international UPDATE 2/96

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Growth vs Stability: Pointers for South Africa from Argentina and Chile

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This fellowship has been established with the financial support
of the Anglo American and De Beers Chairman's Fund.

While there is broad consensus within such forums as NEDLAC on the broad outlines of the economic strategy South Africa should adopt, in recent months dissenting voices have raised concerns about the fine print of this agreement. There are those who argue that what we need is a less conventional, more dynamic approach to economic growth - one which may be less orthodox but will deliver the levels of growth which are necessary to begin to seriously address South Africa's socio-economic challenges. It is a debate concerning the correct balance between a less predictable high growth path and stability (defined as consistent, predictable economic policy, fiscal conservatism, moderate rates of growth, and political and economic middle-of-the-road-ism).

On the face of it, growth and stability are perfectly compatible. Indeed, growth is unlikely without some measure of political stability and *vice versa*. However, problems arise when one probes the policy-relevant specifics of this relationship. Is growth on its own enough? How much growth? And what is the correct balance between growth and stability?

Part of the problem for emerging markets like South Africa, is that growth requires the simultaneous pursuit of a range of apparently contradictory strategies: the political and economic stability which is so crucial to encouraging domestic savings and building business confidence demands tight monetary policies and high interest rates. Vigorous growth, on the other hand, requires low interest rates and easily available funds to facilitate risk-taking and provide incentives for investment. It is commonly accepted that while political stability in the short term may be bought with looser fiscal policy, in the long term, sustained high growth requires low inflation. Nonetheless, a number of analysts have questioned the conservatism of the fiscal policy adopted by South Africa and have argued that the balance is wrong. They argue that the price of our new-found stability is sluggish growth and endlessly rising unemployment. Such critics contend that substantially higher rates of growth, and more dynamic government policy (such as a more proactive intervention in the economy to set up a public works programme or new system of national [non-military] service) are necessary to consolidate the political and economic transition.

The debate is a difficult, ideologically loaded dispute over the state's precise role. Here, it is helpful to consider the respective experiences of Chile and Argentina. The very different recent histories of these countries suggest that the foundation for sustainable growth is one that must be laid over a number of years. Evidence points to the importance of getting the (fiscal) basics right and vindicates many neo-liberal economic prescriptions. Two key lessons emerge: firstly, that there is a role for the state in this process, albeit a narrowly circumscribed role; and secondly, a stark warning that the price of fiscal and monetary profligacy is a high one.

Argentina

The experiences of Argentina in the 1980s provide cogent and striking lessons of what South Africa should avoid. Despite a rigorous reform programme, Argentina's ongoing troubles in the 1990s continue to speak volumes as to the difficulties of economic restructuring.

In Argentina in the 1980s, public expenditure as a share of GDP approached a massive 35%. Unionized labour was protected by rigid rules governing hiring and firing - but protectionism and perks were not limited to the trade unions. The Argentine government pandered to every conceivable organised interest group. Industry, for example, was protected by closed markets, subsidised credit and tax concessions. Consumers enjoyed below-cost tariffs from public enterprise and lax collection practices. Provincial governments in the most economically depressed areas addressed the problem of unemployment by themselves employing over 50% of the workforce. Tobacco and sugar farmers and the merchant marine all benefited from special taxes. The military enjoyed a generous budget comprising 14.1% of overall government expenditure. (By comparison, South Africa's peak was 19% in 1977 and defence expenditure currently stands at about 7% of overall government spending.) By 1989, state subsidies were costing US$8 billion, an unsustainable figure, which drove the state towards effective bankruptcy.[1]

Attempts by President Alfonsin in the 1980s to rein in inflation proved largely unsuccessful. Then, in 1989, Carlos Menem assumed the Presidency and embarked on a rigorous and thoroughgoing set of reforms, in an attempt to prime the economy for recovery. These reforms included the law of convertibility whereby the Argentinean peso was pegged to the US$, reform of federal government and the slashing of the federal bureaucracy, an extensive privatisation programme, the restructuring of debt, and tax reform (a much broadened and uniformly applied VAT). These reforms have had a significant impact on rates of inflation and growth.

Nonetheless, the road to economic recovery continues to be a long and uncertain one as policy-makers struggle to restructure the fundamentals of the economy. A crucial weakness remains the low level of domestic savings. The domestic savings rate is a miserable 17.1% of GDP, creating a savings shortfall which leaves Argentina at the mercy of international capital flows. (South Africa's domestic savings rate for 1994 was not much better at 17.6%.)

The consequences of this were clearly demonstrated by the sudden reversal of investment flows in the wake of the Mexican peso crash in December 1994 which sent the Argentine economy reeling. Buenos Aires has since responded with tough new austerity measures, a revised budget and new tax, labour and social security bills. Their commitment to economic reform appears relatively solid, despite the difficulties attached to the process - and these difficulties are considerable.

The Argentine economy has sunk into a recession in the aftermath of the *tequila effect* (the dramatic reversal of capital flows away from emerging markets which followed the Mexican currency crash) and the short-term prospects for economic recovery appear bleak. Key structural weaknesses are proving remarkably stubborn and difficult to rectify. Defence spending, at around 10% of budget, still comprises too big a chunk of state expenditure. It is, however, an essential part of the 'bribe' that Argentineans pay to their military in order to reconcile it to the new democratic order, and hence a crucial component of the trade-off between political stability and the prerequisites for growth. Stability, it seems, must always be paid for.

The fiscal deficit also remains high, a problem largely attributable to overspending by the provinces. Fiscal deficits in Argentina are notoriously difficult to control because of a 'co-participation' law which legislates that every cent that central government collects must be shared, 50-50, with the provinces. Despite attempts by central government to control its expenditure, spending in the provinces has risen by 71% since 1990. The deficit in the current account currently stands at 4.4% of GDP and is increasing under the impact of growing imports and consumption.

The low domestic savings rate is linked to the excessive extension of domestic credit. Like many others, Argentinean consumers spend too much and save too little. The spending power of Argentineans was long crippled by the effects of hyper-inflation (which soared over 3000% in 1989) and a boom in consumer demand has followed the stabilisation of the inflation rate. The continuing high rate of unemployment is an obstacle to the consolidation of political stability and democratisation. And, crucially, despite extensive tax reforms, tax revenues are down. There is a growing sense of unease in Argentina as the budget surplus continues to dwindle.

Transition from an inward-looking economy with extensive state involvement to a dynamic, export-driven economy is thus a slow and painful process with few short-cuts. Six years after President Menem began his reforms, exports still account for only 5.5% of GDP in Argentina - as opposed to 23% in Chile. And it increasingly appears that export potential is crucial to economic growth.[2] President Menem's reforms will take time to deliver the expected benefits. It remains an open question as to whether Argentina's fragile polity can wait that long.

Chile

By contrast, Chile is now reaping the benefits of a reform process begun in the 1970s. In eight years the economy has expanded by 75% and growth is expected to exceed 5% in 1995. Annual inflation fell to 8.9% in 1994 and looks set to continue this trend through 1995-96. Foreign reserves (at US$14.8bn) are high and rising. Exports grew by 25% in 1994. Foreign investment stood at US$4.7bn or 9.1% of GDP. Despite a widening of the current account deficit, capital inflows have remained strong and kept the 1995 balance of payments in a surplus of 1.5 to 2%. And unemployment, at 5.9%, is low by Latin American standards. Unlike Argentina, Chile weathered the fallout from the Mexican crisis remarkably well. Why these differences?

The Chilean economy has, since the mid 1970s, been working at getting the basics right: The state has not only made significant strides in reducing external indebtedness, but has also succeeded in establishing macro-economic stability with much improved public finances, and has developed the framework for a vigorous private sector and a liberal, export-oriented trading environment.

Chile has reduced its dependency on the inflow of foreign capital by sustaining a domestic savings rate of 26%. In addition, however, relatively strict regulations govern the issuance of foreign bonds by Chilean companies - foreign equity investment must be invested for at least a year, mitigating the impact of investor pull-outs, like the one which followed the Mexican peso crash.

Yet, Chile does not represent the vindication of neo-conservatives who argue for a complete abandonment to free market forces. Chile's successes are not the result of a complete withdrawal of the state from the economy. Rather, they represent the development of a thoughtful reassessment and restructuring of the role of the state within the economy. While the state *has* cut back its involvement in crucial areas through privatisation and deregulation, it has also redirected its attention to those areas where the role of the state is perceived to be crucial to long-term economic growth. For example, President Eduardo Frei plans to increase spending on education in the next seven years from 4.6% of GNP to 7% in order to develop Chile's human resources more efficiently.

The success of Chile demonstrates that economic recovery is a fundamentally long term process - and one which goes beyond fiscal policy and the amputation of the state's capacity. According to this view, '(r)eal development is not merely a task of macroeconomics, but of social changes too. It is easier to increase per capital consumption than to change social mores or to focus social expenditure in a way that encourages efficiency and support for the poorest strata'.[3]

President Frei remains committed to the continuing internationalisation of the economy. In the tussle between the frequently conflicting demands of stability and dynamic growth, a sustainable balance is difficult to strike. Chile generally appears to be heading in the right direction: while encouraging trade openness, the *fiscus* remains wary of vast capital flows; and while the state aims to alleviate poverty, it tries not to do so at the expense of stability.

What has made the difference between the success of Chile's reforms and the still uncertain outcome in Argentina? The first factor is simply one of the time framework: Chile embarked on her reforms almost a decade ahead of Chile - and did not have quite the same level of state extravagance and regulation to remedy that Argentina did. The second factor concerns the institutional capacity of the Chilean state to play an appropriate role in promoting economic growth, a capacity less evident in Argentina. How then does South Africa compare to the respective examples of Chile and Argentina?

South Africa

On the face of it, South Africa's economic recovery is firmly on track and looks set to deliver growth of around 3% in 1995 alongside single digit inflation (for the fourth year running). While some economic actors are still building inflationary expectations into their projections, it appears that the cyclical pattern of economic growth and tight monetary control (which dictated that whenever growth exceeded 3%, the Reserve Bank had to apply the brakes) is diminishing in intensity. The Government of National Unity's (GNU's) commitment to fiscal discipline is widely accepted and the growing internationalisation of the South African economy is forcing local companies to become more competitive. Certainly business confidence is at its highest level in over a decade; car sales are up, production volumes in manufacturing are up, the value of approved building plans is up, and the number of insolvencies is down.

With fixed investment spending as the major driving force behind the recovery, there appears to be no immediate risk of slipping back into a recession. Seen alongside the substantial shifts in the political climate since April 1994, the economy is in a better position to improve the lot of South Africans than at any time since the 1970s. There, is however, an inevitable caveat to all this optimism - and it goes to the heart of the tussle between growth and stability. The South African economy retains key structural weaknesses, similar in nature if not in scale to those of Argentina, and there is considerable debate about the role of the state in tackling these areas.

While R3bn in direct foreign investment has flowed into South Africa since early last year, the nature of this investment[4] limits efforts to promote South Africa's manufacturing capacity and has *not* been accompanied by the creation of significant numbers of new jobs. As a senior American foreign policy committee member commented in November 1995 concerning the nature of American investment in South Africa: 'You are getting offices and not factories'.

There is also reason for concern over the state of the fiscal deficit. Recent figures anticipate that overspending will push the deficit above the 5.8% of GDP which was budgeted for. The boom in imports, as in Argentina, is placing severe pressures on the balance of payments. The growing deficit in the current account of the balance of payments (R12.5bn or 3% of GDP) is certainly cause for concern, although it does not yet compare with the 7% budget deficit of Mexico at the time of the peso crash. While the fiscal deficit is unlikely to be higher than 6%, which is still below last year's 6.4%, it *has* given rise to speculation about the need for an increase in the VAT rate next year - a political hot potato for the GNU.

Certainly, early indications are that government will not succeed in cutting the public sector deficit in 1995. As in Argentina, the overshooting of budget targets at second- and third-tier levels of government makes this difficult. Overspending in the Eastern Cape can be attributed to the shocking state of the finances of the former Transkei and Ciskei, but Gauteng and the Western Cape also appear to be heading for shortfalls.

The strong demand for bank credit is a further area of concern. Credit extension to the private sector is currently running at 19% and annual money supply at 16%. Much of the growth in sales in consumer spending appears to be credit driven and unsupported by higher earnings. This could force inflation to rise again. Like Argentina, our rate of domestic savings remains low and may reflect a lack of sufficient progress with structural reform, especially financial sector reform.

Finally, and perhaps most devastatingly, the current level of growth in the economy has not had the desired impact on employment levels. In fact, since the end of the recession in mid-1993, 41,000 people have *lost* their jobs. Economists are arguing that we will need significantly higher (and potentially destabilising) levels of growth in order to significantly impact on job creation.

What emerges from the recent history of Argentina and Chile is that political stability, bought in the short-term with over-permissive fiscal policy, must, in the end, be paid for. It remains the case that South Africa can ill afford that price. It seems clear that in order to lay the foundations for long-term growth, South Africa must persist with trade reform and the liberalisation and deregulation of the economy. Trade unions must restrict their wage demands and business must get used to competing internationally without the benefit of state protection.

In the face of increasingly dogmatic insistence on the need to simply amputate the functions of the state however, it is also necessary to consider more thoughtfully what capacity the South African government has to play a role in a national growth strategy. The reform process demands the existence of an actor capable of adequately designing and implementing economic policies. This critical prerequisite is overlooked by a one-dimensional emphasis on reducing the public sector, and should be replaced with a more considered 'trimming of fat' and restructuring. Both the extended time framework and the strengthening of the public sector as an actor and institution have been central to the success achieved in Chile. Equally, the absence of these features, with all the attendant consequences, are clearly evident in Argentina.

Endnotes

1. *Trends in Developing Countries*, The World Bank: Washington D.C., 1994.
2. If we look to newly industrialised countries (NICs) like Singapore and South Korea, growth is connected in these economies to a significant increase in exports (mainly manufactured) to the most developed countries, facilitated by a liberal trade regime.
3. Fermandois J & MA Morris, *Democracy in Chile: Transition and Consolidation 1987 to 2000*, Conflict Studies Series No.279, Research Institute for the Study of Conflict and Terrorism: UK, 1995, p.7.
4. Most investment has been portfolio investment rather than investment in real assets.