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PROSPECTS FOR THE GLOBAL ECONOMY AND THEIR REVELANCE FOR SOUTH AFRICA

THE SOUTH AFRICAN INSTITUTE OF INTERNATIONAL AFFAIRS

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The Institute has published these papers as it was felt that their quality and high standard of their presentation warranted a wider audience than the relatively few fortunate individuals who were able to attend the actual seminar.

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PROSPECTS FOR THE GLOBAL ECONOMY AND THEIR RELEVANCE FOR SOUTH AFRICA

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INTRODUCTION TO THE SEMINAR ON THE PROSPECTS FOR THE GLOBAL ECONOMY AND THEIR RELEVANCE FOR SOUTH AFRICA

by

The Chairman, Dr. D.C. Krogh
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You will all agree that this subject is most appropriate at this time in South Africa's history. We have just concluded a very important decade in our history, when we all became too wrapped up with our urgent internal problems at the expense of the need for a wider international perspective. We have perhaps been too preoccupied with these problems, which is understandable. On the one hand, we have been forced to concentrate on insulating ourselves economically from a politically hostile world. On the other hand, we have also been spending a lot of time and effort in fighting sanctions and reforming politically in order to remain part of that outside world. There are therefore paradoxes in our priorities. We shall no doubt stumble across some of them this afternoon in discussing South Africa's future in a global context.

Domestic issues will, of course, continue to occupy most of our time in the future, but I only hope not as much as in the past. There is a big new world out there that has already become less hostile towards South Africa and is, in fact eagerly waiting to welcome us back into the international community, but it is a world that moves on and will not wait forever. We have some important homework and catching–up to do. At the same time, however, we must not make the unrealistic assumption that our internal political and economic problems will be resolved within the next year or two. They will always demand first priority and I am sure that when we come to the economic policy side of the seminar (which is the topic of the final speaker, Dr. Meijer) we shall have good reason to re–emphasise this point. When we talk about the foreseeable future, we shall have in mind the next few years to the mid–90s as the medium term – to be addressed by Dr. Bethlehem – while Dr. Lombard will apply his remarks to the longer period stretching to the end of the 90s.

Not only has South Africa changed dramatically, but the outside world has also changed beyond recognition. Fifteen years ago the United States of America still dominated the world economy. It was the most important single pole of

economic activity. Today that is no longer the case – the United States has to compete with at least two other poles – the one in Europe, particularly Europe beyond 1992, and the other in the East. There is no longer a single dominant world economy. Trade and finance have spread all over the globe, and the international community has become much more integrated as far as trade and finance are concerned. In fact, during the past few decades international trade has grown 50% faster than world output. The United States of America has also become the biggest single borrower in the history of the world, surpassing the whole of the developing world. This is a major global shift that occurred only during the second half of the 80s and which must receive full cognisance in our deliberations.

Looking back, the 70s is today generally regarded as an exceptional decade, not to be repeated soon. In other words, to think that we will go back to the 70s or early 80s as we emerge into the 90s would be a grave misjudgement. The industrial world today regards the two oil price crises of the early 70s as exceptional, as demonstrated by the recent Gulf War. It is unlikely that the world will again have to cope with another primary commodity price–crisis in the foreseeable future. In many respects the second half of the 80s has reminded the world that as far as the future pattern in the flow of funds and the availability of foreign capital is concerned, we must expect a return to pre–1973 times, rather than to the 70s or early 80s when capital was plentiful and cheap, flowing largely from the developed to the developing world.

I think we must also bear in mind that only during the last few years the world has also changed beyond recognition on the political front. Dr. Lombard will remind us that the new world has opted for plural democracy, not people's democracies or one–party states, but for a great variety of democratic forms of representation, particularly in what is transpiring in Eastern Europe and in the Soviet Republics. From the point of view of economic policies that has great implications. This dramatic change will probably prove to be the most important of the century, apart from the two World Wars. Policy–makers must expect that more people are going to be represented politically and, therefore, be much more sensitive to macro–economic policies. The economic impact of the outside world on South Africa and how South Africa is going to respond to these outside forces or policies, will have to be discussed more widely and regularly than before. It is a new policy development that we can only ignore at our peril.

Ladies and gentlemen, I think that I have said enough by way of introduction. Let me conclude by saying something about you our audience. I think that you will agree that we have a very good mix for the occasion today. We have economists, political scientists and members of the financial and business

community thanks to the efforts of the Institute of International Affairs, SACOB and the Economic Society We are looking forward to many questions and a live discussion after first listening to our three main speakers.

May I remind you that this is a seminar in which we are all expected to participate.

The discussions have been so structured that we have three introductory talks of thirty minutes each, followed by a panel discussion and questions from the floor for an whole hour. First, we will have a talk on Global Cyclical Prospects, followed by another on Global Structural Changes in order to distinguish the medium term from the longer term. We will conclude before breaking for tea with the third speaker on South African Policy Responses, followed by an open discussion form the floor.

I think my 10 minutes is up, and it now gives me great pleasure to introduce our first speaker.

THE GLOBAL ECONOMY: STRUCTURAL CHANGE

by

Dr. Ronnie Bethlehem
Group Economic Consultant
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Mr. Chairman, thank you very much for your introductory comments. I want to make a few introductory comments of my own about the presentation I am going to give you this afternoon. There is a problem in the title – The Global Economy: Cyclical Prospects. It seems to imply that we know something about the future, that there is a kind of determinism at work, which would make it possible for us to forecast economically. As an academic economist, rather than a business economist, I have some reservations about that. I wonder to what extent we do know the future – or have any possibility of knowing it.

I am reminded of what Professor Lachmann once said in a "solution" to this particular problem: 'The future might not be knowable but it is certainly imaginable` and you will forgive me if this exercise becomes an essay in economic imagining. It is going to be very much a look into the rearview mirror in an attempt to see the road ahead – whether that is the right way to drive either a motor vehicle or the economy is questionable.

By way of introduction, it is important that we should look at the global economy, pre–occupied as we are with the South African economy and its destiny. This is often forgotten in the hurly–burly of the political debate going on here. I would say, if you asked me to estimate a figure – and I don't know if Jaap Meijer would agree with me or not – that 80% of the performance of the South African economy is determined, not endogenously, but exogenously. Such is the leverage of the balance of payments for the rest of the economy that it could be argued that the major part of the South African economy depends on how the global economy is performing at a particular stage. In other words, if we are going into a protracted recession globally in the 1990s, you can remove all the sanctions from the South African economy and do what you like but it will still stagnate. On the other hand if we have a booming global economy, you can apply all the sanctions you like on the South African economy and we will still have money pouring out of our ears – if the gold price is $850 an ounce, if the platinum price is up and we have healthy markets for our mineral and other exports. So remember that the global economy is very important for the South African economy and presumably that is

why this is the first item on the agenda.

The first diagram is an illustration of what is happening to the global economy in terms of its real performance – that is the volume of industrial production. What emerges very clearly from this is a mix of performances. What can be seen here is that if we take the United States, industrial production has been declining – it is below zero. These are percentage changes per annum in the performance of the global economies concerned. The United States has been in recession for some time now. The UK economy has been in recession for even longer. We are showing in this diagram the performance of our leading trading partners. While we have good performances from Germany and Japan, we have a rather disappointing performance from Britain and the United States. Yet we can also see that the general tendency, even for Germany and Japan, has been for the rate of increase in production to decline in recent years.

In a sense the 1980s represented a long period of economic upswing in the global economy without a break – the US for example kept above that zero line throughout the 1980s. It has now dipped in the 1990s below that line. While the 1980s was a period of extended and almost continuous upswing in the global economy, the situation has changed and part of the reason why our own economy has been experiencing some difficulties is because of this general wind-down in the global economy.

Also important to the performance of the global economy is the matter of unemployment. I think that it is important to emphasise that something very important happened in the 1970s in the global economy. Prior to the 1970s, what in economics is known as a Philips Curve seemed to remain intact and there was an inverse correlation between inflation and unemployment. That inverse correlation had important policy implications in that it seemed to indicate that if you wanted to get on top of the problem of inflation, the way to do so was to drive the economy into a recession – that reduced the pressure on prices and inflation came down; on the other hand if unemployment became too high and you wanted to soften the unemployment situation a little, the way to deal with that was to indulge in some inflationary financing. The 1970s saw major and dramatic changes in that pattern of experience, brought about by a major structural adjustment arising out of the first oil crisis in 1973/74. We found in the 1970s and into the 1980s this correlation changing into one of a positive correlation between inflation and unemployment and a huge disappointment emerging with state intervention in the economy. Attempts on the part of the state to address the matters of unemployment and inflation tended to be counter–productive and this disappointment infiltrated or trickled down, if you like, from the Conservative Party to the Labour Party in

the United Kingdom. This occurred in other countries as well.

Unemployment is an important dimension to consider in tandem with inflation. What you can see in the second diagram, particularly in the case of the United Kingdom, is the success of the Thatcher Government in bringing down unemployment – it took some five years for the policy to be effective, and then the decline in unemployment was dramatic. It occurred right through to the end of the decade. It has only been in 1990 and 1991 that the United Kingdom has run into difficulties again because of a rise in inflation, and unemployment itself is rising again. In the case of the United States the 1980s was an important decade of job creation – well over 20 million new jobs were created by the expansion of the United States economy in the 1980s, but as we moved on to the end of the decade, rising unemployment has started to emerge as a problem again.

You can see also that in the case of Germany unemployment had started to decline and in the case of Japan it has always been relatively low and has been tending to fall.

The other side of the policy coin is the matter of inflation and what we see in the third is rather important, particularly for the emerging consolidation of the European economy. We see, for example, in the major countries, a convergence of inflation. But what is interesting in this is that whereas in the United Kingdom and the United States inflation has come down, in Germany and Japan inflation has been rising. Inflation has started to fall in Britain as a consequence of a tightening of policies and has also declined in the United States. If you take the overall picture since 1986, the overall tendency for global inflation, particularly in the major economies, has been for global inflation to rise.

We have to ask ourselves a question about that – why has the gold price been so subdued, when the underlying inflation rate, particularly of Germany and Japan, but also of other countries (look at the huge rise in inflation in the United Kingdom), has increased? Even in the United States inflation has risen to high levels. This has happened from 1986, when in Germany and Japan inflation was negative and was low in both Britain and the United States We have had this huge increase in the global level of inflation, particularly in the major countries, and yet the gold price has remained subdued? I think that the answer is going to emerge in some of the later diagrams to be discussed. The fact is that with the policies now being pursued by the G–7 countries, particularly policies which emphasize positive real interest rates, inflationary expectations in the global economy are being kept under control. While inflation has certainly risen, the cost of moving out of money has become punitive, with positive interest rates playing an important role in

keeping inflationary expectations subdued and under fairly strict control.

The third critical element in the global policy mix is the question of imbalances in the global economy - trade and payments between the major countries. Here you can see how the United States' position changed to one of massive deficit in its foreign accounts, largely counter-balanced by surpluses in Germany and Japan. It was necessary for a return to global stability that those imbalances should be eliminated. What Diagram 4 suggests is that some important progress has been made in the elimination of those imbalances, and if one takes this picture at face value it looks quite encouraging. The imbalances in the global economy have been eliminated, there is greater convergence as far as inflation rates are concerned, and that would seem to point to a tendency towards greater global economic stability. I shall not argue that this is not the case, although I will say that there is some reason to be concerned that this may be too superficial a conclusion to reach. But this rather more hopeful picture is supported also by the political shifts in the global economy, particularly what has been happening in the Soviet Union and Eastern Europe, the unification of Germany and so on. There there has been the pulling back (coinciding with Bush's announcement of a unilateral initiative on destruction of nuclear weapons) from the precipice of nuclear confrontation, with the possibility of a huge peace dividend accruing to the global economy. That is the hopeful perspective. Behind that hopeful and perhaps superficial perspective is something more tricky to which I feel it is important we apply our minds. For example, there are major structural changes now taking place in the global economy which give rise to some concern - for example, the developments in the Soviet Union. The Soviet Union is in the process of disintegration and possible collapse. Certainly its economy is touching bottom and there is the danger, bearing in mind that the Soviet Union remains a nuclear power, that its disintegration could have the consequence of nuclear proliferation if the KGB itself is dragged into fragmentation and nuclear weapons end up in the hands of newly independent republics.

The instability of the Soviet Union and in the whole area that comprises the Soviet Union is very serious for the global economy, particularly because of the implied threat of major migrations of people under the duress of economic collapse. The same applies also to Eastern Europe. In Western Europe, the unification of Germany itself poses very serious problems. Although it now has a common currency and unemployment in West Germany has continued to fall, there has been a huge rise in unemployment in eastern Germany and the problems of the unification of Germany are horrendous. The German surplus has disappeared and become a deficit largely because of that unification and the terms on which monetary union took place. The consequences of this have been a sucking in of

imports into Germany and the complete wiping out of the German surplus. Happily for the United States it coincides with the emergence of a surplus in that country. Japan's surplus has been reduced, but still remains significant.

A lot of progress has yet to be made and there is no reason why we should be too euphoric when contemplating what appears to be a superficially encouraging picture.

Real interest rates are very important when we come to consider the prospects for currencies in the global economy. We define real interest rates as nominal interest rates, with inflation deducted. In Diagram 5, you can see in the United States' case – and this is going to be important when a later diagram is discussed – that the tendency has been for real interest rates in the United States to decline fairly significantly. But an important thing to note is that even though real interest rates in the United States have declined, they still remain positive in real terms. In Germany, in order to deal with the instability that unification has caused, with inflation being the consequence, real interest rates have had to increase. Nominal interest rates have risen very substantially, and even though inflation has risen, interest rates have risen more in order to preserve the monetary stability; and so you have still a significant rise in the level of real interest rates. The same also is true in the United Kingdom where you have a significant positive real interest rate element.

Now let us look at the currency position. Currencies are important because they indicate an enormously important element in terms of policy determination. The Deutschemark/Dollar diagram (No.6) shows the value of the dollar expressed in terms of the Deutschemark. Our starting point is the Smithsonian realignment of currencies which took place in December 1971. The thick line indicates a purchasing power parity value for the dollar. In other words if our starting point was the actual exchange rate of the dollar against the Deutschemark in December 1971 and only inflation differentials had been at work to cause a change in that starting off exchange rate, that is the path the exchange rate would have followed: a decline.

You will remember – and it is amusing to recall – the statement that Nixon made at the time of the Smithsonian realignment. He described the Smithsonian realigment as the greatest event in the history of the world. If you consider the difficulty of getting all the members of the IMF around a single table to agree on this heroic realignment of currencies, I think that was a valid way of describing it. You will recall, however, that it did not last for very long. Within two years the attempt to preserve the Bretton Woods system with fixed exchange rates without

a gold link was abandoned and we had emerged into a world of generalized floating exchanges. As that happened the United States dollar collapsed against the Deutschemark, reaching a low point in the late 1970s and then the dollar started to recover against the Deutschmark as well, until in the mid–1980s it was back to, about 3.45 Deutschemarks. The G–7 countries were alarmed by the continual rise in the dollar – one wondered why it was so, against what at the time appeared to be fundamentals. Finally, the weight of world opinion seemed to overcome the markets and the adjustment downwards was quick and rapid and now we have the dollar lingering in fairly low territory. I think the important conclusion to draw from this particular picture is that, not withstanding the rise that occurred in the dollar in recent months, it remains a depressed currency relative to the Deutschemark. It is not an overvalued currency by any manner of means. It could recover to a level of two Deutschmarks or even more, before one could argue that it was an overvalued currency again. The dollar remains a depressed currency and you can see therefore why that correction in the current account deficit of the United States has happened. It has happened in large measure, over a long time period because the dollar was trading at a generally under–valued position.

The picture of sterling against the dollar (Diagram 7) is equally interesting. The huge rise in the United Kingdom currency coincides, of course, with North Sea Oil. People at the time were describing the UK as a floating sea of oil and so much seemed to be going for it but then came the collapse – in fact the pound came within a hair's breadth of being one pound to one dollar – before it subsequently recovered again. In terms of that model it appears to be over–valued in respect of the dollar.

The next diagram (No.8) is an interesting one, because what it shows is the dollar–Deutschemark rate, which we have looked at before, against real interest rates – the difference between US and German interest rates in real terms. We must distinguish between correlations and causality. I think that in economics what one is interested in is causality. We tend, however, to be very impressed by correlations. US interest rates were falling and German interest rates were rising, and in the correlation between the difference in real rates and the Dm/$ was very strongly intact. Then you have this rise in German interest rates relative to US interest rates, which caused the currency line to rise ahead of that. What we have to ask ourselves is: what is going to be the relationship between the Deutschemark and the dollar in the future? This is an important picture in order to try to draw some conclusions as to which way the dollar is headed, relative to the Deutschemark. Is the dollar going to rise to the level of being over two Deutschemarks or not? We have to look and see what is happening in the area of real interest rates in order to draw those conclusions.

Germany's interest rates are being kept high in order to manage its now emerging current account deficit and also a large federal deficit and which is of concern to the Germans for monetary stability. Interest rates are being used as a deliberate policy to manage that. On the other hand, the strength of the Deutschemark relative to the dollar and the Deutschemark as a central currency in the European system are both proving problematical, because Germany no longer has a surplus. I think one can probably argue that as far as the balance of payments is concerned it is possible to see Germany's retreat into deficit on the balance of payments as being a temporary phenomenon. But if the German deficit is going to become a more permanent feature then you begin to question whether the currency can be sustained at this present high level and whether some downward adjustment may eventually become necessary in order to effect a correction of what is becoming an intolerable deficit on the balance of payments.

We must now discuss what this all means for South Africa. What our next diagram (No.9) shows is South Africa's non-gold exports in relation to the weighted index of South Africa's trading partners' industrial production. What is very interesting is the incredible performance of South Africa's non-gold exports almost throughout the period when sanctions were imposed on South Africa's economy. South Africa's non-gold exports have performed remarkably well against a background of a collapse in the gold price and a very disappointing performance, certainly growth-wise, in terms of gold exports. One must quickly hasten to add that if it had not been for this extraordinary performance of our non-gold exports the balance of payments of South Africa would have looked very different; our policies would have looked very different; our levels of unemployment would have looked very different and so on. If we are going to have in the 1990s a continued good growth in the industrial production of our leading trading partners and that is what we are hoping for in 1992 and 1993 then that will be an important plus for hopes that the growth in non-gold exports will continue.

Our last diagram (No.10) illustrates the rand-dollar exchange rate and it also points to important conclusions. Our starting point is the Smithsonian realignment of currencies. Again, the thick line illustrates what would have happened to the rand from the starting point had only an inflation differential between the United States and South Africa been at work. The rand would have followed that downward path illustrated by the thick line. The path it actually followed was the thin line and you can see that for various periods it was an over-valued currency. The collapse of the currency after 1982, down to the depths of the crisis in 1985, when sanctions were imposed on South Africa, took it from being an over-valued currency to being an under-valued currency. You can see that it has moved in a more-or-less sideways direction since then. It recovered to a point of just over 50

American cents before retreating again – its current position is round about 35 American cents. You can see that the rand is approximately correctly valued in terms of this model. It is neither over–valued nor under–valued. It is certainly does not offer at its correct valuation an opportunity for the monetary and fiscal authorities to use the exchange rate in any deliberate way in order to achieve specific policy or strategy objectives.

I would say that the important job from the point of view of policy must surely be to try to manage this, so that we narrow the gap between South Africa's inflation and overseas inflation. The thick line indicates the path that the rand will continue to follow if we do not succeed in narrowing that gap. If we want the rand to maintain a favourable value then it is absolutely imperative that South African inflation is reduced relative to overseas inflation to stabilise the currency.

That is the end of the presentation. May I just conclude by saying this: What we are hoping for is some recovery in the global economy that makes it possible for a recovery in the South African economy to continue. It is important to recall what I said at the beginning of the presentation: that 80% of South Africa's economic performance depends on how the global economy performs at any particular time.

DIAGRAM ONE: INDUSTRIAL PRODUCTION

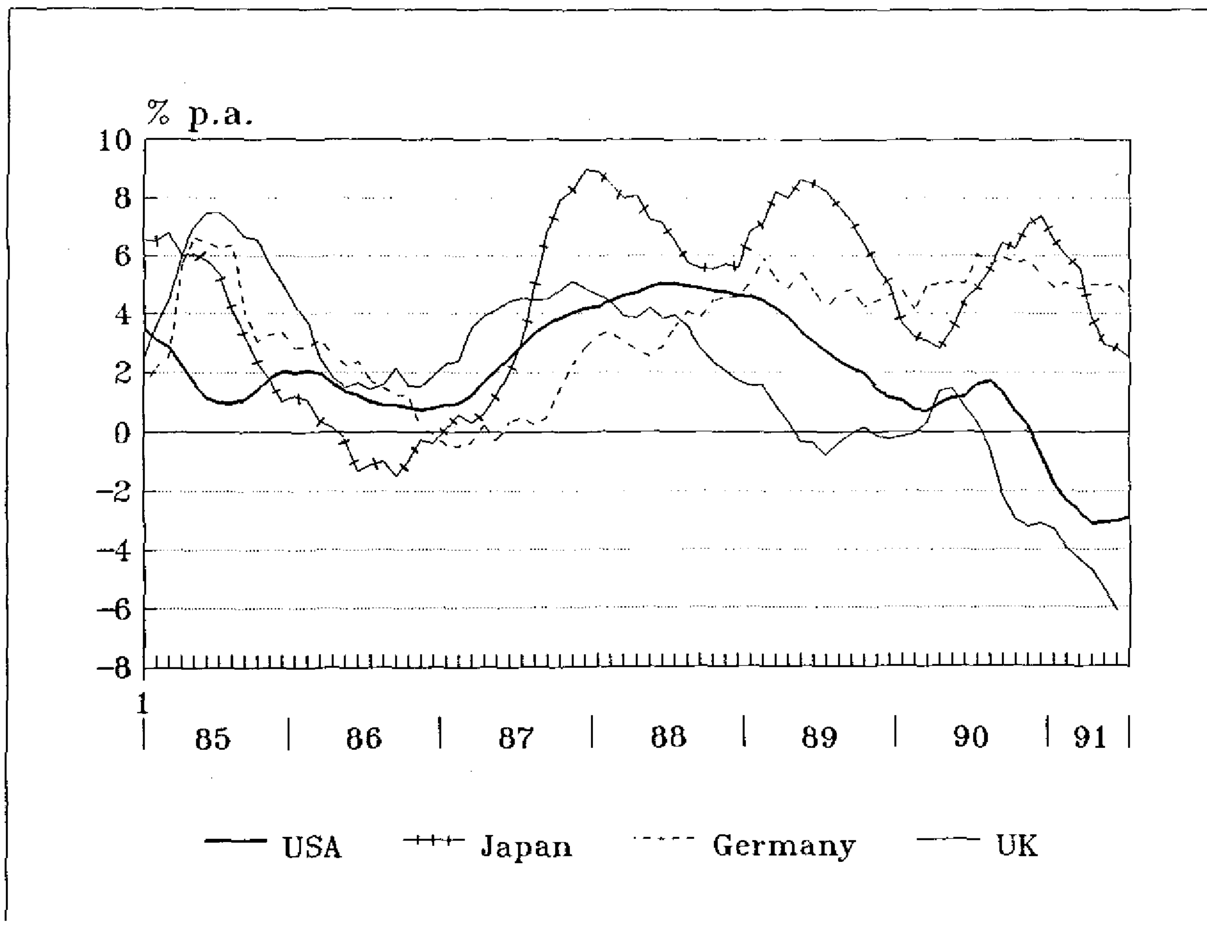


DIAGRAM TWO: UNEMPLOYMENT

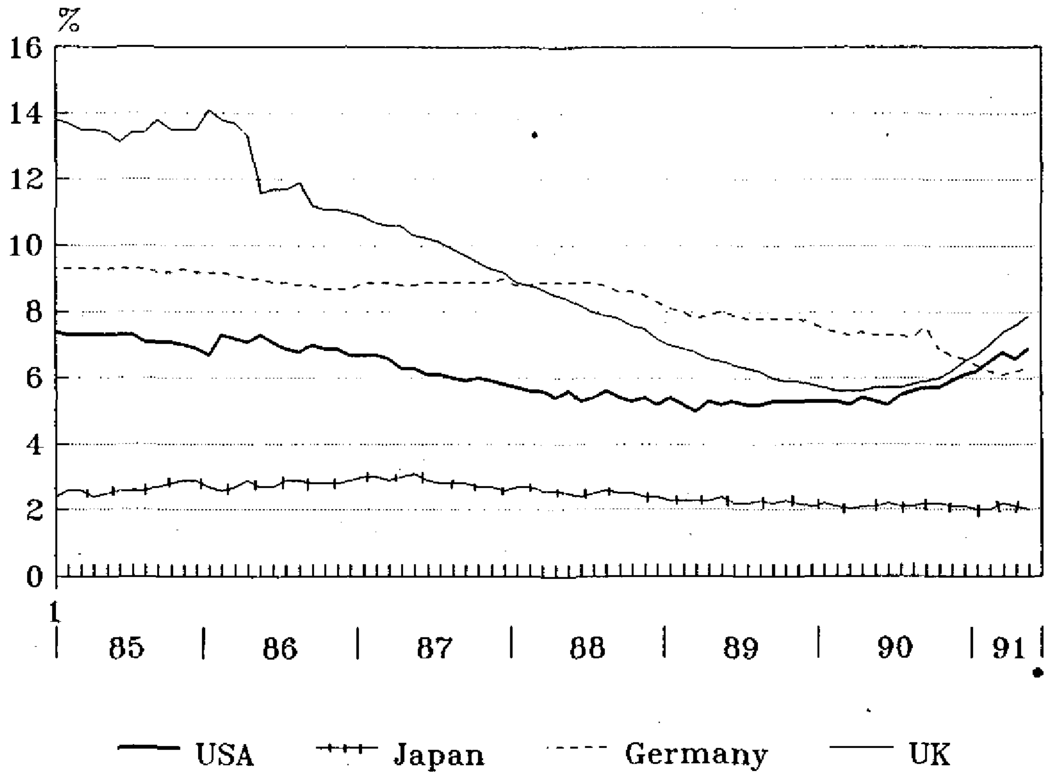


DIAGRAM THREE: INFLATION

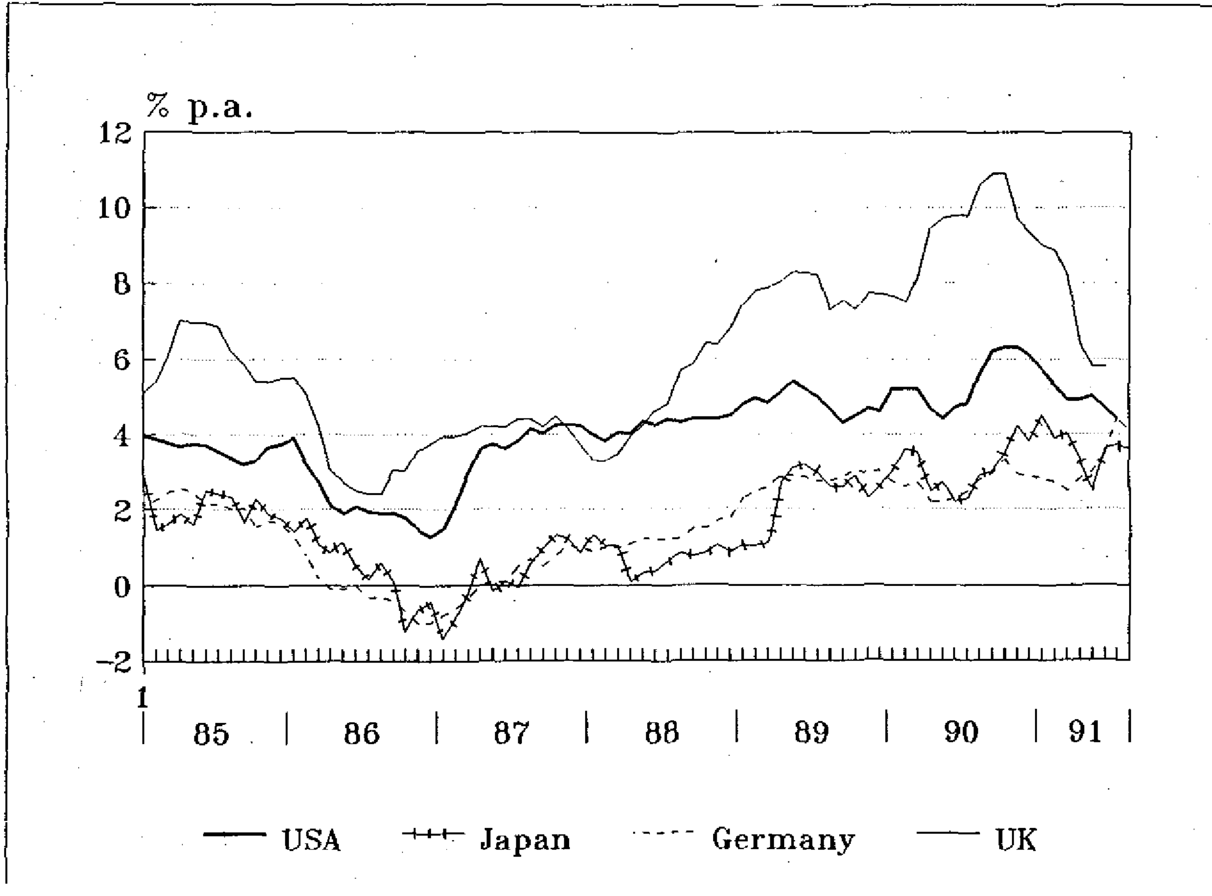
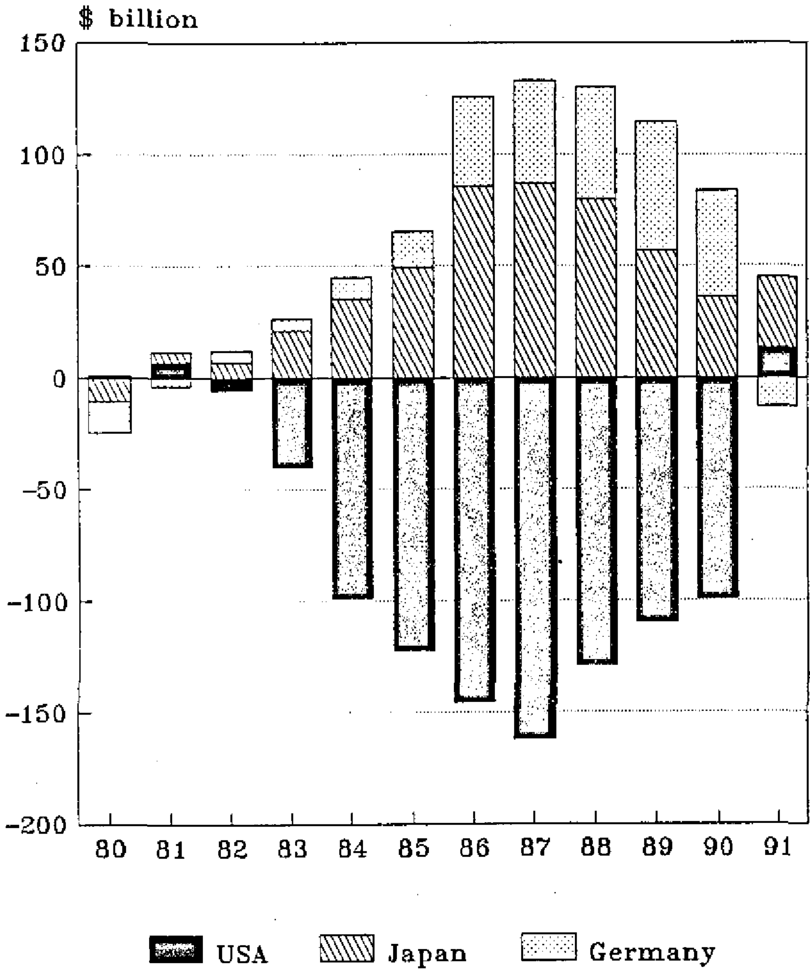


DIAGRAM FOUR: CURRENT BALANCES



1991 - 6 months to June

DIAGRAM FIVE: REAL INTEREST RATES

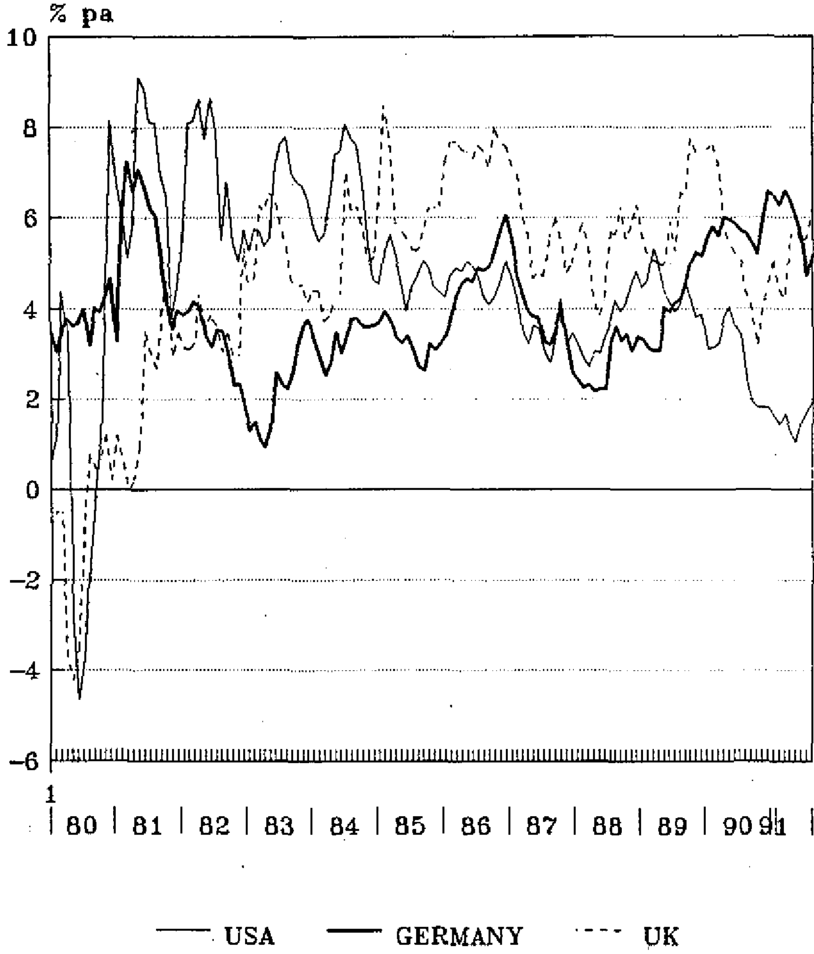


DIAGRAM SIX: DEUTSCHMARK/DOLLAR

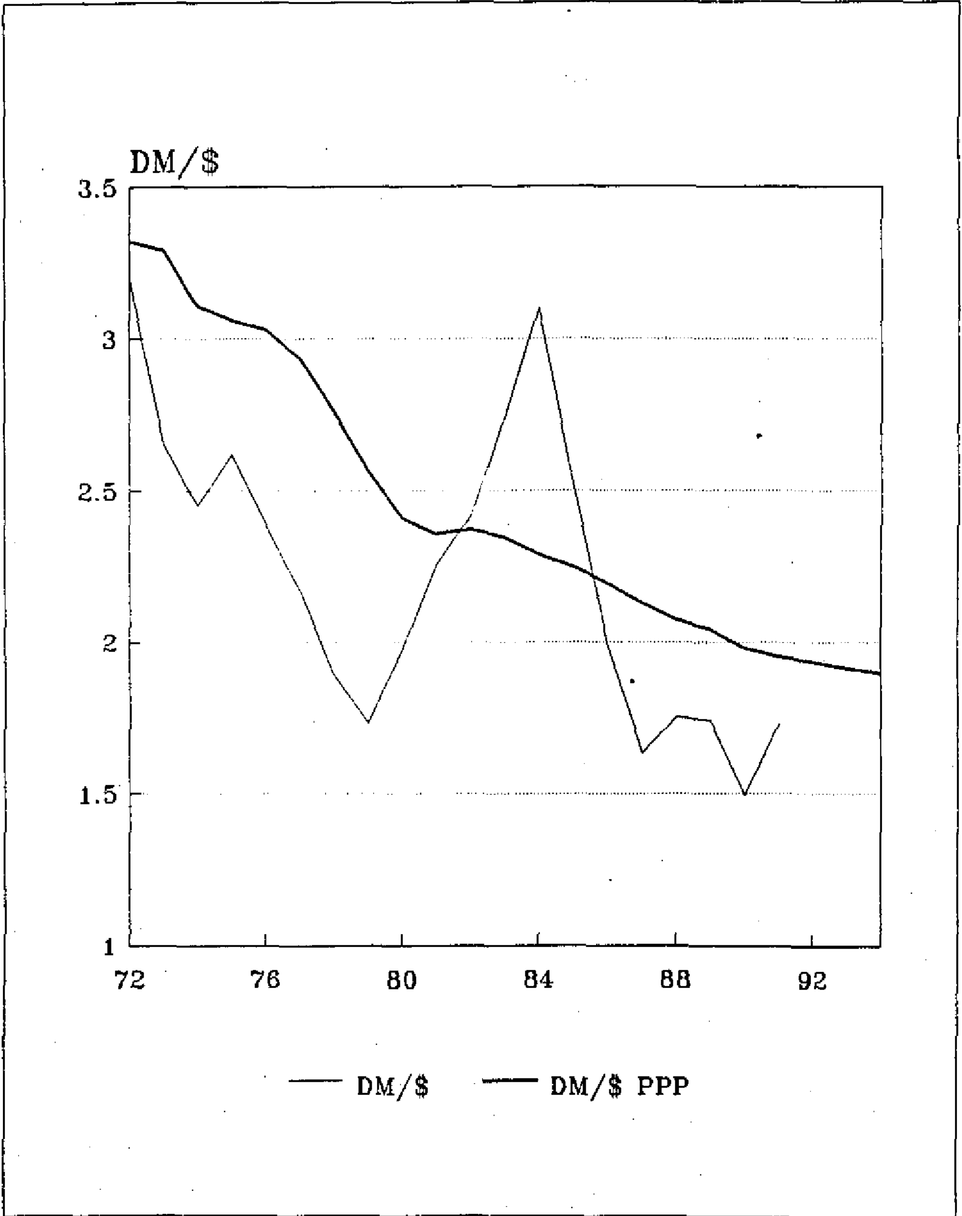


DIAGRAM SEVEN: DOLLAR/STERLING

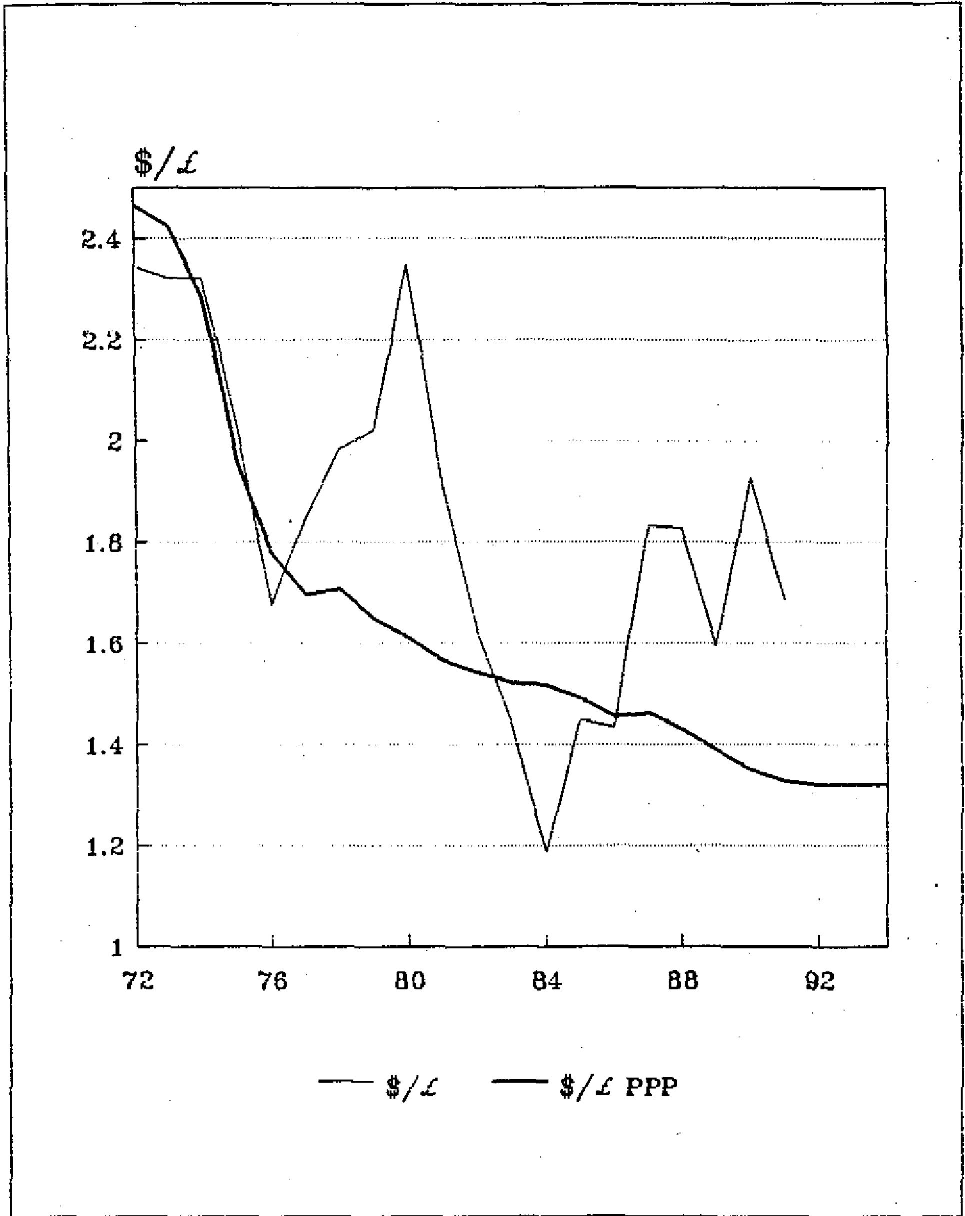


DIAGRAM EIGHT: DEUTSCHMARK/DOLLAR AND REAL INTEREST RATES

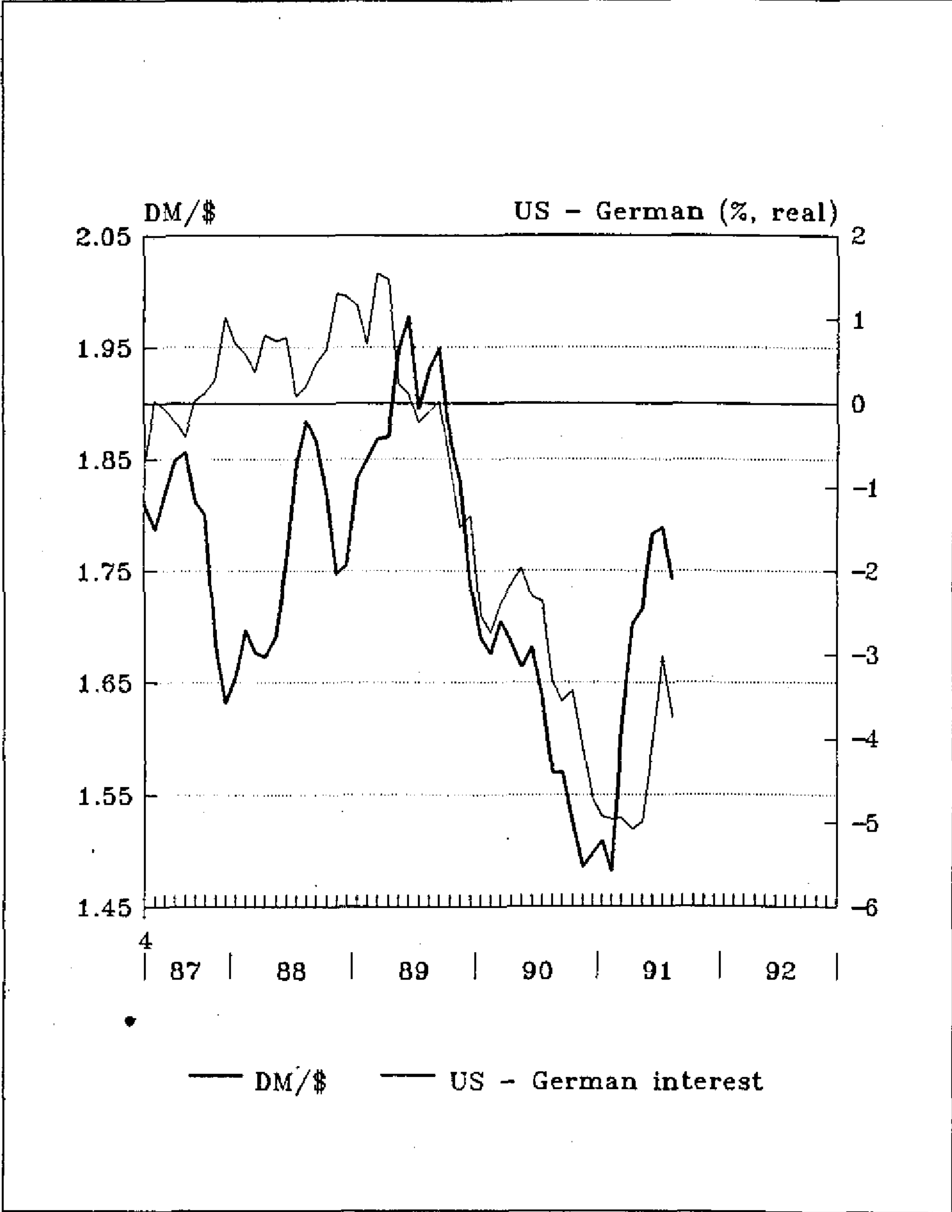


DIAGRAM NINE: SA EXPORTS AND OVERSEAS INDUSTRIAL PRODUCTION

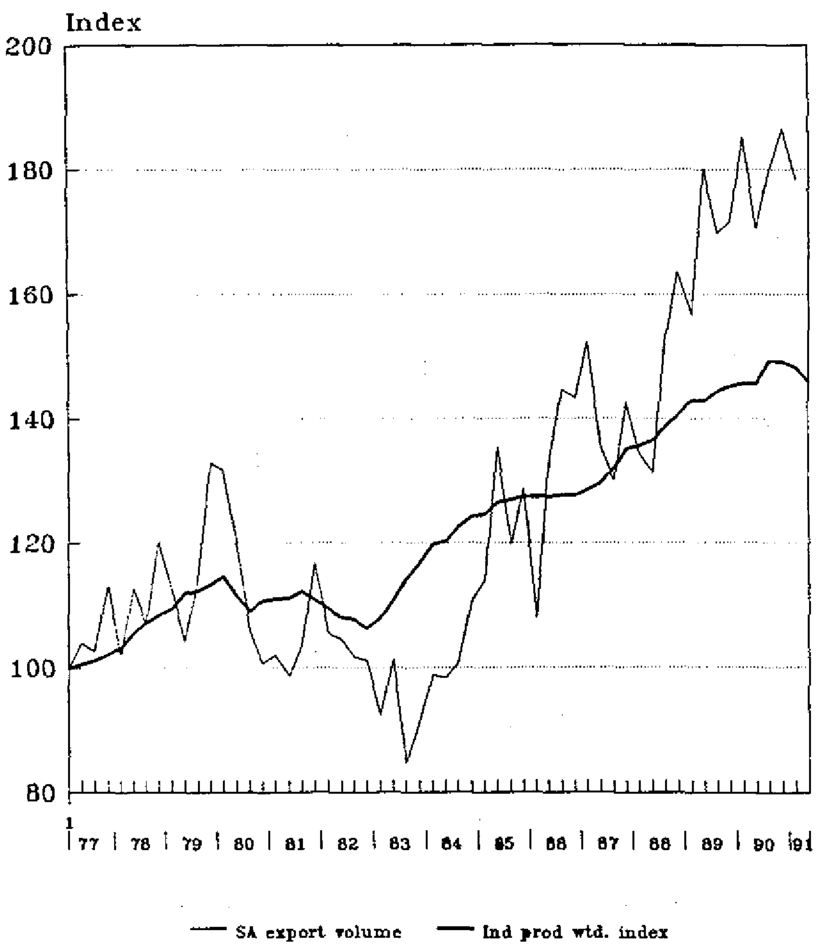
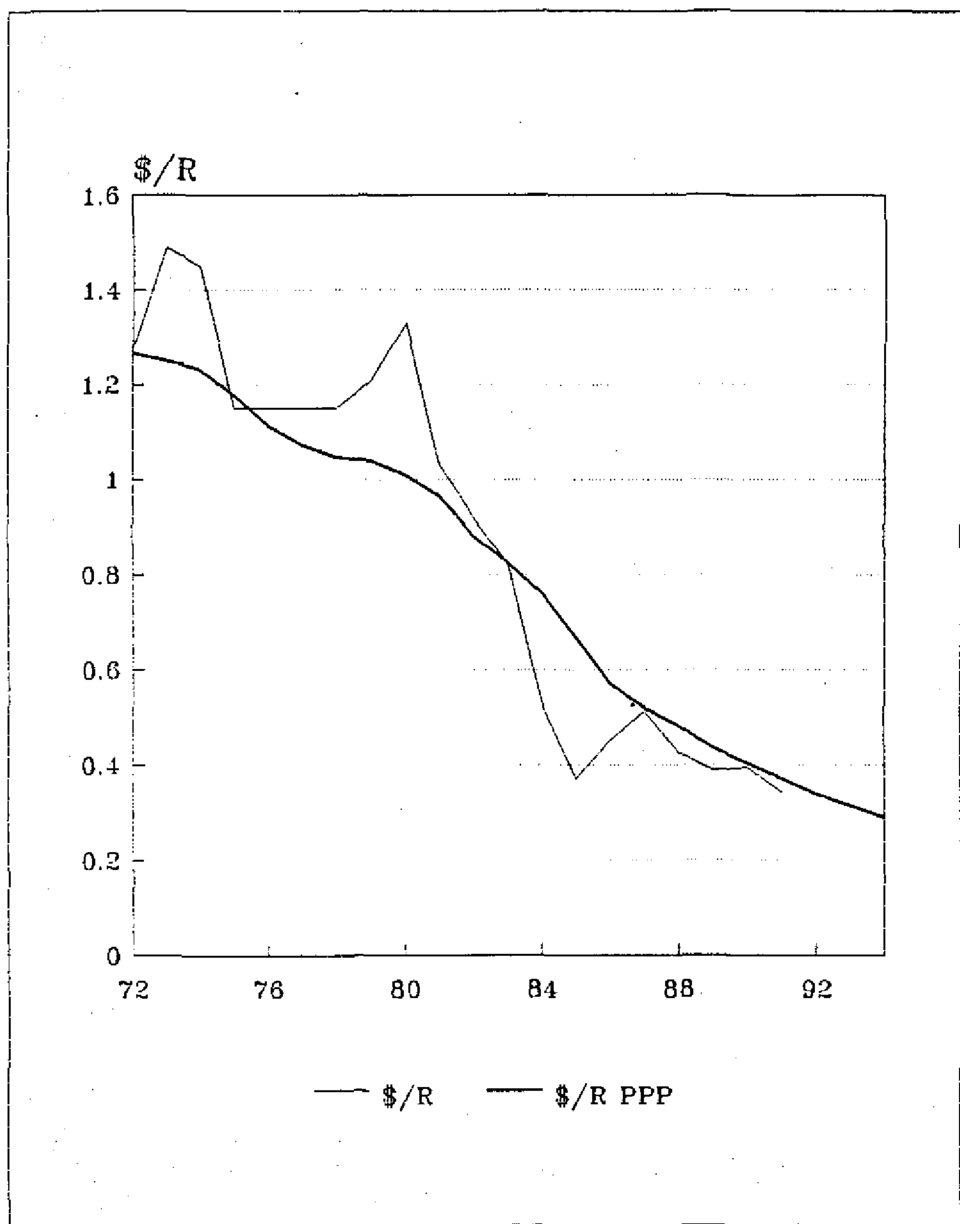


DIAGRAM TEN: DOLLAR/RAND



STRUCTURAL CHANGE IN THE GLOBAL ECONOMY

by

Prof Jan Lombard
Professor of Economics, University of Pretoria

Falstaff:	I will not lend thee a penny.
Pistol :	Why, then the world's mine oyster, which I with sword will open

William Shakespeare
From Act II Scene II of The Merry Wives of Windsor

"The world is mine oyster" has indeed become the watchword of those businessmen who find the scope at home too unrewarding for their capabilities and resources. At the same time the world economy has been transformed in the four decades since the Second World War. In fact the economic links between national economies have grown faster than economic activity itself. This reflects the fact that the major participants in world trade found it to their national benefit to allocate more and more domestic resources towards their international competitive advantages. By the same token they have found that it is nationally advantageous to import increasing proportions of their inputs from the most competitive international sources.

This trend brought about a marked increase in economic interdependence. Simultaneously there has been a marked increase in what Ralph Bryant of the Brookings Institute called political pluralism – a marked expansion in the number of governmental decision–making units in the world and a greater diffusion of power among them.

Moreover, within each national economy the diversity of sectoral vested interest has not diminished over these four decades. Accordingly international relationships remain subjected to stresses and strains caused by the manoeuvres of national governments to manipulate their foreign relations in the service of domestic reconciliations.

Nevertheless there is a gradual but inevitable trend towards enhanced multilateral decision–making and governments will indeed in the years ahead be making much greater efforts to co–ordinate economic policies. On the other hand,the lack of convergence in analytical views about how national economies

influence each other remains an impediment sufficiently severe to preclude ambitious efforts in this regard. Moreover, as we enter the final decade of this century the political plurality of the global economy is being radically increased by the collapse of communism in Eastern Europe and the Union of Soviet Socialist Republics. To these events must be added two more, namely, the movements among the huge populations of Asia towards market orientated domestic economic organisation and foreign economic relationships and the determined endeavour in Western Europe to finalise the unification of its political economy.

The structure of the global economy is accordingly a very dynamic phenomenon which is changing virtually continuously. But broadly speaking this evolution over the post-war period displayed three distinct chronological stages. Each stage has a particular story to tell about how the system of the global economy is put together.

The first stage after World War Two was a period of liberalisation and rapid stable expansion until about the end of the 1960s. Then followed a decade of grave economic instability and slow growth which lasted until the early years of the 1980s and for some national economies well beyond that. The third phase during the 1980s was characterised by structural adjustments to restore micro-economic market efficiency as well as macro-economic balance between aggregate demand and potential supply.

As there is no time to follow the details of events through these three stages, I note only some of the salient features of each phase:

In the first phase the spectacular growth in world trade came in response to a reversal of the far-reaching barriers to trade erected in the 1920s and 1930s, the cartelisation of industry in those depressed years and the tight web of controls over international capital flows during the same period.

- The composition of trade also changed considerably. Much of the growth took place in industries characterised by significant economies of scale, product differentiation and far above average investment in research and development.

- Foreign direct investment (FDI) reshaped the world's industrial geography, notably through the transfer of technical and managerial know-how developed in the mass market of the United States, to the newly emerging European Common Market, to Latin America and to Japan and South East Asia.

- Major structural changes took place in the geographic origins and directions of international trade and investment as European economies and Japan "caught up" with the United States in respect of productivity gains and industrial competitiveness. Close upon the heels of the reconstruction of the Japanese economy in the 1950s, followed the entry into the global economy of the newly industrialised very competitive economies of the Pacific Rim. By the middle of the 1960s the so-called "dollar shortage" problems dissolved and, in fact, approached the opposite situation of a "dollar surplus".

Salient features of the slow-down in the 1970s were:

- The profile of high inflation and how it arose: firstly the decline in productivity gains reduced the scope for absorbing nominal wage increases without cost-push effects on prices. Secondly, the belief that governments through aggregate demand policies would guarantee full employment lulled firms into a false sense of security, slowing down the adjustment to changing circumstances. The resulting inflation confounded market signals and made optimal resource allocation problematic.

- The solutions sought in raising public spending on social programmes, unemployment insurance, etc., made sharp rises in the burden of taxation on private output inevitable.

- The emergence of the dollar surplus problem (partly fed by the huge outlays by the United States on the Vietnam War) together with excessive domestic money creation also in many other industrial countries, led to the breakdown of the Bretton Woods system of exchange rate stability early in the 1970s and to the emergence of the so-called system of managed floating of rates.

- On top of these developments, and probably partly triggered by them, came the first and second oil shocks in 1973 and 1979, respectively. The recycling of the huge amounts of petro-dollars back to the industrial and developing economies of the globe gave rise to a whole train of economically unhealthy effects, including excess liquidity in the international banking system, and severe changes in the relative price of energy and energy intensive products.

Salient features of the period of structural adjustment in the 1980s were:

- A very close correlation between unemployment and inflation in the structure of market economies could no longer be doubted in the light of the experience of the industrial countries over the four post-war decades. Inflation became

enemy number one in the global economy.

- National responses of the several major players in the global economy centred on different adjustment mechanisms at the micro–level of market organisation. Japan and the United States benefited from their respective highly efficient processes of wage adjustment. The decentralised character of their trade unions forged a closer link between corporate profitability and collective bargaining outcomes. Moreover, in both countries producers faced fierce competition, domestically in the United States and mainly internationally in Japan. But because the Japanese propensity to save was much greater than that of the United States, the Japanese economy could grow much faster, which made adjustment much easier for Japan. Productivity in Japan continued to rise much faster than in the United States. In European countries with centralised systems of wage bargaining, the process of adjustment required much more political intervention from central governments. Wage setters had to be forced to bear in mind the macro–economic consequences of their actions. Moreover, traditional industrial structures in Europe with limited domestic markets remained less flexible, so that government protection remained strong while public expenditures continued to rise until late in the 1980s.

- The diverse national policy responses led to further large shifts in international industrial competitiveness and serious imbalances in international trade and payments. This was reflected in a continuation of severe exchange rate instability into the early 1980s, i.e. until the 1986 Tokyo Economic Declaration by the so–called G7 countries, introduced the current degree of close co–operation between these major countries in the international foreign exchange market.

- A return to much greater reliance on monetary discipline and the harmonisation of monetary policies reflected in the return of interest rates to positive real levels throughout the industrial world.

- The deterioration of the commodity terms of trade of developing countries and the sharp increase in interest rates gave rise to extensive debt moratoria by these countries.

- With the advent of the international debt crisis, two distinct trends have emerged. First, international bank lending fell and the international market for securities began to grow vigorously. Second, most developing countries lost access to external finance from commercial sources.

- The renewed surge in foreign direct investment (FDI) in the last few years of 1980, although most of the FDI took place among industrial countries. during this period, the United States found its position as the leading source of foreign investment changed to that of being the largest recipient.

- In the developing countries FDI aligned itself to their export promotion policies, mainly in the assembly and manufacture of labour intensive products such as textiles, clothing, electronics and intermediary stages of industrial processes. Among these countries FDI grew the fastest in Asia at between 13 and 16 per cent, with most of it in East and South East Asia. Africa's share of FDI was less than 3 per cent. This geographic integration of the N.I.Es was powerfully strengthened by technological advance and the spread of technical education.

- This globalisation of factor and product markets, has not only accentuated international cost and price competition, but it has also led to a greater awareness of the cost of tax induced distortions - especially on savings and labour supply. This has, since about 1988, in turn spurred fiscal reforms of unprecedented scope. Since 1988 measures have been taken to reduce rates of personal income tax and corporate income tax in almost half of the industrial countries associated with the O.E.C.D.; selective consumption taxes have been replaced with broader ones, and tax collection procedures have been considerably simplified.

- Areas in which international harmonisation of policies are still problematic are industrial and trade policies aimed at protecting vested domestic interests, e.g. increasing resort to anti-dumping actions, countervailing duties, use of non-tariff barriers which are specific and discriminatory. The main hope for a reversal of those trends in trade policies still lies in the ultimate successful outcome of the Uruguay Round of G.A.T.T. negotiations.

A full, or even an effective understanding of the structure of the global economy on the basis of the evidence available still seems to be beyond reach. And so the co-ordination of national economic policies will accordingly proceed at a pedestrian pace - governments feeling their way in an area full of shadows. But a clearer idea about how things work in international economic relationships and how government intervention in markets has changed in recent years is emerging.

Thus the structure of the global economy is becoming increasingly market orientated. The expectation of World government in economic affairs is fading progressively. The direct influence of formal international organisations like the

I.M.F, the World Bank, the O.E.C.D. and the B.I.S. on structural change in the global economy remains fully subordinate to the convergence or divergence of the political wills of their major member governments. At the same time, as was said above, their most influential function has been in promoting general analytical foundations to permit policy makers to attempt full-scale exercises in the co-ordination of economic policies.

In the meantime, it seems the process of economic integration is mainly driven by market forces which by their nature take the course of least costly resistance. Thus stresses arose....These stresses arose typically from those domestic economic activities which have traditionally been least integrated internationally. However, in economics, "everything depends upon everything else". The economic support systems in whatever sector of the economy sooner or later affect the health of all the other sectors. This definitely applied to the effect of agricultural support systems in most countries. The problem also exists in much of national industrial policies, national social security systems and the organisation of national collective wage bargaining.

On the other side of the spectrum, the forces which displayed the greatest propensity towards international harmonisation were the financial flows in all forms: i.e. trade credits, commercial loans, and especially foreign direct investment, and in recent years the revived interest in securitisation of obligations, and the development of financial derivatives such as futures and options.

Closely allied to the financial flows and strongly supporting their international levelling effects was the acceleration of technological advance and its dissemination to the far corners of the globe. Probably the most prolific carrier of technology across national borders was the process of foreign direct investment in which transnational enterprises have been a principal propelling force.

The financial integration of the global economy certainly forced the central banks of the major trading countries and their Treasury counterparts towards a very high degree of international co-ordination in monetary policies and, in particular, with regard to attitudes about the role of interest rates in national stabilisation policies. It also led to harmonisation of the rules and regulations covering banking practices and operations in capital markets.

Finally the international flow of finance and technology in turn placed heavy pressure on governments to sensitise their domestic tax systems and policies to international trends in respect of taxes on corporate profits, and their subsidies to the introduction of industrial technology.

The major "structural issue", so to speak, in the philosophies behind economic policies was certainly the recent revival of classical supply side thinking as opposed to Keynesian demand management philosophies. Basically there is no necessary conflict between Keynes' thoughts about solving problems of deficient aggregate demand, on the one hand, and classical truths about optimal allocation of productive resources through efficient markets on the other. Unfortunately, in public affairs, as Keynes himself remarked on occasion, "If you wish to be heard, you have to shout!" Accordingly, badly truncated propagandistic versions of the policy agendas of these schools of thought usually carry the day. The effect is that policy stances till tend to swing like pendulums between liberating markets and controlling aggregate demand as the key to stable growth.

Ideas, rather than circumstances, however badly they may often represent reality, still determine the run of events. This obtains not least in the events of the global economy.

Although a fully comprehensive and generally acceptable analytical framework for the co–ordination of national economic policies certainly does not exist, there is no doubt that the process of structural reform among national economies has been mutually re–enforcing. This was notably the case among the members of the O.E.C.D. – the industrial countries.

To some extent,the tendency of national governments to follow one another's example in policy styles may have been driven by the immediate need for one country to defend itself against new pressures from its partners in international trade and finance, e.g. in the field of international financial flows, interest rates and industrial incentives. However, in other respects, governments may have indirectly learned more from each other's successes or failures, e.g. in their policies with regard to wage bargaining and even taxation. To this extent, it may be said that a beginning has been made to establish standard international principles of economic policy.

SOUTH AFRICA: POLICY RESPONSES TO GLOBAL CYCLICAL AND STRUCTURAL CHANGE

by

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INTRODUCTION

The 1980s, like the 1930s, are now seen to have been a decade in which a substantial number of economies worldwide fared poorly, showed major degeneration or experienced acute difficulties. "Africa", for one, refers to the ten-year period concerned as "the lost decade" of the 1980s. The weak performances and distressed conditions in these economies have provided reasons for a re-examination of the workings of national macro-economic systems, as well as a reappraisal of the appropriate role of governments in these systems, and a reconsideration of appropriate policies for these governments.

The similarities between the 1930s and the 1980s, however, generally do not extend much further than this agonised search for new directions. The 1930s were a decade of deep depression; their most prominent and acutely felt problem was mass unemployment in the industrially most advanced economies (Germany, Britain and the United States). The perceived source of that problem was a failure of aggregate monetary demand. The solution, therefore, was held to lie in deliberate demand management, and more specifically in the boosting of demand through stepped-up government expenditure and deliberately increased budgetary deficits.

In contrast, the problems of the 1980s have typically concerned the collapse of economic growth and national economic deterioration in the poorer and more severely underdeveloped economies in particular. A major source of their difficulties, or at least a strongly exacerbating factor, is perceived to have been the mistaken actions of unduly and sometimes oppressively interventionist governments. Proposed solutions have taken in supply-side economics, liberalisation of markets and institutions, and side-lining of the authorities as economic decision-makers. New respect is displayed for the individual, his ability to respond positively to incentives, and his innate business acumen, energy and drive.

If, however, the authorities in many less developed economies often failed to pursue appropriate policies, they frequently did so in the face of and in response to major external and internal "shocks". Both the 1970s and the 1980s were marked by upheavals of dramatic size and intensity in the world economy; these included such *diverse (but often sequentially linked and interrelated) developments* as the United States' closing of its "gold window" in August 1971; the oil crises (and the gold booms) of 1973–74 and 1979–80; occasional sharp rises and declines in selected world commodity prices and the international debt crisis which broke in 1982. In recent years – extending into the 1990s – we have seen the reunification of the two Germanies, the Gulf War, the presumed ending of the Cold War, and the progressive disintegration of the Soviet Union. We in South Africa experienced periodical outbreaks of socio-political unrest as we prepared for a fundamental reorientation of the government's macro-political policies. In addition, our economy was subjected to major outflows of capital on its balance of payments from the mid-1980s onwards, and to an abrupt termination of many of the country's overseas credit facilities from July 1985.

The present article aims to deal with policy responses to global cyclical and structural change. An extensive literature, for the edification and enlightenment of national economic authorities, has, however, sprung up from the fountainheads of the World Bank and the International Monetary Fund around the subject of dealing with "shocks" rather than of responding optimally to cyclical ups and downs or to gradual structural shifts in the world economy.

"Shocks" of the types referred to above and cyclical or structural changes in the world economy are, however, closely related to one another. From the point of view of a national economy, cyclical and structural changes in the international economic environment may be approached on the one hand as long-drawn-out shocks that are of a temporary and reversing nature and on the other hand as a quasi-permanent, indefinitely cumulative and generally non-reversible character, respectively. Conversely, shocks of the kinds discussed here may be viewed as very rapid, abrupt and mostly unforeseeable changes in the cyclical condition or in certain structural features of the world economy.

Most frequently – but not, of course, by any means always – the pertinent aspects of shocks, as well as of the more slowly moving cyclical and structural changes in the world economic environment, present themselves to countries at the receiving end of such changes in the form of major shifts in the world demand for (or in the conditions *governing* the world demand for), or in the world supply of (or in the conditions *governing* the world supply of), *internationally traded goods* and services that are of particular importance to the countries concerned[1]; the effect

of such changes therefore normally is a major shift in those countries' so-called terms of trade (i.e. in the ratio of the general level of export prices to the general level of import prices). Next to these rank shifts in the cost and availability of foreign capital and finance.

Subsequent paragraphs will deal with the subject matter of policy responses to shocks and other cyclical or structural disturbances by –

* providing an outline of what governments are supposed to do, as well as what they are supposed to *avoid* or *not* to do, (1) in response to world cyclical and structural change, and (2) in preparation for the *possibility* of world cyclical and structural change. The objective of these policy actions and responses obviously must be to allow the domestic economy to adjust to such changes in the smoothest, least disruptive and most damage-containing manner. Sub-optimal adjustment will slow down the real expansion of the domestic economy to below the maximum level of its (still) attainable and sustainable real growth.

  Alternatively, failure to adjust appropriately may give rise to acute problems or "crises" which may force the authorities to take direct command of certain production, pricing, allocative or distributive processes. In the wake of such crises, the economy may have to be run at below-capacity levels for prolonged periods; resultant distortions in price and production patterns may take a considerable time to remove;

* illustrating some of the points made by brief reference to Indonesia's policy responses to the oil price declines of the 1980s, as a favourite World Bank example of sensibly handled and appropriate adjustment;

* analysing briefly the South African authorities' responses to the sharp rise in the dollar price of gold in 1979–80 and subsequent policy adjustments; and

* reflecting, similarly concisely, on what current and future socio-political developments in South Africa may imply for our economic system's responsiveness and ability to adapt to changes in the world economic environment, and for our prospects for maintaining a stable domestic macro-economy.

Various topics, not to be pursued here, suggest themselves as being related to a discussion of governments' role in helping their economies to weather "shocks". Such subjects include the history of governments' macro-economic

interventionism, the dynamics driving changes in views ("conventional wisdom") concerning the appropriate degree of government intervention in the national economy, and the budding literature on the appropriate "sequencing" of liberalisation measures in more comprehensive programmes of macro-economic and socio-political reform.

Views on governments' role in macro-economic management have shifted since the 1930s from Keynesian short-term stabilisation and full-employment aspirations, through various refinements of the relevant analyses and through the doubts and disillusions raised, by the vertical-Phillips-curve and the Monetarist/Rational Expectations critiques, to the present "mainstream modesty". Debate on the dynamics of government interventionism should address the question why - if government involvement beyond the Adam-Smithian minimum can so easily be argued to be sub-optimal - governments are both so eager and so readily permitted to play a larger and more obtrusive role. Thinking on the appropriate "sequencing" of liberalisation measures has come to the fore as countries in Africa and elsewhere, sometimes under pressure or tutelage from the IMF and the World Bank, have sought to restore the "openness" of their economies, free (or freer) operation of their markets, and the dismantling of direct government controls.

WHAT GOVERNMENTS SHOULD DO, AND SHOULD NOT DO, IN RESPONSE TO CYCLICAL AND STRUCTURAL CHANGES IN THE EXTERNAL ECONOMIC ENVIRONMENT

The multi-racial finanical and economic co-operation agencies, notably the World Bank and the IMF, have, for many years now, sought to instruct the world's national governments in sensible and appropriate responses to cyclical or structural disturbances that are impinging on these governments' national economies. Where an external shock has occurred, governments should -

* duly identify the relevant change in the external economic environment;
* recognise, and attempt to assess, the (possibly highly unfavourable) potential impact of such a change on domestic output, the terms of trade, real national income per capita, and the general welfare and standards of living of their populations;
* seek to gain an impression of the cyclical or "structural", temporary or permanent, character of the change;

* take such steps as may be required to –

  - avoid a major increase in the government's budgetary deficit;

  - avoid a major deficit on the balance of payments current account;

  - adjust the rate of increase in the money supply in such a way as to avoid inflation/deflation or accelerations of inflation/deflation in the now prevailing or prospective conditions; and

  - support the adjustments in money and real wage levels, and in relative money and real wages, that will be needed to ensure the minimum of frictional or otherwise "involuntary" unemployment. At the same time, the *mobility* of labour and capital should be fostered to ensure the rapid redeployment of these resources in the "best" employment opportunities now available to them (which will, however, almost certainly be inferior to that to which they had been accustomed previously). These steps would, of course, be additional to those presumablya taken in earlier "structural" reforms of the labour and capital markets.

Conspicuous by its absence from this list is any recommendation to the effect that the authorities should seek *to compensate for* the activity–depressing effects of an unfavourable change in the external economic environment by adopting deliberately re–stimulative monetary and fiscal policies. An unfavourable external shock, by definition, necessitates a decline in real wages and a lowering of living standards: as certain activities are rendered "uneconomical" by the unfavourable external shock (at least "at the margin"), labour and capital must be shifted to alternative uses in which the real value of their marginal revenue product is bound to be lower than in their earlier utilisations in the pre–shock situation. The resultant degree of national and individual impoverishment – such as followed the two oil crises of the 1970s in oil–importing countries – must be accepted.

Organised labour's resistance to real–wage reduction is, however, likely to create unemployment. Such unemployment should not be countered, however, by aggregate–demand stimulation through a relaxation of monetary and fiscal policies: an increase in domestic monetary demand in the face of a decline in real domestic production is bound to turn out inflationary and may also worsen the balance–of–payments problems the country is likely to be experiencing in the wake of the external shock. Instead, the economy should be assisted in effecting a speedy and efficient redeployment of its newly unemployed resources in their "next most

productive" areas of utilisation. This is a "supply-side" rather than a "demand-management" response.

Secondly, in assessing the potential impact of any – but more particularly of a favourable – external shock, it is wise to err on the side of caution. As stated by the World Bank in its most recent *World Development Report*:

> "Boom and bust episodes (resulting from internal or external shocks) show it is important to pursue policies that do not give rise to large macro-economic imbalances, to adjust quickly, and to respond cautiously to shifts in the terms of trade. There is an important distinction between terms of trade shocks that give rise to a permanent change in wealth and those that do not. The windfalls from temporary changes in terms of trade *should be saved.* It is difficult, however, to determine a priori whether a shock will be permanent or temporary. *Prudence calls for treating all favourable shocks as temporary, at least until the dust settles.*"[2] (Emphases added).

A potential issue in this context may be noted in passing. As indicated earlier, World Bank thinking, while allowing for a small but important active role for the State, clearly favours the free operation of market forces and the use of market-related policies. Rapid but sustainable economic growth is to be brought about by avoiding macro-economic imbalances and instability (including, in particular, such imbalances as may arise from governments' own policies), and by maximising "the system's" powers of adjustment through the removal of natural and government-imposed impediments to labour and other factor mobility.

Essentially, therefore, the Bank subscribes to the self-equilibrating and optimising character of "the system" in the absence of government interference. By implication, the Bank also accepts the superiority of the markets' judgement, vis-à-vis the government's or the central bank's judgement, in assessing the "true" nature, extent, durability and significance of both externally imposed and domestically generated disturbances.

In strict logic, however – and, for the sake of watertight reasoning, admittedly also in an assumed absence of restrictions and non-freedoms imposed by the government at other points in the economy – this view also means that *the markets* should be the judge of the extent to which, for example, the exchange rate should be allowed to rise in consequence of a favourable external shock or international business cycle development. At the same time, *the markets* should be

the judge of the extent to which a "windfall" should be "saved".

Since, in the absence of central-bank intervention in the foreign-exchange markets, the demand and supply of foreign exchange will be in equilibrium continuously or on a day-to-day basis, the part-saving of a windfall will not, however, take the form of a nest egg of *official* gold and other foreign reserves. Instead, it may take the form of increased private-sector holdings of foreign paper or tangible assets, a reduction of the private sector's earlier foreign indebtedness, or a strengthening of private domestic holdings of imported inventories or imported fixed-capital stock.

This point is important inasmuch as a significant strengthening of the exchange rate under the impact of a favourable external development may cause certain sectors of the domestic economy to suffer an attack of the so-called "Dutch disease"[3]). Consistent reasoning in the spirit of the World Bank would not seek to forestall potential exposure to this disease; it would, however, seek to equip the economy with the powers of ready flexibility and adaptability that would limit the ill effects of the disease and allow it to be regarded with fair equanimity. It should be noted that the World Bank itself – at least in those of its writings that have come to our notice – refrains from explicitly pressing its argument to these conclusions.

WHAT GOVERNMENTS SHOULD DO, AND SHOULD NOT DO, IN PREPARATION FOR CYCLICAL AND STRUCTURAL CHANGES IN THE EXTERNAL ENVIRONMENT

For creating the *sound underlying conditions* of stability and adjustability that will minimise the loss of income and wealth in consequence of an unfavourable external development, it is, again, of more important what governments should not do rather than what they should do. *First*, governments *should*, of course, take care of the "Adam-Smithian" minimum of their duties, which comprises the maintenance of internal and external security; the preservation of law and order and of the enforceability of lawful contracts; and the provision of a universal, broadly based, education which will leave its charges well prepared to benefit, rapidly and at short notice, from more advanced training in specialised areas, and for the development of skills in a broad variety of economically useful activities.

Secondly, governments should avoid macro-economic imbalances of their own making. This means that their budgetary deficits must be held at "reasonable" levels: deficits should not generate inflation either by adding unduly to monetary

demand or by having to be financed through direct recourse to money creation. Neither should they be so large that, even if financed non-inflationarily, they may create an impression of being in danger of getting out of hand. Monetary policy should be aimed at an approximate stability of the general price level as a medium-term objective. The exchange rate, which is assumed (tacitly) to be fixed or at least managed by the authorities, should be pitched at a "realistic" level.

Thirdly, to ensure "the system's" maximum flexibility and its ability to respond both quickly and appropriately to disturbances, the government should: (1) remove structural deficiencies from the goods and labour markets; (2) remove barriers to entry into the goods markets; (3) enhance the competitiveness, accessibility, sophistication and efficiency of the financial system, which may also be helpful in encouraging domestic saving; (4) allow interest rates to be freely market-determined, which may similarly be helpful in raising domestic saving propensities; and (5) "ease" the path of technological progress and its transmission. Finally, (6), protectionist thinking should be avoided, and, (7), (moderate) tariffs should be substituted for quantitative import restrictions.

Especially important in this context are the prescriptions for ensuring the mobility of labour and the flexibility of the labour markets, which have to play the crucial role of making the downward adjustment of real wages in an unfavourable-shock situation both (1) possible to the economy, (2) tolerable to the displaced and/or to-be-disadvantaged workers, and (3) more acceptable to their disgruntled and hostile unions. Labour market flexibility is to be fostered by –

- avoiding nation-wide bargaining;
- facilitating, or assisting, the spatial, horizontal, occupational and vertical mobility of labour;
- avoiding high costs of, or other impediments to, the entrenchment of workers;
- avoiding high non-wage costs of employment;
- keeping, or making, the long-term unemployed capable of re-entering the labour market;
- appropriate training and retraining of workers, and regular updating of their skills.

In the general conditions of safety and stability to which such healthy policies should give rise, inflows of foreign capital will respond readily and sensitively to the signals of changes in relative domestic, vis-a-vis international, yeilds and interest rates. This will ensure the timely and adequate availability of foreign capital for both short-term "bridging" and long-term investment purposes. An unduly large foreign debt (which may scare off foreign investors on account of possible future exchange rate changes, or potential increases in taxation) should, however, be avoided. Low inflation will facilitate the "corrective" inflation that may be needed after an unfavourable shock.

If all this sensible advice also sounds platitudinous and self-evidently correct, it should be remembered that it represents the World Bank's tactful way – embarked on several years ago – of impressing solid home truths on countries who had, as yet, not taken note of them, had already gone wrong in not heeding them, or had honoured them deliberately in the breach rather than in the observance. The soundness of advice is, of course, no guarantee for its being taken or acted upon.

Although, as stated earlier, the growing literature on the "sequencing" of liberalisation measures is not to be discussed here, the obvious relationship between the liberalisation of economies, and therefore of the "sequencing" of liberalisation measures, to the building-up of economic systems' shock-resistance may still be noted. Sequencing refers to the determination of the most beneficial order in which measures for the one-by-one removal of direct government restrictions, regulations, interventions, controls and systems of controls are to be implemented.

Primacy in an appropriately sequenced liberalisation plan usually goes to "getting the government's finances in order", i.e. to reducing the relative size of the government's budgetary deficit through cuts in expenditure and the levying of additional taxes. This takes precedence (even) over the raising or (real) interest rates to realistic levels for stopping the inflationary expansion of the money supply. The reason is that "sanitization" of the monetary system has little chance of success as long as the government still finds itself forced to have recourse to money creation. At the same time, realistically high interest rates would threaten the government's "intake" of "revenue" on account of the so-called "inflation tax". This would diminish the government's chances of moving closer to a balanced budget and of dispensing with direct central-bank financing of its budgetary deficits.

IN THE WORLD BANK'S GOOD BOOKS: THE CASE OF INDONESIA

Just enough should be said about this to allow two points to be made. Indonesia fell victim to declining oil revenues in 1982, and to the oil price "collapse" of 1986. In 1987, it received high plaudits from the World Bank for having maintained macro-economic stability in the preceding years. Macro-economic stability had been maintained by "stern adherence to a multifaceted adjustment program that [had] sought to constrain domestic demand in line with resource availability" and that, at the same time, had "attempted to stimulate growth through improvements in efficiency".[4]

The Indonesian authorities' actions included the cancellation or postponement of several large public investment projects; maintaining an "austere fiscal stance"; the reduction of domestic subsidies; an initial devaluation of the currency by 28%; reform of the financial sector to encourage private saving and to raise the efficiency of investment; a broadening of the tax base; and increasing public savings.

A second devaluation of the rupiah (by 31%) was effected in 1986. The government also moved away from import substitution in its trade policies and "reformed significantly the regulatory environment for foreign investment".

The two comments are as follows: Firstly, credit should go to the Indonesian authorities for having seen and acknowledged so clearly the need for a cut in living standards in the light of the country's economic adversity. The government's response, however, largely consisted of ceasing to do things which, in the World Bank's views, it should have avoided doing from the beginning, and of beginning to do things which it should have done from the start.

Secondly, it bears repetition that the Indonesian government's brave actions of austerity, frugality and "cutting its coat according to its cloth" would not have suggested themselves to a native Keynesian, who might have accepted uncritically labour's reputed refusal to accept a cut in real wages by any other means than by the effect of inflation on the money wage; whose prime concern would have been to forestall or to counteract the impending rise in unemployment; and whose instinctive reaction would have been to reach for the levers of fiscal and monetary stimulation. If all these kinds of actions and reactions now sound "obviously wrong" to us, they would not, perhaps, have seemed that way only a few brief years ago.

CLOSER TO HOME: SOUTH AFRICA IN THE 1980S

External shocks which South Africa experienced in the 1980s included the approximate doubling of the average dollar price of gold from 1979 to 1980 and the very high level of the gold price in 1980 as the counterpart of the second oil crisis; the vagaries of the gold price, and its generally downward trend, in the remainder of the decade and the generally downward tendency of real commodity prices which have affected us in common with other primary-producing countries, since approximately 1974 (with accelerated declines in the wake of the first and the second oil crises and in the 1984-1986 period in particular). In addition, South Africa was subjected to trade sanctions, boycotts and disinvestment campaigns, the termination of many overseas credit facilities from July 1985 and large outflows of capital, the imposition of the debt standstill in September 1985, and sharp drops in the exchange rate in 1984-85 and (to a lesser extent) again in 1988. A recent quantification by Reserve Bank staff shows the shocks originating in the terms-of-trade and international interest-rate effects on the South African economy in the 1970s and in the second half of the 1980s - as compared with similar shocks experienced by sub-Saharan Africa, South and East Asia, and Latin America and the Caribbean - to have been of medium severity.

Domestically, we had to deal with uncertainty, and some occasional apprehension, arising from socio-political developments. We also witnessed uncommonly large swings in nominal and real interest rates, and some substantial shifts in the stance of fiscal policy and in the relative size of the budget deficit. The need for current-account surpluses was related to the size of our capital outflows. Both these surpluses and these outflows became less obviously cyclical than they used to be, and whereas in the 1950s, 1960s and 1970s the South African business cycle was a fairly faithful if lagging follower of cyclical tendencies in the industrialised world, it has pursued a more independent course since approximately 1984.

With the benefit of hindsight, it now seems clear that our policy responses to the gold bonanza of 1979-80 were sub-optimal and would not have satisfied the World Bank's precepts and norms. We fell into the trap of not being sufficiently prudent in treating this favourable shock as "temporary until the dust settles". We were over-hasty in making use of this opportunity "to let the economy rip" and to move to full employment and a high measured "growth" rate rapidly.

We relaxed our fiscal policies while the balance of payments and the extraordinarily flush state of the government's finances seemed to allow us to do so in consummate comfort. We made light of our double-digit inflation while our

real incomes were rising, and because all of the world was still in a highly inflationary condition. Like other countries which responded over-enthusiastically and over-optimistically to a temporary surge in the world prices of their principal export produce, we then allowed ourselves to be tempted into (short-term) foreign borrowing – although not to any really excessive extent – when the gold price declined, so as to "bridge the gap" to the next major gold price rise which we anticipated confidently.

In summary form, we –

* lowered the effective tax rates on individuals and companies, repaid loan levies and eased hire-purchase conditions;

* allowed our interest rates to remain at quite extraordinarily low levels. The Treasury bill tender rate sank to a low point of 3,81% on 23 November 1979; it was only modestly higher (at 5,50%) on 21 November 1980;

* allowed the M2 money supply in the various calendar quarters of 1980 to rise at seasonally adjusted annual rates ranging from 25 to an unconscionably high 41%;

* allowed the inflation rate to accelerate to 13,8% in 1980 and to 15,2% in 1981;

* allowed the exchange rate to strengthen markedly in this highly inflationary environment.

The rate of increase in the average money wage per worker accelerated from 12,2% in 1979 to 17,9% in 1980.

It now seems reasonable to argue that we should not have eased up on our fiscal policies while the economy was still subject to very strong expansionary and inflationary pressures. Monetary policy should have been tightened in these conditions; the resultant slow-down of the rate of monetary expansion would have been justified in the light of the reduced rates of inflation which the strengthening of the exchange rate should have brought within our reach.

A resultant tendency towards an excessive strengthening of the exchange rate and towards a consequent bout of the "Dutch disease" should have been countered by a more comprehensive and well-structured relaxation of the exchange controls. The rise in real wages, which the situation clearly permitted to some extent, should

have been effected at reduced rates of increase in workers' nominal remunerations.

The authorities' actions and inactions at the time are, however, clearly more understandable in their context of the conditions in 1980 itself. With all systems seemingly "go" for good times ahead, a tightening of monetary and/or fiscal policy would have been wholly incomprehensible to the man on the street, and could probably not have been made acceptable politically. With rare exceptions, local economists did not call for such action.

Interest rates, moreover, did not yet constitute the operational variable (the "cutting edge") of the authorities' policies; they could, therefore, presumably continue to be held at arbitrarily low levels. Inflation rates were still high worldwide, and little evidence had been forthcoming as yet of the industrialised countries' newly awakened anti-inflationary resolve. In these circumstances, a bright future for the dollar price of gold still seemed to be assured.

To their credit, moreover, the authorities did embark on major liberalisations. Direct interest rate controls and the ceilings on monetary institutions' credit extension to the private sector were abandoned in 1980, and interest rates were set on a strongly upward course from late 1980 into 1981. Exchange controls as pertaining to non-residents were lifted in February 1983.

From approximately mid-1982, the level of interest rates, rather than the self-defeating liquid-asset system of monetary and credit control, became the operational factor effectively governing bank credit extension and the growth rate of the money supply. The authorities, however, were not yet ready to start de-emphasising the use of interest rates for short-term expansionist purposes when the gold price seemed to allow them to do so: real short-term interest had been lowered to negative levels again by early 1983.

From 1984, the authorities increasingly were no longer fully free agents in their behaviour. Balance of payments considerations, a strongly expansionary 1984/85 Budget, and accelerating inflation, called for emergency action in monetary policy in July-August 1984.

In the ensuing years, South Africa's foreign-debt repayment obligations and the sensitivities of domestic socio-political developments have had to be taken into account in the formulation of our macro-economic management policies. Our strict adherence to the terms of our successive interim arrangements with foreign creditor banks, and an unhelpful and unsympathetic attitude of the international financial community until recently, have made our debt crisis more truly a shock to which

adjustment has been required, than is true of several other countries that have suffered from indebtedness problems. As noted with some satisfaction by the late Dr. Gerhard de Kock, this adjustment has generally been carried out successfully, albeit probably too inflationarily.[5]

WHERE DO WE STAND NOW?

I believe that important lessons have been learnt. Our monetary policies, now aimed explicitly at "protecting the internal and external value of the rand", have taken on a medium-term orientation and no longer seek to fine-tune the economy. Interest rates are unlikely to be lowered to negative real levels again, and are also unlikely to be allowed to assume negative real values if South Africa were to run into a windfall of highly favourable international business cycle developments, a surge in world commodity prices, or (miracle of miracles) a gold price of $600 per fine ounce.

More awareness now exists of the precepts and norms for a sound fiscal policy, which nevertheless are proving increasingly hard to adhere to; the adjustability of fiscal policy, i.e. its power to adjust rapidly, flexibly and appropriately in response to and in acknowledgement of a need for belt-tightening, had almost certainly deteriorated significantly.

We can still boast a highly sophisticated, flexible and innovative *monetary-financial system*, which is currently operating under few statutory directives, non-freedoms and impediments. A distinct possibility exists, however, that those of our population groups that stand to be empowered politically (or the political representatives of these groups) may wish to intervene prescriptively again in financial institutions' lending and investment practices, in support of so-called socially deserving credit needs or for "populist" and egalitarian purposes. A possible return to deliberately low levels of interest rates and accompanying quantitative credit controls, or even to nationalisation of parts of, or even entire institutions in the financial-services industry, cannot, at this stage, be ruled out with confidence.

A mixed bag is presented by the labour market. By now, we have, of course, removed all, or virtually all, our earlier statutory restrictions on the spatial, occupational, horizontal and vertical mobility of labour. The "new" labour union movement, and the new political forces in our "new" South Africa, may, however, come to press more strongly than we have been accustomed to for centralised bargaining, enhanced job security (i.e., assurances against dismissal or

retrenchment), affirmative action in recruiting and promotion policies, high real minimum wages, or annual wage revisions that are un–attuned to developments in physical labour productivity or to changes in the real value of workers' marginal revenue product. It would, therefore appear to be prudent to make allowances for some "rigidification" of the labour markets and of the wage–formation processes in these markets, in future policy formulation.

Our system of education and training, on which I am no expert, still seems to be marked by poor returns on the amounts of funds that are channelled into them, as well as by a continuing mismatch of output and needs, i.e. by an inability of these systems to produce the right numbers of trainees, school–leavers and students with qualifications that are useful to commerce and industry and relevant to our development needs. It should be obvious of course that poorly adapted education and training systems, "hemmed–in" and unadjustable fiscal policies, and more rigid labour markets and wage–formation processes – in conjunction with a monetary policy that continues to be aimed (correctly) at the restoration and preservation of monetary stability – may, in the case of an unfavourable external or internal shock, produce poor macro–output and employment results.[6]

None of this or the foregoing is meant to sound negative or disheartening. If difficulties were to arise, however, we shall not be able to claim that we have not had fair warning of the possible pitfalls in the road ahead: many are the examples of the errors made elsewhere that we should be able to avoid.

The job we are now facing is one of explaining, demonstrating and persuading. Provided we can show that our forthcoming new South African society will also be a caring society, we in the Reserve Bank remain confident that opinion–makers in all population groups can yet be convinced of the benefits of an open, adaptable, limited–government and essentially free–market and free–enterprise economy. If blows were to start falling again, the economy that is geared to roll with the punches will, indeed, be the one least likely to get hurt. It is a goal we should all be striving for.

NOTES AND REFERENCES

1. Two observations may be added here. Firstly, "shocks" and other cyclical and structural changes to which the economic authorities see a need to respond, may, of course, also be of domestic origin, and may, in fact – as the text emphasises repeatedly – be of the authorities' own making. Secondly, I have not succeeded timeously in finding a definition of the "structure" of an economy, or of "structural change". "Structural change" is an extremely comprehensive concept. It may embrace, among many other things, durable shifts in economic subjects; habits, tastes and preferences, in the demographic characteristics of the population, in the type of government and in laws and regulations, and in technology, production methods and production techniques. Its essential feature is that it will tend to call forth a shift in the steady–state equilibrium level or composition of output rather than fluctuations around the equilibrium level or composition of output.

2. *World Development Report 1991*: "The Challenges of Development", p.112.

3. The "Dutch disease" refers to the loss of competitiveness (and therefore of the output and employment–generating capabilities) of most export industries and import–competing industries in a national economy on account of a strengthening of the exchange rate which itself is due to strong world demand for the output of one particular industry.

4. *World Development Report 1987*: pp.24–25.

5. De Kock, G.P.C.: *Growth–oriented Balance of Payments Adjustment via Market–oriented Economic Policy: South Africa – A Case Study*, S.A. Reserve Bank, April 1989.

6. It is of interest to note in this context that a recent World Bank publication shows IMF adjustment programmes to have had their lowest rates of success in economies under "transitional democratic" political systems.