South African Economic Policy on the Horns of a Dilemma

The overwhelming election victory of the African National Congress (ANC) at the second general election in June 1999 can be interpreted as confirmation of the approach to social and economic policy pursued by the Mandela government. No significant changes are expected under the new South African President to the cornerstones of the Growth, Employment and Redistribution (GEAR) programme,[1] one of the aims of which is to create favourable conditions, particularly for foreign capital. However, so far South Africa has clearly failed to achieve the targeted high rates of economic growth and its goal of reducing the high level of unemployment. While this partly reflects the turbulence on the international financial markets, which severely hit South Africa's trade with other emerging economies, the core problem is that the initiation of dynamic economic growth has been blocked by the high real interest rates required by a central bank interest-rate policy geared to defending the exchange rate, together with wage increases that far exceed productivity growth.

Political signals for institutional continuity

The economic policy of the new South Africa faces the difficult task of creating attractive conditions for investors while at the same time reducing the socio-economic disparities inherited from the Apartheid regime. In international comparative terms, income distribution in South Africa is one of the most unequal in the world.[2] In 1996 the ANC government adopted a strategy, in the form of the GEAR economic programme, that aimed to induce the economic growth required for substantial redistribution primarily by improving supply-side conditions. Above all else, GEAR is a declaration of faith in a stability-oriented monetary and fiscal policy, in privatisation and labour market flexibilisation. The election in June 1999 has done little to change this basic approach. Fears had been expressed that market principles and their institutional underpinning would be undermined, and not least whether the independence of the central bank, the South African Reserve Bank (SARB), would be respected. However, the new government has followed a course of institutional stabilisation and continuity that satisfies international standards.

The success of this policy to date can be seen from the consolidation of government finances. The overall budget deficit declined steadily from 8% in 1994 to 3.5% of GDP in 1998, in spite of the immense economic policy problems involved in rebuilding the country (cf. table 1). South Africa's total government debt, just under 50% of GDP in 1998, has remained at a stable and, in international comparative terms, not unusually high level. The level of foreign debt is also moderate, at 29% of GDP (1998). More than a third (36%) of this debt is denominated in South African rand, an enormous advantage compared with the situation facing most other developing and newly industrialising countries. To this extent there are no exchange rate risks involved in servicing these debts, unlike the situation facing the Asian NICs hit by crisis last year.

Opening the country to world markets

The economic development of South Africa[3] since the democratisation of the country was initially heavily influenced by the impact of a forced opening of the country to world markets. Parallel to the removal of the trade and financial sanctions against the Apartheid regime, an economic upturn began as early as June 1993. Following a long period characterised by a net outflow of capital (since 1985), the country enjoyed a net inflow. Up to 1996 investment in machinery and other equipment increased at double-digit rates, as did goods exports and imports (cf. tables 1 and 2).

This dynamic expansion – evinced by GDP growth rates of up to 4.2% – came to an end in the autumn of 1996. Subsequently the economy lost much of its momentum, with annual growth rates of 2.5% (1997) and 0.5% (1998); indeed, in the last quarter of 1998 and the first quarter of 1999, slight absolute declines in GDP were recorded. Thus technically South Africa is in a recession. In 1998 manufacturing industry recorded a decline in real output of even 1.8%, whereas the service sector managed to expand by 1.5%.

Against this background there has so far been no sign of an improvement in the labour market situation. On the contrary, the already high level of unemploy-

[1] Cf. 'Growth, Employment and Redistribution. A Macroeconomic Strategy', Cape Town, 14 July 1996; URL: http://www.gov.za/reports/1996/macroeco.htm

[2] The World Bank estimates the Gini coefficient – a measure of the inequality of income distribution – for South Africa at 58.4; cf. The World Bank, *World Development Report 1998/1999*.

[3] Unless otherwise indicated, the sources for this overview are: SARB, *Quarterly Economic Bulletin*, No. 212, Statistical Supplements, June 1999; URL: http://www.resbank.co.za/economics/econ.html

Table 1
Selected Economic Indicators for South Africa

	1991	1992	1993	1994	1995	1996	1997	1998
Population (millions)	36.3	37.0	37.8	38.6	39.5	40.2	41.2	42.1
Employment[1] (1990=100)	98.0	96.0	93.9	93.5	92.5	91.9	90.3	86.5
Real GDP[2] (billion rand at 1995 prices)	520	509	515	532	548	571	585	588
Real GDP (% change on previous year)	–1.0	–2.1	1.2	3.2	3.1	4.2	2.5	0.5
Real GDP per capita (rand at 1995 prices)	14 320	13 749	13 621	13 759	13 884	14 150	14 193	13 965
Exports (f.o.b.) (% change on previous year)	8.0	9.3	15.8	19.6	23.9	20.0	13.6	14.4
Imports (f.o.b.) (% change on previous year)	9.3	9.5	16.4	28.4	28.0	19.3	12.1	13.3
Inflation (consumer prices; % change on previous year)	15.3	13.9	9.7	9.0	8.7	7.4	8.6	6.9
Total debt (% of GDP)	37.2	36.8	40.4	43.6	49.0	49.7	49.2	48.3
Foreign debt (% of GDP)	20.7	20.5	20.7	21.8	23.4	24.1	26.6	29.1
New public borrowing (% of GDP)	2.7	3.9	7.2	5.8	5.0	4.7	4.9	3.5
Gross fixed investment (% of GDP)	17.1	15.6	14.7	15.2	15.9	16.2	16.4	16.5
Gross fixed investment (% change on previous year)	–7.4	–5.3	–0.6	8.2	10.7	7.5	5.2	4.8
Investment in machinery and equipment (% change on previous year)	–8.6	4.0	10.2	12.9	16.8	14.2	7.4	6.8
Savings-to-income ratio (% of GDP)	18.6	16.2	16.4	16.9	16.5	15.8	14.6	14.1
Savings by private households (% of disposable income)	4.2	6.8	4.5	2.8	1.8	1.8	1.6	1.4
Sectoral contributions to GDP (%)[3]								
Agriculture and mining	12.4	11.4	12.3	12.4	10.8	11.2	11.2	11.0
of which: mining and quarrying	7.2	7.5	7.6	7.4	7.0	6.6	6.6	6.5
agriculture, forestry and fishing	5.2	3.9	4.7	5.0	3.9	4.6	4.6	4.5
Industry[4]	27.8	27.7	27.1	27.2	27.9	27.3	27.3	26.9
of which: manufacturing industry	21.2	20.9	20.6	20.5	21.2	20.7	20.7	20.2
electricity, water and gas	3.3	3.3	3.4	3.5	3.5	3.5	3.6	3.6
Private and public services	59.8	60.9	60.5	60.5	61.3	61.5	61.5	62.1

1 Excl. those working in the informal sector and agriculture. — 2 GDP at market prices. — 3 Shares of gross value added. — 4 Energy sector (excl. coal mining), construction industry and manufacturing industry.
Sources: Statistics South Africa; South African Reserve Bank; DIW calculations.

ment has increased further since democratisation. With an overall population of 40.2 million (1996), the most recent census (October 1996) estimated unemployment at 34% of the economically active population aged between 15 and 65. According to the official statistics the number of people officially employed by private and public-sector employers (excluding agriculture) fell by 400 000 between 1994 and the end of 1998. In particular, the mining industry, which is extremely important for the South African economy and highly labour intensive, has suffered under the deteriorating world market conditions. Since 1995 around 190 000 jobs, or more than 30% of the total, have been shed in this sector.

Alongside cyclical factors, structural factors must be considered as causes for the weak economic development. According to South Africa's foreign trade statistics (cf. table 2), the ratio of exports of goods and non-factor services to GDP has increased from 17.2% in 1994 to 22.2% in 1998, but this was accompanied by a parallel increase in imports, from 19.8% of GDP in 1994 to 24.4% in 1998. Consequently, the current account remained consistently slightly in deficit until the end of 1998. This is not without its problems, because South Africa still largely owes its low overall current account deficit to its gold exports, although gold exports have fallen as a proportion of export revenue from 25% in 1994 to 16% in 1998. South Africa's trade in other goods and services exhibited a marked deficit, suggesting significant problems of competitiveness in these areas. Moreover, the concentration of exports on just a few goods makes the economy more susceptible to global fluctuations in demand.

One of the central problems facing the South African economy is the substantial upward pressure on costs emanating from wage trends. According to a study by the International Monetary Fund, during the 1990s South African manufacturing industry experienced a marked acceleration of productivity growth, but it still

Table 2

Balance of Payments of the Republic of South Africa, 1992 to 1999

Billion rand

	1993	1994	1995	1996	1997	1998	1998				1999	
							I	II	III	IV	I	II
Foreign trade	–2 084	–7 809	–12 845	–14 752	–15 049	–15 697	–1 096	–1 151	–7 199	–6 251	1 744	– 445
Exports (excl. gold)	58 428	69 866	86 580	103 906	118 012	135 054	32 256	33 070	36 860	32 868	35 431	35 230
Imports	–60 512	–77 675	–99 425	–118 658	–133 061	–150 751	–33 352	–34 221	–44 059	–39 119	–33 687	–35 675
Gold exports	22 449	23 670	22 538	26 300	25 818	25 907	6 368	5 760	6 735	7 044	6 185	5 945
memo item: Gold as a % of total exports	27.8	25.3	20.7	20.2	18.0	16.1	16.5	14.8	15.4	17.6	14.9	14.4
Non-factor services	–4 706	–4 766	–4 916	–3 092	–3 070	–1 083	478	– 918	–1 019	376	– 131	–1 028
Exports	10 701	13 306	16 751	21 589	24 587	29 126	6 926	6 865	7 356	7 979	7 387	6 943
Imports	–15 407	–18 072	–21 667	–24 681	–27 657	–30 209	–6 448	–7 783	–8 375	–7 603	–7 518	–7 971
Factor services	–8 698	–8 599	–10 426	–13 378	–14 797	–16 681	–4 117	–3 730	–4 391	–4 443	–4 754	–4 152
Exports	2 288	3 455	4 128	4 663	6 011	7 255	1 423	2 219	1 885	1 728	1 690	1 816
Imports	–10 986	–12 054	–14 554	–18 041	–20 808	–23 936	–5 540	–5 949	–6 276	–6 171	–6 444	–5 968
Transfers	–2 092	–2 160	–2 340	–3 206	–3 328	–4 076	–1 094	– 996	– 985	–1 001	–1 019	–1 531
Balance on current account	4 869	336	–7 989	–8 128	–10 426	–11 630	539	–1 035	–6 859	–4 275	2 025	–1 211
Capital transfers	– 188	– 236	– 145	– 203	– 892	– 310	– 57	– 94	– 84	– 75	– 57	– 61
Direct investment (net)	– 941	–3 040	–4 557	– 970	6 756	–6 471	– 553	1 079	–6 155	– 842	–2 259	– 568
Outflows[1]	– 974	–4 388	–9 059	–4 485	–10 831	–9 575	– 958	– 133	–8 074	– 410	–4 305	–2 152
Inflows[2]	33	1 348	4 502	3 515	17 587	3 104	405	1 212	1 919	– 432	2 046	1 584
Portfolio investment (net)	2 417	10 008	9 020	9 576	30 580	20 375	19 359	11 211	–6 529	–3 666	5 117	16 738
Outflows	– 10	– 290	–1 631	–8 407	–20 983	–30 077	–7 138	–11 306	–5 461	–6 172	–5 815	–9 415
Inflows	2 427	10 298	10 651	17 983	51 563	50 452	26 497	22 517	–1 068	2 506	10 932	26 153
Other investment (net)	–7 145	–2 609	15 318	4 788	–10 287	3 662	–6 579	–2 424	5 268	7 397	–3 204	–5 327
Outflows	– 813	–1 055	–1 899	–2 704	–8 957	–2 872	–5 133	– 85	3 844	–1 498	–2 066	–2 298
Inflows	–6 332	–1 554	17 217	7 492	–1 330	6 534	–1 446	–2 339	1 424	8 895	–1 138	–3 029
Balance on capital account	–5 669	4 359	19 781	13 394	27 049	17 566	12 227	9 866	–7 416	2 889	– 346	10 843
Unrecorded transactions[3]	–7 923	–1 572	–3 060	–10 166	–4 869	–9 643	–4 671	–9 064	2 977	1 115	3 296	–7 040
Overall balance	–8 911	2 887	8 587	–5 103	10 862	–4 017	8 038	– 327	–11 382	– 346	4 918	2 531
Financing	8 913	–2 887	–8 587	5 103	–10 862	4 017	–8 038	327	11 382	346	–4 918	–2 531
Reserve assets	7 427	– 413	–5 306	– 6	8 089	4 529	–1 421	5 591	999	– 640	– 793	–1 325
SDR allocations and valuation adjustments	1 609	344	315	3 245	257	6 165	1 186	5 539	195	– 755	1 563	–1 810
Change in gross gold and other foreign reserves	– 123	–2 818	–3 596	1 864	–19 208	–6 677	–7 803	–10 803	10 188	1 741	–5 688	604
memo item: current account as a % of GDP	1.1	0.1	–1.5	–1.3	–1.5	–1.6	–0.4	–0.7	–2.7	–2.5	0.8	–0.4

1 Investment by South Africans abroad. — 2 Investment by foreigners in SA. — 3 Transactions on current, capital transfer and financial account.
Source: South African Reserve Bank.

lags behind other emerging economies.[4] The official South African statistics report annual labour productivity growth of around 4 to 5% in the economy as a whole. Yet wages are growing even more rapidly (cf. figure 1). Compared with 1995 the SARB estimates total productivity growth at around 15%; wages, however, have grown by almost 50% in nominal terms, implying a 30% rise in nominal unit labour costs.[5] This inevitably leads either to higher inflation or to a squeeze on profits.

Flexible exchange rates, but tight interest-rate policy

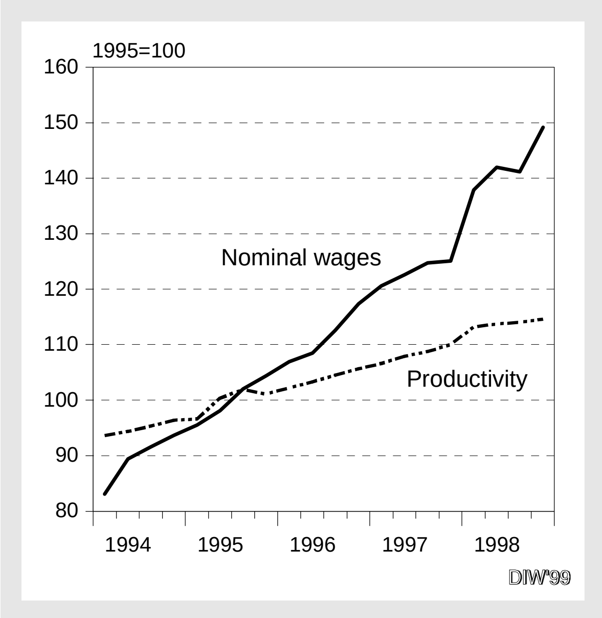
Without the equilibrating effect of gold exports, the substantial surplus of goods and services imports would exert downward pressure on the external value of the rand. Pressure in the same direction comes from the high rates of inflation; if exchange rates were completely flexible, this would sooner or later lead to currency deprecation. Yet until the start of 1996 the real external value of the rand remained relatively stable, compared with the position at the start of 1994; there was scarcely any change in the exchange rate to the US-dollar during this period. This meant, however, that the country's international competitiveness in trade in goods and services has deteriorated markedly.

The substantial exports of gold have served to offset the consistent deficit in the balance of trade in goods and services (excluding primary goods). This enabled domestic prices to rise more rapidly, without the inflationary pressure automatically and immediately affecting the exchange rate. However, such a constellation is damaging to the development potential of the real economy, which fails to diversify goods production in the face of the lack of competitiveness in these areas. This would serve to cement dependence on exports of primary goods. The declining importance of gold exports, on the other hand, a trend that has been observed for many years, raises the pressure for a depreciation of the rand and thus will tend to improve the competitiveness of other export branches.

The policy of the central bank, which has attempted to bring down the rate of inflation substantially, has also served to counter the trend towards a real appreciation. And indeed, the inflation rate (consumer prices) has fallen markedly, despite the rise in real wages, and in

Figure 1

Nominal Wages and Labour Productivity in South Africa (excluding agriculture)



Source: South African Reserve Bank.

April 1996 was at a year-on-year figure of around 5.5%, a distinct improvement on figures of 14 to 15% at the start of the decade. The price of this strategy is that South African companies, faced with high real wage increases, must accept corresponding reductions in profits.

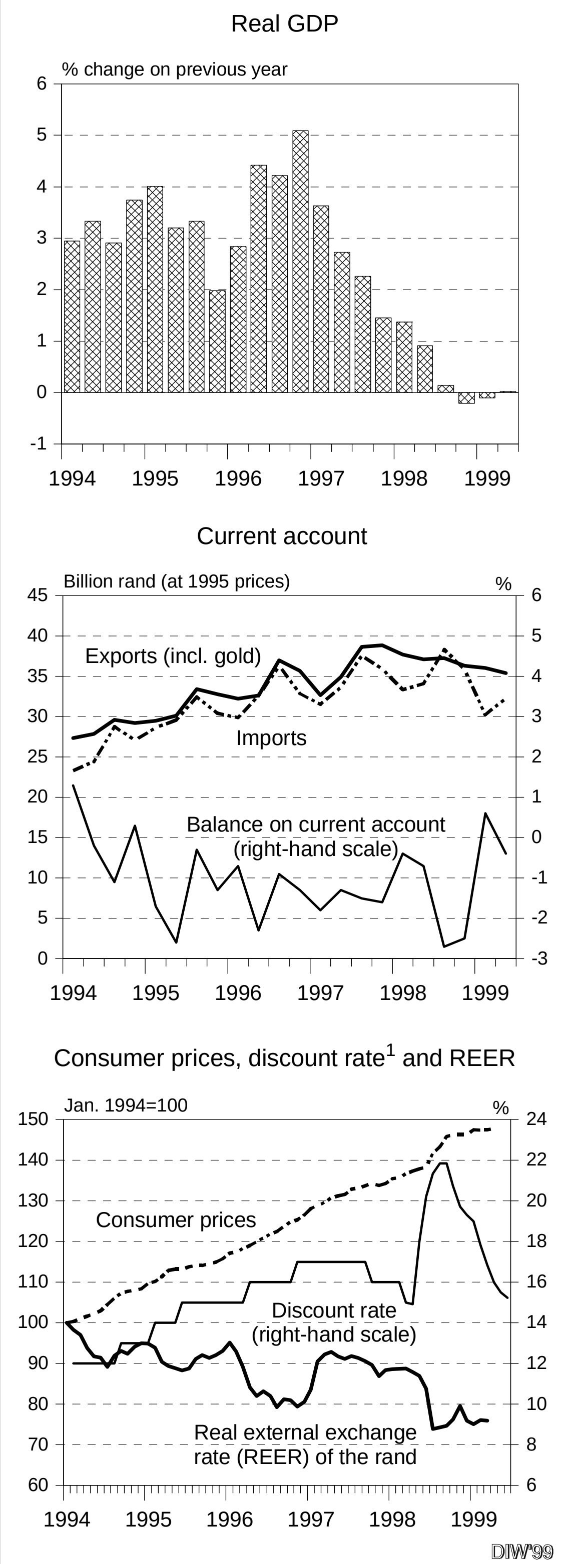
The restrictive impact of monetary policy has been exacerbated by the fact that, almost a year after the abolition of the financial rand, the South African currency – given floating exchange rates and almost completely liberalised currency movements – came under depreciation pressure, a trend heightened by speculative attacks. The central bank sought to counter the fall in the exchange rate by raising its base rate in two steps from 15 to 17%. Dynamic economic growth is no longer possible at interest rates of this magnitude (cf. figure 2).

In 1997 the international goods and financial markets came under the pressure emanating from the Asian crisis. Although the South African financial markets withstood the first tremors of the Asian crisis largely unscathed, in May 1998 a second shock wave, accompanied by the crisis in Russia, hit the country. It was at this point in time that international investment managers undertook a massive restructuring of their portfolios away from investments in emerging markets, which were considered too risky. Whereas between the start of 1998 and May of that year South Africa experienced a net capital inflow of ZAR 16 billion, between May and

[4] Cf. International Monetary Fund, 'South Africa: Selected Issues', *IMF Staff Country Report*, No. 98/96, Washington D.C., September 1998, pp. 33–55.

[5] It has to be noted, though, that statistical coverage of labour market data remains incomplete.

Figure 2
South Africa



1 March 1998: change from bank rate to repurchasing rate.
Sources: South African Reserve Bank; IMF; DIW calculations.

December 1998 international investors withdrew portfolio investment totalling ZAR 26 billion.[6] In the wake of this the South African currency once again came under massive pressure. The central bank reacted with a renewed marked hike in its base rate. At times the repo rate for lending to commercial banks rose by 7 percentage points to a level of more than 21%. Towards the end of the year, net capital flows reversed once more, and the SARB steadily reduced the base rate to just over 15% in May 1999. During the course of 1998 the external value of the rand fell by a further 20%. The fluctuations in the external value fed through into domestic prices and also interrupted the trend towards lower inflation rates. Against the background of these exchange-rate and interest-rate trends, and simultaneous high real wage increases, the South African economy inevitably entered into recession, as its international competitiveness had been damaged and its profitability squeezed by domestic wage pressure.

Although the South African central bank managed to restrain the depreciation without resort to the International Monetary Fund, the still low level of international reserves held by the central bank (cf. figure 3) remains as a risk factor. Since 1994, the first year in which the capital account was positive, the SARB has increased its foreign currency reserves (excluding gold) from the value of six weeks' imports to three months'. This figure is still low in international comparative terms, however.

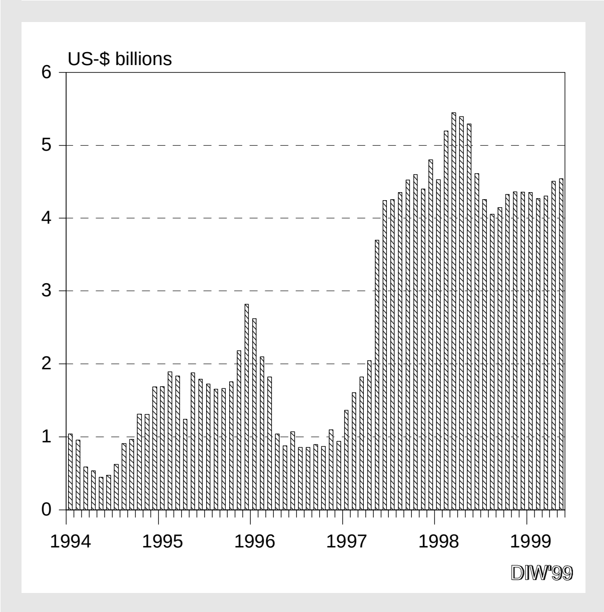
Investment dynamic inadequate

The monetary policy pursued by the central bank successfully weakened inflationary trends. A stable currency and low inflation rates were to exert a positive influence on expectations, especially those of foreign investors. However, at the same time the high real interest rates have damaged prospects for a recovery in investment activity, as expected profits could not compete with interest rates. One indicator of this is the relatively low investment share of 16.5%, a level that is far from adequate to generate the economic impulses required. Although investment in equipment grew at two-digit annual rates between 1994 and 1996, the rate of growth has since fallen and in 1998 was only 7% above the 1997 level.

Given a savings-to-income ratio of 14% of GDP (1998), South Africa is dependent on capital imports from abroad, despite the low investment share. Indeed,

[6] Cf. Stals, C.L., 'The challenges to monetary policy in increasingly volatile international markets', Johannesburg, 25.5.1999; URL: http://www.resbank.co.za/economics/pdf.htm

Figure 3
South Africa
Foreign exchange reserves (excluding gold)



Source: South African Reserve Bank.

the private households save only around 1.5% of their disposable income, a figure far lower than that in other emerging markets. Yet most of the capital imports from abroad consist of portfolio investment, whose short-term, and in some cases speculative character – in contrast to direct investment – is only of benefit to the economic development of the country under certain conditions. Yet without massive investment, productivity growth will not be sufficient to raise the competitiveness of South African products and thus the demand for its exports.

South African economic policy finds itself on the horns of a dilemma between the goals of stabilising the monetary and fiscal parameters, on the one hand, and dynamic development of the domestic economy, on the other. Although South Africa is the most important economy on the African continent, in global terms it must be considered to be a small country. The course of economic development since the elections of 1994 reveal the influence on South Africa of fluctuations on international goods and capital markets. Generally speaking, an economic policy approach oriented towards institutional stability and continuity is to the country's advantage. Ambitious absolute goals, however, such as that of swiftly bringing the inflation rate and public borrowing down to a 'European' level are problematic for a country such as South Africa, undergoing, as it is, a transformation of historical importance, because they unnecessarily restrict the scope for the necessary economic policy intervention and real economic impulses. In the longer run it will only be possible to reduce inflation in a sustained way, without at the same time inducing a recession, if wage growth is in line with productivity.

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