Mr. Stals discusses the performance of the South African economy in the light of recent developments in East Asian countries Address by the Governor of the Reserve Bank of South Africa, Dr. Chris Stals, at the Annual Convention of the South African Chamber of Business in Somerset West, on 28/10/97.

1. Recent economic developments in East Asian countries

The world economic scene is currently dominated by the collapse of the financial systems in a number of formerly very successful East Asian economies. Turmoil in the financial markets of these countries will not only have a serious adverse effect on real economic development in those countries, but can indeed hold important consequences for the world-wide process of economic globalisation and the international integration of financial markets.

The problems started in May this year in Thailand when the Thai currency, the baht, suddenly came under severe pressure. The initial reaction was that it was only a few renowned international currency speculators who were trying to make a quick profit, and that the Thai economy would be strong enough to withstand the pressure. However, only one month later, on 19 June 1997, the Minister of Finance resigned, the exchange rate of the baht was left to float and the onslaught against the economy of the country assumed untenable proportions. Early in July the International Monetary Fund was called in, the currency depreciated by more than 20 per cent, and interest rates went sky-high. Now, four months later, the situation has not yet been salvaged. About sixty banks and financial institutions have been placed under management of government, share prices declined by more than 30 per cent, and the property market has collapsed. A special rescue fund of about US$20 billion was put together by the IMF, Japan and other East Asian countries in an effort to stabilise the Thai economy.

In the meantime, a number of other countries in East Asia were similarly affected. The Philippines was the next country to be forced into the painful adjustment process. Then followed Indonesia, Malaysia, Korea and Vietnam, and even the more healthy economies of Hong Kong and Singapore could not escape the contagious effects flowing from the malady of their neighbours.

The interesting question that is now being asked is: What went wrong in the East Asian Tigers that were, until recently, regarded as role models for developing countries on sound macroeconomic management? In all these countries, people are hardworking, extremely high national savings ratios are being maintained, and governments spent billions on providing the infrastructure for sustainable economic growth.

No better answer can be given to this question than by quoting from an article that appeared in the South China Morning Post of 25 September 1997 under the name of John Greenwood, Chief Economist for Chancellor LGT Asset Management.

“The origins of the Asean currency crisis since the devaluation of the Thai baht on 2 July can be boiled down to three essential ingredients:

- The primary cause in all cases was the prolonged period of excessive money and credit growth from 1993 onwards. The acceleration of money and credit in turn began with the exceptionally low levels of interest rates.

- Managed or quasi-fixed exchange rates in the Asean region combined with financial liberalisation, poor quality management and lax supervision enticed corporates to take on excessive foreign debt.

- The third common denominator of the Asean crisis has been the failure on the part of the authorities to ensure that their financial sectors were strong enough to deal with a volatile cycle. There was neither adequate prudential supervision nor adequate financial disclosure by local financial institutions."

Despite all the good macroeconomic management in these countries, they failed in pursuing the basic elements of sound monetary and financial controls. They did not control the growth in the money supply; they did not check excessive growth in bank credit extension; they tried to maintain unrealistic interest and exchange rates, and they allowed the quality of their banking and financial systems to deteriorate.

There was a time when countries could get away with this type of easy money and lax financial policies. But that was when countries were more isolated and when national policies different from international norms and standards, could still be pursued within economies shielded from international competition through excessive, protective government controls. But the globalisation of the past decade, and the integration of the world financial markets, created a new situation where even the smaller countries of the world are now subjected to the universal disciplines of integrated financial markets.

2. The South African experience with the international financial markets

What happened recently in the East Asian countries is not a new experience. The Mexicans and a number of South American economies were similarly affected late in 1994 and in the first half of 1995. South Africa and a few countries in Central Europe, for example the Czech Republic, were tested in 1996. Some of these countries are only now recovering from the afflictions, others are still going through the process of painful correction.

South Africa was not excluded from the new game of global market participation. In February 1996, the international financial markets threw down the gauntlet when the rand came under pressure and painful macro-economic adjustments were forced on the country. At the time, certain political developments in South Africa, supported by unfounded rumours about the health of President Mandela and resignations in the public sector, may have triggered the speculation against the rand. With the advantage of hindsight, it is now clear that various unfavourable developments in the South African economy over the preceding two years justified the forceful action of the international financial markets.

Firstly, during 1994 and 1995, real gross domestic expenditure in South Africa grew by about 6 per cent per year, and gross domestic product by about 3 per cent. It stands to reason that this kind of disequilibrium growth could not be sustained for too long. Either production had to be stepped up, or expenditure curtailed. No country can consume more than it produces for ever. The international financial markets brought this message home to South Africa very clearly in 1996.

Secondly, the disequilibrium in overall domestic real economic activity affected developments in the current account of the balance of payments over this period. In value terms, total imports of merchandise rose by about 28 per cent during each of 1994 and 1995, whereas exports of merchandise increased by only 3 per cent in 1994 and by 16 per cent in 1995. At the same time, net gold exports declined by 8 per cent per year. The current account of the balance of payments therefore switched from a surplus of R6 billion in 1993 to deficits of R1.2 billion in 1994 and R10.2 billion in 1995. During the second quarter of 1996, the seasonally adjusted annualised rate of the current account deficit increased to R13 billion. With a low level of foreign reserves and a process of gradually removing exchange controls, South Africa became very dependent on a continuous large

capital inflow from the rest of the world. When this capital inflow disappeared in the second quarter of 1996, a painful downward adjustment in the economy became inevitable.

Thirdly, the increase in real domestic economic activity, and particularly in gross domestic expenditure, was financed to an important extent by large increases in bank credit extension and the creation of additional money. In both 1993 and 1994, total bank credit extended to the private sector increased by more than 17 per cent, and the M3 money supply by more than 15 per cent. This was clearly excessive in an environment of real economic growth of 3 per cent (measured from the production side), or 6 per cent (from the expenditure side).

The message signalled by the international financial markets to South Africa in 1996 therefore was to restore macroeconomic equilibrium and to come to live within the means of its own production capacity, or to lift the production potential permanently to a higher level. South Africa took on the challenge both ways. The financial policy reaction was:

- to let the exchange rate depreciate to a level that would satisfy the markets in respect of their expectations of future sustainability. The rand depreciated by 23.2 per cent from 15 February 1996 up to 31 October 1996;

- to let the outflow of foreign currency payments related to the overall balance of payments deficit drain domestic liquidity from the South African banking sector. In the process, the average daily amount of the money market shortage increased from R4.9 billion in January 1996 to R10.6 billion in March 1997;

- to allow interest rates to adjust to underlying conditions and to reflect the shortage of funds that developed in the markets. Interest rates indeed already started moving up during the course of 1994/95 under the pressure of the increasing domestic demand for loanable funds. The rate on three months bankers' acceptances, for example, rose from 10.15 per cent at the end of 1993 to 12.50 per cent at the end of 1994, 14.60 per cent at the end of 1995 and 17.00 per cent at the end of 1996. In line with these movements, the Reserve Bank raised its Bank rate in five steps from 12 per cent at the end of 1993 to 17 per cent in November 1996;

- a rise in the rate of inflation became inevitable after the depreciation of the rand in 1996. The authorities nevertheless adopted a restrictive monetary policy stance to ensure that the adjustment in relative prices of tradable and non-tradable goods would not perpetuate into a long-lasting new era of high inflation. The rate of increase in consumer prices rose from 5.5 per cent over the twelve months up to April 1996, to 9.9 per cent in April 1997.

The Government's response to the other part of the challenge, that is to raise the production capacity of the South African economy permanently to a higher level, was provided with the publication of the Macroeconomic Strategy for Growth, Employment and Redistribution (GEAR). This economic structural adjustment programme will obviously take a longer time to produce results than the shorter-term measures introduced last year to restore business cycle equilibrium by restricting growth in demand.

3. Economic consolidation in 1997

The economic consolidation process forced on South Africa by the events of February 1996 provided satisfying results so far in 1997. The international financial markets already signalled their satisfaction in November 1996, when stability returned to the market in foreign exchange, the outflow of capital through the balance of payments receded, and the exchange rate recovered some of its losses earlier last year.

After the middle of 1996, there was a substantial slow-down in the rate of expansion in gross domestic expenditure. In the second half of 1996 and during the first quarter of 1997, total gross domestic expenditure actually declined at an annualised rate of about 2 per cent, before growth was resumed again in the second quarter of 1997. The growth rate in production unfortunately also slowed down marginally but at this stage better equilibrium has now been restored between these two basic macroeconomic activities.

The current account of the balance of payments also improved as the rate of growth in imports slowed down. In the second quarter of 1997, the seasonally-adjusted, annualised current account deficit amounted to only R3.4 billion.

In addition, although adjusting only very slowly, the rates of increase in both bank credit extension and in the money supply have slowed down since the middle of 1997. Measured over a twelve months' period, the total amount of bank credit extended to the private sector still rose by 14.6 per cent in August 1997. However, over the three-month period from June to August 1997, the seasonally adjusted annualised rate of growth in the total amount of bank credit extended to the private sector declined to 5.9 per cent. Over the same period, the rate of increase in M3 slowed down to 11.4 per cent on an annualised basis.

Finally, inflation, which threatened to run out of control earlier this year, also abated and, after peaking at 9.9 per cent in April 1997, the rate of increase in consumer prices slowed down to 8 per cent over the twelve months that ended in September 1997.

The international financial markets confirmed approval for these macroeconomic adjustments that were achieved, not without pain, but with a substantial improvement in the basic fundamentals. Over the first nine months of 1997, non-residents increased their holdings of South African bonds and equities by no less than R39.1 billion which enabled South Africa to continue with the process of removing exchange controls, and also to increase its foreign reserves. The gross amount of gold and foreign exchange reserves held by the Reserve Bank increased by R16.2 billion from 31 December 1996 to R26.5 billion at the end of September 1997.

The improved underlying conditions were also reflected in a decline in interest rates. As the overall money market situation eased and the Reserve Bank acquiesced in a gradual decline in the money market shortage to an average daily amount of only R4.5 billion in the first three weeks of October, money market interest rates moved downwards. The rate on three months' bankers acceptances gradually declined from 17.00 per cent at the end of 1996 to 14.25 per cent last week.

The Reserve Bank endorsed these movements in the underlying financial aggregates by reducing the Bank rate from 17 to 16 per cent on 20 October 1997.

4. The role of monetary policy in the adjustment process

As the globalisation process progresses, financial markets, and particularly those of the smaller economies, lose some of their independence. In these countries, the task of central banks becomes more difficult. They can no longer follow an independent monetary policy that will please politicians or internal pressure groups, but must learn to understand to respect and to respond to international market pressures.

In most of the countries referred to above, international economic disciplines were transmitted to domestic economies through financial markets. Adjustments in exchange rates, interest rates and financial asset prices provided the main transmission mechanism used by the markets to

force the disciplines of the international markets on central banks and governments. As with the East Asian countries, excessive increases in bank credit extension and in the money supply, and unrealistic interest and exchange rates, or unacceptable fiscal deficits, were severely punished.

South Africa will have to learn to live with, and to adapt to, these market disciplines. This country can not on a permanent basis maintain lower interest rates than those ruling in most of the other emerging markets. Our inflation rate will have to be reduced to come more in line with the average rate of inflation in the economies of our major trading partners and international competitors.

There is no magic formula to determine what the level of the exchange rate or interest rates should be on any particular day in South Africa. The world financial markets are too volatile, changes too erratic and unpredictable, and economic models based on past experiences unreliable. Against this background, monetary policy decisions must of necessity often be based more on discretion, and less on pre-established rules. This makes short-term forecasting of financial developments even more difficult, if not impossible.

In this environment, it is important to have flexible markets that will emit understandable signals to all the participants in the economy, including the monetary policy authorities. Or even better, to have markets that can be trusted to determine prices with a minimum of government intervention.

5. Prospects for the South African economy

Now that the consolidation process in the South African economy has been achieved with some success, the basis has been laid for a new phase of steady and, hopefully, more sustainable growth. In the sphere of real economic activity, some scope has been created for higher growth in both production and expenditure. It will, of course, be good for future development if any increase in expenditure at this juncture could be concentrated in fixed investment rather than in private sector or government consumption expenditure.

The South African balance of payments remains vulnerable and dependent upon a sustained inflow of capital from the rest of the world. We must continue to nurture the confidence of all potential foreign investors, and particularly of the long-term investors who are prepared to participate directly in real economic activity. Without foreign capital inflows, any recovery in domestic economic activity will be short-lived.

Finally, the short-term consolidation process in the financial sector has not yet reached its final and acceptable destination. International financial markets observe the still relatively high rates of expansion in bank credit extension and in the money supply, the above average-rate of inflation, and the growing indebtedness of particular private individuals with circumspection. Provided we can continue with the process of also improving equilibrium in the financial markets, the prospects are good for a better overall economic performance next year.

In the longer term, economic growth at a suitably high level will, however, only become possible once the more fundamental economic reforms envisaged in GEAR have been implemented. The restoration of business cycle stability in the short-term was an important precondition for a revival of economic development, but it also paves the way for a more determined effort by all of us over the next few years to raise the overall production capacity of the economy on a permanent basis to a higher level.