19.2%	18.9%	15.5
11. Central Government Budget deficit as % of gdp	4.9	5.1	2.5

*Forecast

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