T T Mboweni: The restructured South African economy

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the South Africa ten years on - empowerment, finance, trade and investment conference, Cape Town, 20 May 2004.

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1. Introduction

Ladies and Gentleman, thank you for the invitation to speak at this conference. After ten years of democracy in South Africa, I think it is useful to consider what we have achieved and what challenges we will still have to face. My address this morning is a summary of a more detailed chapter that I wrote on this same subject for a book to be published by the World Economic Forum entitled "South Africa, The Miracle Continues". This may be a book of interest to many of you. I believe it will be launched at the Africa Economic Summit 2004, which will be held from 2 to 4 June in Maputo, Mozambique.

2. The South African economy in 1994

When the first democratically elected South African government came to power in 1994, the country was to a large extent economically isolated from the rest of the world. Trade boycotts, economic sanctions, disinvestment, the withdrawal of other capital and the declaration of a partial debt standstill from September 1985, forced the authorities to pursue an inward-oriented policy that had a severe impact on domestic economic performance. At the time of the standstill, the affected debt amounted to US$13,6 billion and the total debt amounted to US$23,7 billion. As a consequence living standards deteriorated, economic growth was constrained, unemployment rose, productivity growth slowed down and economic management became less effective.

The refusal of foreign creditors to roll over the short-term credit facilities of domestic borrowers led to a shortage of foreign exchange and a confidence crisis in 1985. Despite the debt standstill on the repayment of foreign debt, capital continued to flow out of the country. At first this consisted mainly of short-term capital that was not affected by the standstill arrangements. Blocking this capital would have jeopardised trade flows. Later these capital outflows also included amounts which became payable in terms of the various standstill agreements. From the beginning of 1985 to 1993 the net financial outflow from South Africa amounted to about R45 billion, or to 11 per cent of gross domestic fixed investment.

As a result of this outflow, the South African authorities were forced to generate current account surpluses. The gold and other foreign reserves of the country remained at low levels and domestic savings had to be used to finance the withdrawal of capital. The balance of payments constraint effectively limited the policy options the authorities had at their disposal. Although the forced repayment of loans improved the overall foreign debt position of the country, the policy of constrained domestic expansion called for huge sacrifices by the South African population and continued to affect the domestic economy for a long time after 1994.

3. Global integration

Even before the new government came to power, many countries started to normalise trade relations with South Africa when it became apparent that the political transition would be negotiated in a peaceful manner. Trade boycotts, economic sanctions and the disinvestment campaign were suspended. However, debtors in South Africa had to continue making repayments on debt affected by the standstill arrangements for a number of years. The standstill only ended on 15 August 2001 when the final repayment on the affected debt was made. In the meantime, the South African government started raising funds again on international capital markets from 1995 and non-residents resumed investing in private entities in the country.

This normalisation of international relations allowed the newly-elected democratic government to gradually reintegrate the domestic economy into the global environment. High priority was given to the reform of trade policy in this process.

The trade regime at the beginning of the 1990s was characterised by three interrelated strategies, namely the promotion of domestic industries through import substitution, the development of specific industries to attain self-sufficiency and the promotion of mineral beneficiation. South Africa's industries therefore became heavily protected by formulae, specific and *ad valorem* duties and surcharges. High tariff levels were complemented by quotas that limited the quantity of imports. The tariff structure was extremely complicated. Overall the strategies pursued by the authorities resulted in a complex discretionary regime with an anti-export bias.

After the transition in 1994, government became committed to a policy of import liberalisation, and agreed to import tariff reductions to levels even lower than that required by GATT, i.e. the predecessor of the World Trade Organisation. Key aspects of the trade reform included a five-year tariff reduction and tariff rationalisation programme; a decrease in tariffs and subsidies on agricultural products and the conversion of all quantitative restrictions on agricultural imports to *ad valorem* rates; an increase in the number of binding rates applicable on industries as well as in the percentage of zero tariff lines to total tariff lines; a phasing out of the export subsidy scheme applicable at that time, which was called the "General Export Incentive Scheme (GEIS)".

As a result of these changes to the tariff regime, the number of tariff categories was reduced from over 100 to only six and the average weighted import duties on manufactured goods to the total value of manufacturing imports decreased from 14,0 per cent in 1994 to 4,7 per cent in 2002. Several free trade agreements were also signed to dismantle trade barriers and to gain increased market access.

In addition to these measures undertaken to promote competition, industrial policy was adjusted to enhance the competitiveness of manufacturing enterprises in export markets. In particular more emphasis was placed on supply-side measures, rather than demand-side measures such as expensive export support programmes. These measures included investment incentives for large investments of a strategic nature and for small and medium enterprise development; training grants to firms investing in the promotion of skills; the development of industrial development zones; improved access to finance; and support for investments in economic infrastructure.

A new Competition Act was passed in Parliament in 1998 to, among other things, create a greater spread of ownership in enterprises, to expand opportunities for South African participation in world markets and to provide consumers with competitive prices and product choices. The Act further focuses on preventing any form of anti-competitive conduct by a firm or a group of firms arising from agreements. Institutions were established in terms of the Act to ensure that these objectives are achieved and to monitor implementation and adherence to the law.

A further step to reintegrate the South African economy into the world economy was the gradual dismantling of exchange controls. The financial rand system was already abolished in 1995 and considerable success has been achieved in relaxing all the other controls. Limits are still applicable on the amounts that residents and emigrants may repatriate from South Africa, but these limits have been increased progressively over the past ten years. Moreover a foreign exchange control amnesty and accommodating tax dispensation were announced in February 2003 to allow individuals to bring funds back that are held illegally offshore or to pay a 10 per cent charge on funds remaining offshore. The amnesty offers individuals an opportunity to regularise their affairs. The period for filing for amnesty relief ran up to 29 February 2004.

4. Fiscal policy

The liberalisation of South Africa's trade relations with the rest of the world was accompanied by considerable changes in the management of public finances. At the beginning of the 1990s an unsustainable fiscal situation had started to develop, and the deficit before borrowing and debt repayment of the government reached 7,3 per cent of gross domestic product in the fiscal year 1992/93. Government expenditure continued to rise relative to domestic production, the tax burden increased, the public sector made increasing demands on the domestic capital market, the ratio of government's interest payments to gross domestic product rose steeply and government dissaving increased to unacceptably high levels.

The post-apartheid South African government therefore placed considerable emphasis on restoring fiscal stability. The economic strategy at first was to create stable macroeconomic conditions as a necessary precondition for sustained growth and employment creation. It was believed that by improving fiscal sustainability, poverty reduction and income redistribution would become attainable objectives over the medium term. The expenditure restraint applied by the national and provincial governments reduced the fiscal deficit before borrowing and debt repayment to 1,5 per cent of gross domestic product in fiscal 2001/02.

This successful fiscal consolidation allowed the government to adopt a more expansionary fiscal policy stance from fiscal 2001/02. More emphasis was placed on infrastructural development and social upliftment than in the previous years. The government, however, continued to apply fiscal discipline and despite a decline in the growth of tax revenue, was able to contain the main budget deficit to an estimated 2,4 per cent of gross domestic product in fiscal 2003/04. Economic growth was primarily promoted by microeconomic reforms to boost the supply side of the economy, rather than by stimulating demand through rapid increases in expenditure and the lowering of taxes.

An important aspect of the budget reform was the adoption of the Medium-Term Expenditure Framework in the fiscal year 1998/99 and the Public Finance Management Act of 1999. The Medium-Term Expenditure Framework consists of three-year rolling expenditure and revenue projections for the national and the provincial governments. This creates greater certainty and transparency to the budgetary process. The Public Finance Management Act has enhanced the accountability of public sector managers by emphasising disciplines such as regular financial reporting, sound internal expenditure controls, improved accounting standards, performance monitoring and independent audit and supervision systems.

The asset and liability management of government has also changed considerably over the past ten years. After years of isolation, the South African government established itself again as a credible borrower in the international capital markets. This is reflected in the upgraded credit ratings received from international rating agencies since 1994 and the continued interest in investing in bond issues of the national government. However the government has maintained its foreign debt well within appropriate levels. At the end of December 2003 the foreign debt of the national government amounted to only 6,0 per cent of gross domestic product.

In the domestic market the government's strategy has been aimed at reducing borrowing costs and risk, managing maturity profiles, diversifying funding instruments, increasing transparency and building credibility. The marketing of government debt through primary dealers was introduced in 1998, followed by a debt consolidation programme in 2002. The funding instruments were also diversified from fixed income bonds and treasury bills to inflation-linked bonds, variable rate bonds and retail bonds. Moreover, considerable progress has been made in improving cash management through investments in interest-bearing deposits.

As a result of all these measures the government has been able to reduce its net loan debt from a peak of 48,1 per cent of gross domestic product in fiscal 1996/97 to 36,8 per cent in 2003/04. This not only contributed to lower interest payments on total public debt, but also to generally lower long-term yields in the South African capital market. The prudent measures applied by government have brought about a decline in government net dissaving from the high level of 7,3 per cent of gross domestic product in 1992 to 1,1 per cent in 2003.

5. Monetary policy

The more normalised relations with the rest of the world made it possible for the authorities to focus monetary policy on the creation of a financial environment that would be conducive to the attainment of the growth potential of the country. The objectives of monetary policy at the beginning of the 1990s were to reduce the rate of inflation to the average rate of inflation in trading partner and competitor countries; to manage the money creation process in such a way that an adequate, but not an excessive amount of new money would be supplied to the system; to maintain positive real interest rates; to increase the gold and other foreign reserves to a comfortable level and to develop a sound financial infrastructure consisting of healthy financial institutions and financial markets.

In the 1990s the Reserve Bank also intervened heavily on its own initiative in the spot and forward market to influence supply and demand in the foreign exchange market. These operations were undertaken to smooth out large short-term fluctuations in the exchange rate, but it was explicitly stated by the Bank that it did not target the level of the exchange rate. The extent to which the Bank intervened in the foreign exchange market was clearly reflected in the changes in the net open position in foreign reserves (NOFP), i.e. the net gold and other foreign reserves of the Bank less the balance on its net oversold forward book. For example, on 30 September 1998 the NOFP reached a peak of US$23,2 billion.

Despite this active intervention, large fluctuations occurred in the weighted average external value of the rand, particularly during the second half of the 1990s in an environment of more liberalised exchange controls. The monetary policy measures, however, achieved considerable success in bringing the rate of inflation down. After inflation in the consumer price index had generally fluctuated around a level of about 15 per cent in the late 1980s and the beginning of the 1990s it moved below double digits in 1993 and declined to 5,2 per cent in 1999.

In February 2000 the government announced that South Africa had formally adopted an inflation-targeting monetary policy framework to make monetary policy more transparent and accountable and to promote a more co-ordinated approach with other policy measures. In the application of inflation targeting in South Africa, it was decided to leave the external value of the rand to the market and not to intervene in the foreign-exchange market to influence the exchange rate. It was realised that this could lead to volatility in the exchange rate of the rand. Although the Bank would have preferred to operate in an environment characterised by exchange rate stability, cognisance is taken of the fact that fluctuations in the external value of the rand are unavoidable in the current international monetary system of generally floating exchange rates. In these circumstances the authorities can only aim at creating underlying economic conditions that are conducive to exchange rate stability.

Fluctuations in the exchange rate of the rand have nevertheless complicated the implementation of monetary policy. For example in 2002 monetary policy was dominated by inflationary pressures arising from a substantial depreciation in the external value of the rand in late 2001, combined with a sharp rise in international oil prices as well as in domestic food prices. These external shocks were responsible for a surge in the twelve-month rate of increase in the CPIX from a low of 5,8 per cent in September 2001 to a peak of 11,3 per cent in October 2002. Restrictive monetary policy measures and the subsequent recovery in the exchange rate of the rand then brought the rate of increase over twelve months in the CPIX down to 4,4 per cent in March 2004.

With the adoption of the inflation targeting framework, it also became the stated objective of the Reserve Bank to reduce the NOFP because of the negative effect that this position had on foreign investments into South Africa and the assessment of domestic economic conditions of international rating agencies. The NOFP was accordingly reduced from the peak oversold position of US$23,2 billion at the end of September 1998 to an overbought position of US$0,9 billion at the end of July 2003.

The Reserve Bank then shifted its focus to reducing its oversold forward book and to gradually strengthen the official foreign exchange reserve position. As a result of the appreciation in the exchange rate of the rand, the oversold forward book of the Reserve Bank amounting to US$4,1 billion at the end of July 2003 and was quickly turned around to an overbought position of US$38 million at the end of February 2004. The official foreign exchange reserves of the country was also increased from US$7,6 billion at the end of December 2002 to US$10,0 billion at the end of April 2004. It is now the objective of the Reserve Bank to increase its foreign reserves further in a gradual manner whenever the underlying circumstances allow it to do so.

6. The financial sector

In the period of political and economic isolation during the 1980s the domestic financial sector continued to grow rapidly. Many improvements were made to the regulatory framework such as the creation of a uniform legal framework for all deposit-taking institutions; the establishment of appropriate structures for the markets in new financial instruments; and the revision to rules governing the marketing of equities, bonds and derivatives. Moreover, the authorities endeavoured to promote proper risk management procedures and internationally accepted principles with the objective to preserve the soundness of financial institutions.

The efforts made to maintain an effective and efficient financial sector were hampered by the lack of co-operation with foreign regulators due to the political circumstances at that time. As a consequence, some regulations and practices started to deviate from international best practices. With the re-establishment of normal relations with the rest of the world in the 1990s, great efforts were made to bring the rules and regulations on the activities of financial institutions in line with international norms and standards.

From 1994 South African financial institutions started operating on an increasing scale in major international financial centers as well as opening branches or subsidiaries in other African countries. As part of this process, five large domestic companies transferred the primary listing of their stock to foreign bourses. This change gave them greater access to capital resources at lower cost and provided them with opportunities to promote their core business into other countries and regions. All these companies maintained secondary listings on the JSE Securities Exchange South Africa (JSE), and their market capitalisation on the JSE actually increased from R126 billion in 1997 to R471 billion in 2003.

Over this same period foreign financial institutions were encouraged to conduct business in South Africa by the creation of a level playing field between local and foreign service providers. The regulatory authorities also actively encouraged the development of appropriate clearing, settlement, ownership-transfer and market information systems and insisted on proper intra-market and cross-market risk management systems, including capital adequacy requirements for market participants.

The operations of the financial markets in South Africa were improved considerably to bring them in line with international standards. In 1996 bond trading was shifted from the JSE to the Bond Exchange of South Africa. This led to a substantial rise in the turnover in the secondary bond market from R2 trillion in 1995 to nearly R12 trillion in 2003. Improvements to the JSE included the electronic clearing and rolling contractual settlement, the dematerialisation of equity scrip and the implementation of an electronic trading system. The value of shares traded on the JSE increased from R62 billion in 1994 to R752 billion in 2003.

An important further development since 1994 has been the importance attached to the provision of access to finance and banking activities to small, medium and micro enterprises and underbanked communities. This challenge has been accepted with due recognition of the regulatory objective of achieving a high degree of economic efficiency and consumer protection in the economy. This requires an approach that introduces changes to achieve greater participation in banking while financial stability is maintained at the same time.

Developments in the regulatory framework of South Africa’s financial markets during the past years have been aimed at addressing empowerment issues. For this purpose, the financial sector has developed a Financial Sector Black Economic Empowerment Charter to promote increased black ownership of and access to financial institutions. This Charter, which was made public on 17 October 2003, sets out targets that will be pursued up to December 2014 regarding, among other things, investment in human resource development; a procurement policy that favours accredited black economic empowerment companies; improved delivery of and access to financial services to a greater segment of the low-income population; the mobilisation of resources for empowerment financing; increased direct black ownership at the holding company level; the encouragement of shareholder activism in promoting the objectives of the charter; and directing a percentage of after-tax operating profits to corporate social investment aimed at education, training and job creation.

7. Conclusion

The normalisation of relations with the rest of the world made it unnecessary to follow relatively restrictive fiscal and monetary policies to maintain a surplus on the current account of South Africa’s balance of payments and created leeway for the promotion of economic growth. In the past ten years a deficit was therefore recorded on the current account, but this deficit as a ratio of gross domestic product remained low and averaged only 1 per cent per year. Over the same period a net financial inflow was recorded from the rest of the world amounting to nearly R204 billion, compared with the net financial outflow of about R45 billion from 1985 to 1993. As a result, the level of foreign investment in South Africa amounted to R736 billion at the end of 2002.

These developments allowed the authorities to pursue more liberal policies while maintaining financial stability, which contributed materially to a better growth performance of the domestic economy and the improvement in the living standards of the population. South Africa’s real economic growth doubled from an average annual rate of 1½ per cent during the 1980s to about 3 per cent between 1994 and 2003. In addition, the average growth in real gross national income per capita, an indicator of living standards, improved from a negative figure of 1,1 per cent per annum during the 1980s to a positive figure of 0,8 per cent between 1994 and 2003. Moreover, between 2000 and 2003 the average growth in real gross national income per capita amounted to about 1,5 per cent.

The challenge is to further increase the growth performance of the domestic economy. The foundation has been provided over the past ten years to make this achievable. So the future looks promising.

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