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The South African Business Cycle Over the 1990s: What Can We Learn?

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1. INTRODUCTION

This paper was inspired in the first place as the author observed extraordinary resilience in the domestic real economy in the wake of not only the world recessionary conditions of 2000/1 but also the dramatic slide of the currency towards the end of 2001. As possibly the first hard evidence of meaningful (structural) change, this paper may be premature, however, it sets out to study the domestic business cycles of the 1990s and establish in what way has the reintegration of the SA economy into the world economy influenced the business cycle. Running the risk of being premature the paper attempts to derive policy information as well as to provide pointers to what we may expect in the current business cycle.

The 1990s will be remembered for the profound political changes in SA; this process continues unabated. Accompanying the political change has been SA's re-integration with the rapidly globalising world economy which introduced equally sweeping changes in the domestic economy.

A central issue is the question what impact these sweeping changes have had on the *domestic business cycle*. The business cycle is defined as *"… the pattern of upswing (recovery) and downswing (recession) [in economic activity] in relation to the underlying long-term growth trend." (Dornbusch, et al, 1992: 289)*. One's sense is that SA's reintegration with the world economy may indeed have introduced structural changes in the domestic business cycle. The issue is complex and multifaceted and the historical track record possibly not long enough for proper analysis and conclusive answers.

In its April 2002 *World Economic Outlook*, the IMF quotes Arthur Burns (writing in 1947):

> *For over a century, business cycles have run an unceasing round. They have persisted through vast economic and social changes; they have withstood countless experiments in industry, agriculture, banking, industrial relations, and public policy; they have confounded forecasters without number, belied repeated prophecies of a 'new era of prosperity' and outlived repeated forebodings of 'chronic depression'*

This time-honoured quote possibly hints at one constant in SA's profound political-economic changes, not only during the 1990s, but also in the preceding decades, i.e. the cyclical pattern of economic development. The above quote is highly relevant to the contemporary South African situation. On the one hand, the persuasiveness of the socio-political change tends to conceal/distort the underlying business cycle movements. On the other hand, economic history strongly suggests that the *"… unceasing round"* of the business cycle prevails. The fact of the matter is probably that business cycles are both shaped by these external/ exogenous developments and propagated by some endogenous law of regularity. To the extent that we can uncover more of this endogenous cyclical movement in economic activity, we may be able to draw conclusions regarding the economic changes, which in turn inform economic policy and strategic corporate decision-making.

An important focus of the current investigation is the changing international transmission of domestic economic fluctuations. As it is, South Africa has always been subject to external economic fluctuations given the nature of its economy and its place in the world economy. This will remain so, however, interesting evidence of domestic economic resilience is presenting itself, which suggests that the economy is rapidly acquiring its own legs to weather external disturbances as and when they present themselves. The following questions are central issues investigated in this paper:

- *To what extent has the domestic business cycle changed?* The focus of the analysis is on the domestic business cycles of the 1990s compared to that of the structural period commencing around the mid-1970s. Reference is also made to the post-War period, 1946 to 1973.
- Changes in corporate profitability, fixed investment decision-making and private credit utilization are central aspects of the business cycle dynamic (Zarnowitz, 1999). *The question is whether we find any evidence of the domestic economy developing independent and longer-lasting cyclical momentum; alternatively, have we developed a more stable and more robust domestic business cycle following SA's reintegration into the world economy?*
- An associated question is to what extent financial volatility is bedeviling this process, *or can we expect that the financial volatility of the 1990's has been a temporary phenomenon?*

In order to investigate these questions, a number of analytical issues regarding business cycle theory first need to be explored in respect of the domestic economy. This is done in the first part of the paper. In the second part of the paper a characterization and analysis of the domestic business cycles over the 1990's compared to those in the preceding decades follows. In the third part attention focuses on the structural changes on SA's balance of payments. The fourth section of the paper assesses what we can learn from the 1990s in terms of the propagation of domestic economic fluctuations. Current business cycle prospects are also considered in this section. In the fifth and final part of the paper the policy relevance of this material is considered.

As it befits an economist, it is necessary to make some qualification at the onset and acknowledge upfront that this paper is richer in descriptive analysis rather than more rigorous quantitative analysis, which appears to be the intellectual current of our age. As usual time constraints dictate, but it is hoped that the analysis can be expanded in further study and research.

2. BUSINESS CYCLES: THEORETICAL ISSUES

The study of business cycles is a major macro-economic concern. A definition of the business cycle was provided above, *i.e. the fluctuation of economic activity around a growth trend*. Business cycles present themselves in terms of the co-movements of a range of economic variables. The economic variables stretch across a number of production sectors of the economy as well as income and expenditure components. In order to study the business cycle one therefore has to disentangle the structural changes in the various components of production, income and expenditure in the economy, from the cyclical factors; alternatively assess the structural growth trend apart from the regularity/periodicity of economic activity. Given the scope of this field of study, it is to be expected that more than one school of thought will exist in order to 'explain' the existence of business cycles. It is not the purpose of the present paper to expand on the various business cycle theories, but rather to focus on the empirical material at hand, much in the same way that leading students of the business cycle prefer to do[1].

In the first part below, the issue of cyclical versus structural change is briefly considered also in relation to the domestic experience. Thereafter, the issue of endogenous versus exogenous causes of the business cycle is considered.

2.1 Cyclical versus structural change in the SA economy

South Africa is currently in its 14th business cycle of the post-War period[2]. A number of analysts have identified two major structural periods in SA's post-War economic history, partly due to observable changes in the cyclical pattern of economic activity (De Vries, 1994: 18-21; Mohr & Rogers, 1994: 294; Du Plessis & Smit, 2002). During the first structural period from 1946 to 1973 a clear upward trajectory in the secular growth trend was observable. In this period SA witnessed 9 complete business cycles averaging 36,1 months in length with upswing phases lasting an average 23 months and downswing phases 13,4 months. In none of the calendar years over this period negative real GDP growth was registered. However, this changed since the mid-1970s. Over the period 1973 to 1993 no less than 6 calendar years of negative growth was registered, the length of the business cycle increased to 62,5 months, mainly due to much longer downswing phases, which lengthened from 13,4 months on average to 33 months. In fact, the growth trend turned downwards over this period; the onset of the cyclical down turn in September 1974 has been regarded as the turning point (De Vries, 1994). Not only did the downswing phases of the business cycle lengthen over this period, but the amplitude of the fluctuations increased, implying greater economic instability. In a recent paper Du Plessis & Smit (2002) finds that apart from lengthening, the domestic economic downturns also lost duration dependency since the mid-1970s.

Identifying this era - *call it the post-Bretton Woods era* - more or less coincides with the identification of international structural periods in terms of the analysis of business cycles (see Romer, 1999; Basu & Taylor, 1999). Recently the IMF (April 2002) suggested three developments signifying structural change since 1973, i.e. the new international monetary regime of floating exchange rates, lower real GDP growth rates, reflecting a decline in productivity growth in the major industrial countries in the post-WWII period; and the emergence of level recessions in these countries, partly due to the first oil shocks. The key measure of distinction regarding the international structural periods is of course the change over from the Bretton Woods period of fixed

[1] See for instance Brad de Long's comments in his "Introduction to the Symposium on Business Cycles", in *The Journal of Economic Perspectives*, Spring 1999, Vol 13 (2), pp. 19-22.

[2] The South African Reserve Bank regularly determines the upper and lower turning points of the domestic business cycle using extensive statistical and econometric techniques.

exchange rates (1972/3) to the subsequent floating exchange rate regime. SA only moved to a system of floating exchange rates in 1979 (per De Kock Commission recommendations), however, the oil shocks of 1973/4 and the conflict in Angola following that country's independence had major implications for the domestic economy - *see below*.

There has been an important debate regarding the instability of the 1970s and 1980s with some economists emphasizing adverse structural factors explaining the fluctuations in economic activity and others arguing that – despite these exogenous shocks – the SA business cycle still possessed an underlying regularity (see Mohr & Rogers, 1994: 298). One of the modern-day guru's regarding business cycle theory, Victor Zarnowitz, argues that *"… exogenous shocks and policy effects are typically more transitory and peripheral in nature and hence generally less important …"* as far as business cycles are concerned (Zarnowitz, 1999: 73). While this quote may be less applicable to SA, it leads the author to appreciate the central role of corporate profitability, fixed investment decisions and bank credit utilization in the propagation of economic fluctuations, all factors that Zarnowitz emphasizes as underlying causes of the business cycle.

It is fair to conclude that the SA economy experienced major structural disruptions over the period since the 1970s, which must have had an important influence on the domestic business cycle *(see below)* and possibly to a greater extent than implied by Zarnowitz' view quoted above. This, however, does not mean that the regularity of the business cycle was non-existent; in fact this paper finds evidence in support of Zarnowitz' view. *An interesting question is to what extent this regularity was determined by the global economic cycle and what has changed.*

A new literature is emerging with the objective to assess the post-Apartheid economic performance - the question being whether the SA economy has embarked on a new structural growth path. The current paper also focuses on this question in relation to the observed changes in the business cycle over the 1990s. A study is made of the two business cycles over the 1990s in comparison with those since the mid-1970s.

2.2 Endogenous versus exogenous causes of the business cycle

Mohr & Rogers (1994: 294-299) identifies three schools of thought regarding the explanation of business cycles. *Firstly*, the Classical view regarded business cycles as being caused by exogenous factors. This school - also supported later by the neo-classical economists - believed in the inherent stability of the private market economy. Any sustained deviation from the natural stable growth trend (read: business cycle) either was the consequence of misplaced government fiscal or monetary policy or some exogenous shock.

The second view, which gained prominence in the wake of the Great Depression (1929-33), is the Keynesian view, which did not believe in the natural ability of market forces to restore stability and provided for government intervention. In terms of business cycle theory this view was diametrically opposed to the Classical view in that business cycles were rather explained/caused by the natural tendency of market forces according to the Keynesians. In this view each (upward/downward) cycle carries the seeds for the subsequent (downward/upward) cyclical growth pattern. Consequently this school locates the causes of the business cycle in endogenous factors; business cycles need to be explained in terms of their internal dynamics. Specifically endogenous changes in investment behaviour seem to be a central underlying cause of the business cycle (Mohr & Rogers, 1994: 296).

A third view, the Structuralist view differs from the former views on the basis that it rejects/downplays both the idea of inherent economic stability (Classical) as well as inherent economic instability (Keynesian). This school rather finds the causes of the business cycle outside the economy, dependent upon the reigning institutions/ structural factors. In this view, therefore it is mainly exogenous factors causing business cycles, however, they reject the (neo) classical belief in inherent economic stability out rightly.

As noted above, it is not the objective here to analyze the various theoretical issues regarding the business cycle. While not claiming to be Keynesian theory, Zarnowitz's explanation of the business cycle certainly has much in common with the Keynesian view. The author concurs with a somewhat eclectic view that business cycles in a market economy has a predominant endogenous origin and that the economy's vulnerability to external shocks is to a large extent determined by the reigning economic structure.

In fact, a central theme of the current paper is that SA's reintegration with the world economy has introduced key structural changes, which have had an impact on the shape of the business cycle. In the following section the domestic business cycles of the 1990s are analyzed within an historical perspective.

3. SA BUSINESS CYCLES OVER THE 1990S IN HISTORICAL PERSPECTIVE

The evidence on SA business cycles since the 2nd World War suggests a very typical business cycle with extraordinary regularity over the post-WWII (Bretton Woods) period, which became distorted somewhat due to structural changes and exogenous shocks since the mid-1970s. The following quote encapsulates the essence of this "typical" SA business cycle (De Vries, 1994: 20)[3]:

> *"In the phraseology of the King James version, an increase in export earnings enjoyed by a slack economy begat an increase in industrial utilization (and better profits), which together begat an increase in investment spending, which begat excess demand and bottlenecks, begetting when they matured, price inflation and balance of payments difficulties, which begat curbs, slowdowns and slacks in the sixth and seventh generations after the increase in export earnings."*

Domestically, as internationally, the Bretton Woods period (1946-1974) witnessed sustained high economic growth with recessions being defined as periods with slower,

[3] For a somewhat more expanded version of such a characterization, see Mohr, 1994: 293.

but positive growth. This changed since the mid-1970s. According to De Vries (1994: 21) a number of exogenous developments disturbed the regular course of the business cycle in SA since the mid-1970s. Amongst these were:

- The sharp increase in oil prices in 1973-74 and in 1979;
- Large fluctuations in the gold price;
- The conflict between SA and Angola;
- Domestic political unrest and instability (e.g. June 1976, July 1985 and June 1986);
- Protracted agricultural droughts in the 1980s (and early 1990s);
- The international debt moratorium and the collapse of the rand in 1985.

A previous governor of the SARB, Dr De Kock, always emphasized the qualitative continuity of the domestic business cycle, however, even he conceded, *"… the course of any [business] cycle can be drastically affected by political, social and other non-economic factors."* (Mohr & Rogers, 1994: 298). The problem since the mid-1970s was that both monetary and fiscal policies were often subject to non-economic factors and may have contributed to economic fluctuations. Fiscal policy tended to be expansive due to the demands of defense spending and the reigning view at the time of Keynesian demand management to stimulate economic growth. The fiscal expansion was often accommodated by monetary policy, which contributed to excessive growth in bank credit utilization and real domestic expenditure and imports. This, in turn, led to both inflation and balance of payments bottlenecks and consequent sharp adjustments in monetary policy and the attendant "stop-go" business cycles. The balance of payments constraint on growth was the domestic economy's Achilles heel. While a large percentage of SA's GDP was exported, this stagnated over the 1970s and 1980s due to the particular import-replacement industrialization strategy, unsuccessful export promotion as the share of manufactured exports remained unchanged and - more importantly the intensifying impact of international economic sanctions *(see the section on SA's balance of payments below).*

3.1 Business cycles during the post-Bretton Woods/ modern era

Measuring the business cycle from peak-to-peak, SA is currently in the upswing phase of the second business cycle since the onset of the 1990s. The early 1990s were characterized by a protracted economic downturn measuring 51 months in length (see Table 1). The subsequent upturn commenced ahead of the historical April 1994 general elections, but received added momentum once the hazards of election time were cleared. The upswing lasted a total of 42 months, which was long by the standards of the 1980s, but similar in length to the economic upswing of the late 1970s/early 1980s. The (growth) recession, which followed, likewise mirrored that of the mid-1970s in terms of length as well as depth. A striking feature of the figures in Table 1 is the cycle similarities between the business cycle phases of the second half of the 1970s and those since 1993; during the recessions in both periods GDP growth remained positive and in both periods the upswing phases were considerably stronger compared to the 1980s, the latter period witnessing deep level recessions and weak economic upturns. *This theme is developed further below.*

Table 1: SA business cycles: September 1974 to August 2002

Downswing phases	Length (months)	Depth (peak-to-trough)[1]	Upswing phases	Length (months)	Height (trough-to-peak)[1]
Sept 74 - Dec 77	40	+2.9%	Jan 78 - Aug 81	44	+21.2%
Sept 81 - Mar 83	19	-4.7%	Apr 83 - Jun 84	15	+8.1%
Jul 84 - Mar 86	21	-3.2%	Apr 86 - Feb 89	35	+9.5%
Mar 89 - May 93	51	-3.7%	Jun 93 - Nov 96	42	+14.9%
Dec 96 - Aug 99	41	+3.2%	Sep 99 - present	36-plus …	-
Average length	34.4		Average length	34	
% of period in recession	49.5%		% of period in upswing	50.5%	

1. Percentage change in the level of GDP at constant 1995 prices.

Source: SA Reserve Bank, Quarterly Bulletin, June 2002.

Over the complete period, i.e. September 1974 to the present, the SA economy experienced recessionary economic conditions close to half of the time with the average length of recessions more or less equaling that of economic upswing phases, i.e. 34 months. At the time of writing the economic upswing phase in force surpassed the average length of the economic recoveries in the preceding two-and-a half decades. Therefore, only in terms of length and amplitude, the evidence seems to indicate change since 1993. A recent research note by an international investment bank active in SA provides statistical evidence of such a structural break in the SA economy around 1993 (Teixeira, et al, April 2002: 11-17).

However, a closer inspection of the business cycles over the 1990s reveals that relatively little changed in the 1989-96 business cycle - we may need to look beyond 1996 for such structural change. All the reasons for the structural break cited by Texeira either commenced later or could only have any material impact on the economy's growth performance well after 1993/94. In fact, it is suggested in this paper that the 1989-96 business cycle was very much in the style of the 1980s, with the only difference being some (temporary) relief in the balance of payments constraint on growth in the 1993-96 economic upswing phase *(see below)*. In support of this hypothesis, a more detailed analysis (and characterization) is made of the domestic business cycles in the post-Bretton Woods period, also in an international context.

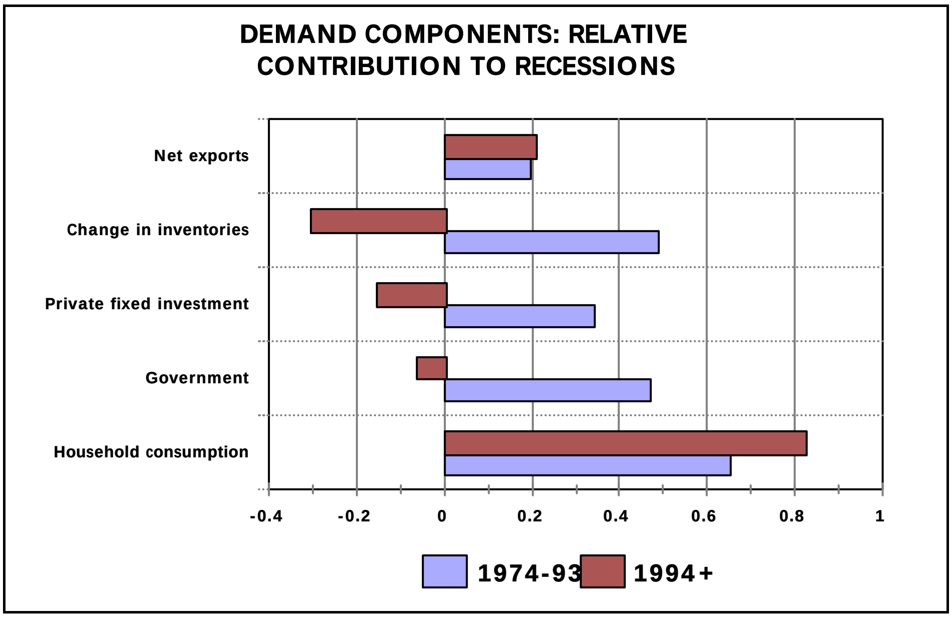
3.1.1 Demand components of GDP

The accompanying chart shows the relative contributions to domestic economic resessions and recoveries respectively of the major demand components of GDP[4]. The most striking feature of the charts is the strong role of real household consumption expenditure in both recessions and recoveries. This contrasts with the

[4] The change in each demand component of GDP from peak-to-trough for recessions and trough-to-peak for recoveries is expressed as a ratio of the change in the overall GDP over the corresponding period. While the contributions should add up to one, this does not happen due to the role of the national accounts residual as well as the way in which the author chose to account for changes in inventories over the course of the business cycle.

evidence in the major industrial countries in respect of recessions, where private fixed investment has been shown to be the dominant driver (IMF, April 2002). In SA, household consumption expenditure is the key driver of economic downturns, with changes in inventories, government consumption and capital expenditure[5] and private fixed investment also being important and - to a lesser extent - net exports. This at least has been the experience over the period 1974-93. The 1997-99 recession (i.e. the only one in the post-1994 period) produced a radically different pattern, with the change in inventories, private fixed investment and the government being contra-cyclical. However, if we bear in mind that the GDP continued to increase during the 1997-99 recession, it follows that these demand components did in fact subtract from growth; the point is though that in each case the contributory role to the recession was milder compared to the previous decade. On the other hand, household consumption had a stronger pro-cyclical influence compared to the earlier decades. The pro-cyclical influence of net exports remained similar before and after 1994 and indicate that the decline in exports during a recession dominates the decline in imports as domestic demand conditions soften. The resilience of private fixed investment is notable and ties in with other evidence pointing to structural change taking shape in the 1997-99 economic downswing phase of the business cycle *(see below).*

Chart 1

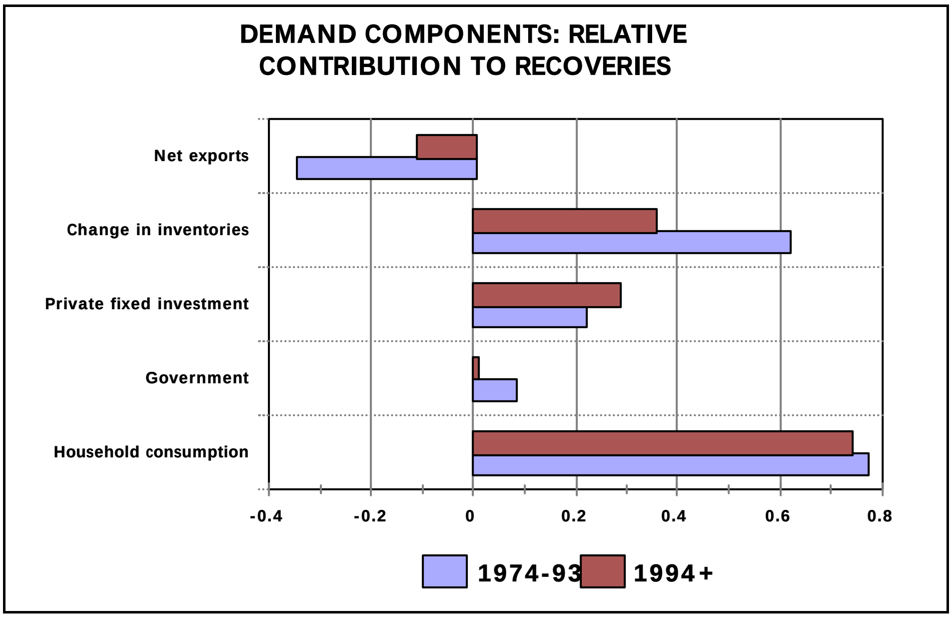


Considering the relative contributions of the demand components of GDP to *economic recoveries*, the strong role of household consumption once more stands out, both before and after 1994. Changes in inventories also make a strong contribution, albeit fading over time it seems. This is consistent with international trends where just-in-time inventory management has over time reduced fluctuations in inventory levels over the business cycle (see IMF, April 2002); the smaller contribution to economic fluctuations is also evident with regard to recessions *(chart 1 above)*. The

[5] For the purpose of the calculations, government and parastatal fixed investment were grouped with government consumption in order to distinguish the government's role in the business cycle.

contribution of private fixed investment to economic recoveries seems to have grown stronger, albeit that the overall contribution is relatively moderate. The influence of net exports is contra-cyclical as one would expect given SA's high import dependence. It is, however, noteworthy that the contractionary influence of net exports during economic upturns appears to have receded significantly, which ties in with other evidence regarding the structural changes on the current account of the balance of payments. Finally, the government is also making a smaller contribution to economic recoveries compared to the period before 1994; in fact the government was more or less neutral over the business cycles since 1994.

Chart 2



With this brief background, providing the general characteristics of the post-Bretton Woods era domestic business cycles, a closer inspection of the actual business cycles follows.

3.2 The 1989-96 business cycle in an historical context

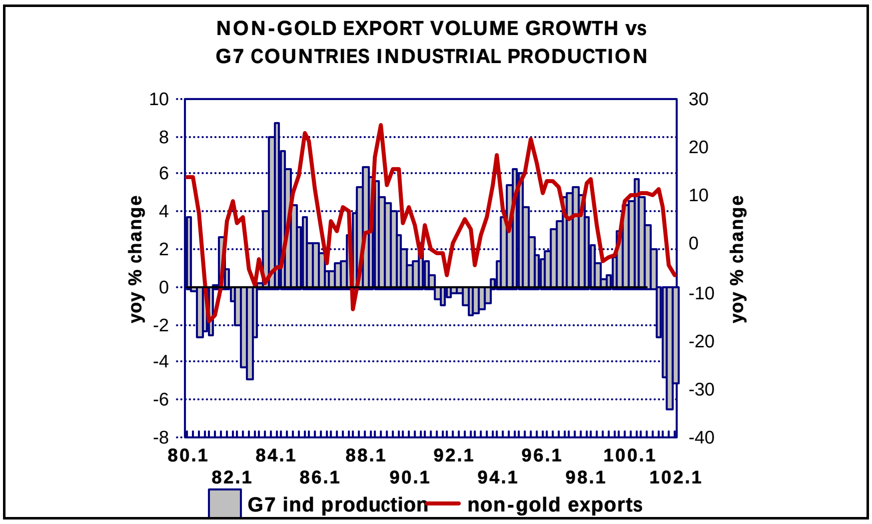
The decade of the 1990s was ushered in with dramatic change on the domestic political scene, as well as the onset of an international and a domestic economic recession. The domestic economic slowdown experienced from the end of 1989 to 1993 was always going to be influenced by the immense political changes in the country; or was it? A close consideration of the empirical evidence suggests that the impact from the political transition could indeed have been *"more transitory and peripheral"* in the words of Victor Zarnowitz. In order to shed more light a descriptive overview of the 1989-96 business cycle is provided below, including analyses of specific features of the cycle.

3.2.1 Business cycles during the 1980s: closely correlated with the international economy

The foregoing heading strikes one as somewhat odd in view of SA's international isolation during the 1980s. However, during the 1980s mining (including beneficiated minerals) and agriculture contributed close to one third of SA's GDP, which made the country susceptible to external economic changes. Chart 3 shows the close correlation (including a time lag of 3-4 quarters) between SA's non-gold exports and the growth in the major industrial countries industrial production. More striking is the fact that the domestic business cycle (depicted by the composite coincident business cycle indicator of the SA Reserve, chart 4) is so closely correlated with the growth in industrial production of SA's major trading partners during the 1980s[6].

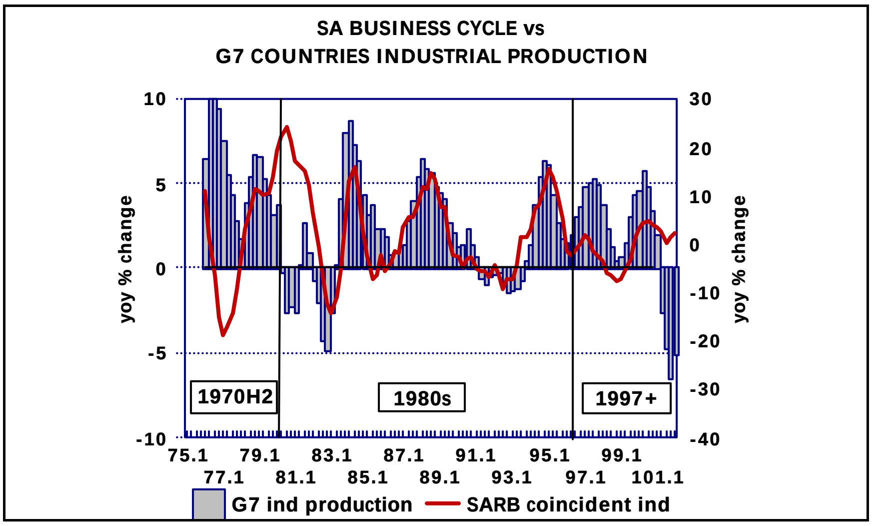
The correlation is extraordinary suggesting a very close relationship between the domestic business cycle and that of our trading partners. As a supplier of commodity inputs to the major industrial country industrial production processes business cycle developments in these countries were rapidly transmitted to SA. The industrial non-oil commodity price cycle is also closely correlated with the G7 countries' industrial production. The chart below shows that the domestic economic recession of the early 1990s was very much in line with the tendency in the major industrial countries' industrial production. This counters arguments that the side effects from the domestic political transition accounted for the protracted recession. It also supports the view that SA's business cycle has a strong endogenous momentum and that this momentum was closely tied to the global economic cycle. Domestic macro-economic policies were also very much in tune with the "stop-go" policies abroad over this period. This would explain why real domestic expenditure was in symphony with the global business cycle and why the introduction of new structural economic policies in the 1990s caused a deviation from the G7 countries industrial production cycle – *see chart 4, the period after 1997*.

Chart 3



[6] The year-on-year change in the composite coincident indicator is shown, which gives the indicator a leading property; the level index reveals a time lag of around 4 quarters between itself and the G7 countries industrial production growth.

Chart 4



The economic upswing phase during the late 1970s does not correlate with the global business cycle, which entered a downturn well before the domestic business cycle. The booming gold price at the time as well as strong pro-cyclical government consumption and capital expenditure prolonged the domestic economic upswing. However, the 1981-83 domestic economic downturn coincided with the world recessionary conditions of the early 1980s, a fall-out from the 1979 oil price shock and the accompanying economic policy reactions in the major industrial countries.

The chart above also indicates that the slump in G7 countries industrial production growth during 2000/1 was not mirrored in the movement of the domestic coincident business cycle indicator, suggesting a decoupling from the pattern over the 1980s and early 1990s. To explain this pattern one needs to appreciate the impact of changes in the domestic economy as a result of economic policies aimed at correcting structural imbalances in the economy; it is for instance evident that the domestic cycle appears to be much weaker in response to the growth in the G7 countries industrial production over the period since 1997 compared to the preceding decades; this reflects more constrained domestic demand growth rather than weaker export growth – *this theme is discussed further below.*

3.2.2 The 1989-96 business cycle: still in the mode of the 1980s

In many respects, the 1989-93 economic downturn resembled that of the 1980s. The onset of a somewhat protracted – and unsynchronized – world economic recession, the tightening of monetary policy responding to inflationary pressures and balance of payments concerns and a deterioration in the terms of trade ushered in the domestic economic downturn. An additional factor in the 1989-93 downturn, was the fact that interest rate policy changed under the hand of the new Governor of the SARB, Dr Stals who favoured a high interest rate policy to protect the value of the rand. This had the typical cyclical consequences for the 1989 downturn, however, also embodied a structural change which had longer term implications in terms of the inflation equation and domestic spending patterns. Real GDP growth declined in 1990 and this decline accelerated in 1991 and 1992. During 1992/93 business and investor confidence deteriorated badly in the face of major uncertainties tied to the political negotiations at the time, as well as recessionary world economic conditions. The economic recession became more protracted as a result and was also deepened by a serious agricultural drought. A significant feature of this early 1990s recession was the huge employment losses suffered in the formal sector of the economy, i.e. an estimated 400000. According to the SARB, these job losses were the result of *"… both cyclical and structural changes in the labour market."* (Van der Walt & Pretorius, March 1995: 38).

The recession also continued the pattern of the 1980's recessions registering outright declines in real GDP, compared to the recessions of the post-War period up to 1980, when growth slowed, but remained positive. The outstanding feature of the recession, however, was its length (51 months) being the longest in SA's post-WWII history and comparable to the Great Depression of the 1930s (see Van der Walt & Pretorius, March 1995: 36-38). The contraction in real GDP (-0,5% p.a.) was nonetheless not as sharp as during 1981/3 (-2,3%) and 1984/6 (-2,7%). What made the recession bad though was that it came at the end of a period of poor secular growth.

The world economy experienced recessionary conditions during the early 1990s; the recession in the US economy was mild and short-lived, but in Western Europe the recession was protracted and only eased towards the end of 1993; Japan experienced a serious recession following the investment boom in that country in the late 1980s. The end of this global recessionary period was signaled when economic conditions in the European countries began to improve more meaningfully following the unification of Germany.

According to the SARB's dating of the domestic business cycle, the SA economy commenced on an upward phase of the business cycle during the second quarter of 1993. The economic upswing phase from 1993 to 1996 was very much in the "old style" (say the 1980's style) of the business cycle, even though the economy embarked upon key structural changes. Key growth-supporting factors were the end of financial and economic sanctions, the phasing out of exchange control (e.g. the scrapping of the financial rand mechanism) and lower inflation. Both business and consumer confidence was bolstered as economic conditions improved. The recovery was led by a recovery in export growth during the second half of 1993 on the back of the world economic recovery, as well as a strong recovery in agricultural conditions following the 1992 drought. A strong improvement in SA’s terms of trade tied to an improvement in international commodity prices was an important feature of the improving economic conditions during 1994/95.

The recovery lost momentum during the first half of 1994 due to the elections and labour market turmoil, however, gained stronger momentum thereafter. A significant feature of the 1994/95 revival in growth was a sharp acceleration in bank credit extension and money supply growth, which increased inflation expectations. Interest rates were therefore hiked from September 1994 and again in February and June 1995. Fixed investment was also a strong component of the economic upswing bolstered by mega investment projects (e.g. Alusaf; Columbus); these public sector projects were an important catalyst in the fixed investment revival, which became broader based during 1995. Strong pent-up demand for capital goods was also a key driver of the renewed growth, however, the fixed investment revival petered out from the second quarter of 1996. It was evident that the domestic private sector still faced important structural constraints and the improvement in business confidence was very much tied to the cyclical improvement in domestic demand conditions. This pattern was also reflected in the changes in inventory investment over this period.

The initial improvement in final household consumption expenditure was moderate compared with the business cycle upswing phases of the 1980s due to positive real interest rates (Pretorius, et al, 1998: 41). Government consumption initially added to the growth momentum, however, slowed as fiscal policy was tightened in line with the GEAR longer-term growth strategy. It is important to realize that the impact of the government's austere fiscal policies materialized mainly after 1996. Apart from the 1989 switch to more stringent monetary policies, which had some impact on household consumption expenditure during the recovery phase of the business cycle, most of the changes in key economic policies only had an impact beyond 1996 (the calendar year when the GEAR economic growth strategy was adopted).

A key change, however, was that the current account of the balance of payments was allowed to go into a deficit during the second half of 1994 as SA experienced strong capital inflows from the middle of that year and particularly during 1995 in the wake of abolishing the financial rand mechanism (March 1995). Nonetheless the classical balance of payments constraint on growth asserted itself when the footloose capital inflows reversed in February 1996 and again during the third quarter of 1996. It became evident that in a financially integrated global market place domestic economic policy was not entirely independent (see Basu & Taylor, 1999). The SARB's policy was to rebuild the country's foreign exchange reserves, to gradually relax exchange controls and to restructure the market for foreign exchange, including the forward market. However, in the words of the then Governor, *"Good progress was made … during 1994 and 1995, but the country was surely not yet in a position to withstand the adverse developments of early 1996 …" (*Stals, February 1997: 3). The financial volatility experienced in 1996 also served as a wake up call of things to come in this regard. The structural shortcoming of course being insufficient balance of payments reserves. In fact net reserves declined in 1996, short-term interest rates were hiked (including some delay), long-term interest rates spiked sharply and the rand depreciated by close to 22% between January and December 1996 against the US dollar. All this signaled the end of the economic upswing - by 1997 growth slowed, inventory investment was down and real domestic expenditure slowed down.
In all, the domestic 1989-93 business cycle seems both in terms of its amplitude *(see chart 4)* and its content to have been closely related to the business cycles of the 1980s. The reprieve on the balance of payments was short-lived and too little for it to be labeled as structural change; for this we had to be more patient as the 1994/95 current account deficit certainly signaled the beginning of new things to come. *Was any of this evident in the economic downturn which commenced towards the end of 1996?*

3.3 The 1997-99 economic downturn: evidence of structural change?

The major components of real domestic expenditure began to slow down during the second half of 1996; inventory investment declined sharply. The slowdown in growth was desirable to restore the imbalance on the current account of the balance of payments, even though capital inflows improved during the course of 1997. The major event of 1997, however, was the economic problems in the East Asian region commencing around mid-year. Initially SA weathered the financial contagion well with the currency remaining stable, despite the sharp devaluation of many East Asian currencies. Early during 1998, the domestic economy was starting to move beyond the recessionary phase; the decline in business confidence stabilized, interest rates declined (October 1997 and March 1998) and most economic indicators pointed to an immanent economic recovery. However, as the contagion spread to Russia in 1998 international investor risk aversion reached extreme levels (Apr/May 1998) and the rand came under tremendous pressure as portfolio capital flowed out from the country. What followed was a sharp increase in domestic interest rates from April to August 1998. According to the SARB *"[t]hese events delayed the recovery in general economic activity and prolonged the downward phase of the business cycle." (Venter & Pretorius, September 2001: 68).*

A key problem was the high level of household indebtedness, which in any case did not bode well for the economic recovery (before the East Asian contagion erupted in full force). The sharp increase in interest rates led to declines in real household consumption expenditure (1998Q4 and 1999Q1), as well as private real domestic fixed investment (1998/99). However, it was interesting to observe that in all real domestic expenditure remained relatively resilient in the face of the sharp hike in interest rates in 1998 - *see the bahaviour of real gross domestic expenditure compared to other economic downturns in chart 5 below; chart 6 also shows that fixed investment was resilient in this downswing phase of the business cycle*. This can be interpreted as the first evidence of a more resilient economy following the onset of structural economic changes in the first half of the 1990s. From the production side, an important factor in the resilience of the economy was the growing share of the services sector in GDP.

Chart 5

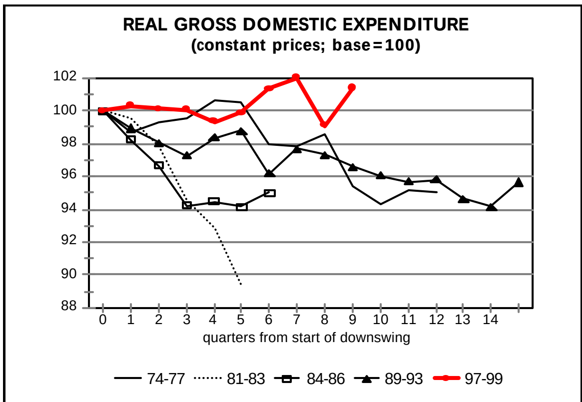
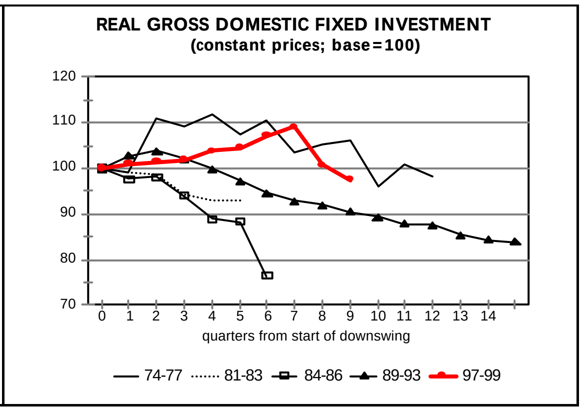


Chart 6



Nonetheless, real domestic expenditure was lackluster, even in the ensuing upswing phase of the business cycle from the middle of 1999. The 1998 interest rate shock at the height of household indebtedness had a major impact on consumer behaviour, specifically reducing their propensity to consume on credit *(see chart 11)*. It furthermore sensitized consumers and business to developments regarding interest rates *(chart 12)*. <u>This counts as strong evidence of the adverse real economic impacts of externally induced financial volatility</u> *(see below).*

The upswing was led by the decline in interest rates - by July 1999 prime interest rates were back to the level before the sharp hikes of 1998; and a sharp improvement in world economic activity following the East Asian fallout. From the second half of 1999 real household expenditure and business fixed investment began to improve, led by increases in business confidence.

3.3.1 Structural change

The SA economy was faced with immense structural imbalances at the start of the 1990s decade, apart from the impact of the socio-political changes. These structural deficits needed to be corrected in order to improve the longer-term growth potential of the economy. The macro-economic discipline required to effect these structural improvements in the economy was always going to demand a price in terms of forfeited growth during the interim. Factors which constrained the economic revival of 1993-96 and general economic growth beyond, included:

- The phasing out of export subsidies and import tariff reductions to remove the anti-export bias in the economy;
- Stricter monetary policies to contain inflation in SA;
- From 1996, the adoption of the GEAR economic growth strategy, which made the achievement of macro-economic stability a key priority.

The impact of these measures had a constraining influence on real domestic expenditure, particularly in terms of personal income growth. The 1994/95 revival still benefited from strong growth in bank credit utilization as the formal sector credit market deepened in SA. However, as noted above real household expenditure was less robust compared to earlier cycles under pressure from higher real interest rates. Furthermore, the sharp depreciation of the rand exchange rate in 1996 posed inflationary dangers particularly in view of the high growth in money supply at the time, putting additional pressure on interest rates (Stals, February 1997: 6). <u>The combination of speculative attack on the currency, leading to sharp rand depreciation, and higher interest rates marked the beginning of a new growth pattern in SA</u>. The domestic demand components of real GDP came under pressure from higher interest rates (read: stricter monetary policy) as well as stricter fiscal policy.

The experience in 1998 was more dramatic compared to 1996. The East Asian financial contagion eventually caught up with SA. The currency crisis at the peak of household indebtedness and the SARB's futile attempts to protect the currency by hiking interest rates and supplying the market for foreign exchange with forward dollars delivered a substantial shock to the domestic economy. The result was that the revival in the domestic economy shaping up in the early months of 1998 was abruptly aborted. Nonetheless real domestic expenditure remained surprisingly resilient *(chart 5)*, albeit under pressure from austere macro-economic policies. Furthermore, the "new growth pattern" referred to above deepened as it became evident in the ensuing economic upswing phase of the business cycle. Chart 7 shows a much weaker revival in real domestic expenditure in 1999 compared to the 1993/96 recovery and earlier recoveries; the largest contributor to the recovery, namely household expenditure also appeared to have been under pressure compared to previous economic recoveries *(chart 8)*.

Chart 7

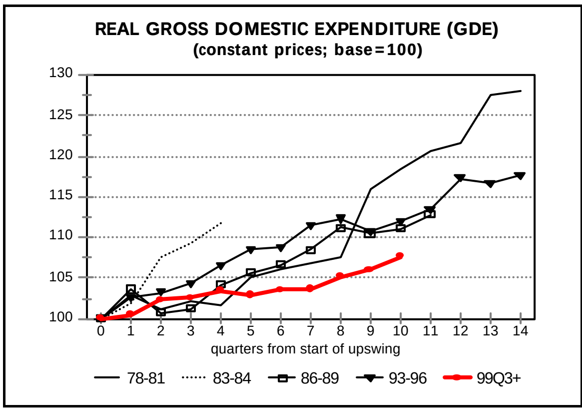
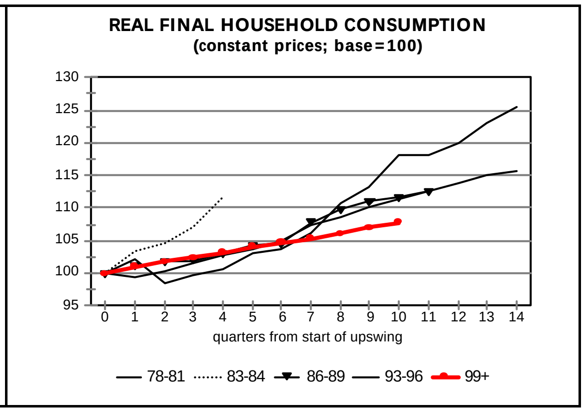


Chart 8



The export sector benefited from the increased price competitiveness following from the rand's cumulative depreciation and the industrial restructuring, accompanying trade policies and the increasing export focus in the industrial sector. SA's export performance of the late 1990s was clearly a qualitative improvement compared to the preceding decades, when SA failed to increase the manufacturing component of exports. This change is furthermore reflected in the import/GDP and export/GDP ratios *(chart 10)*; the import ratio reflects the reduced import penetration from the weak rand exchange rate as well as less than robust real domestic expenditure under pressure from weak formal sector employment conditions *(chart 9)* as well as strict monetary and fiscal policies.

Chart 9

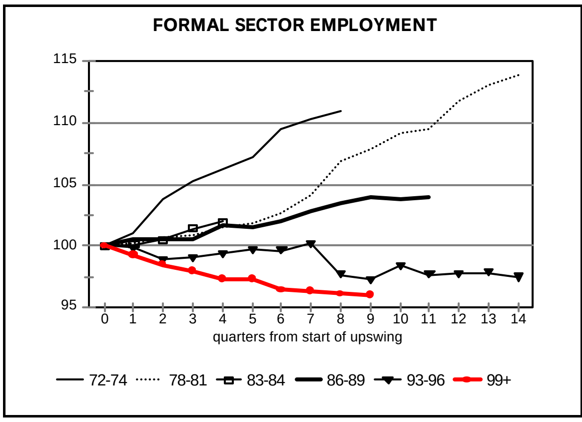


Chart 10

What is interesting is the fact that while exports performed well and in line with the external economic growth performance, the overall composite coincident indicator of the SARB tracking the domestic business cycle did not correlate that well with the growth in the major industrial country industrial production as it did over the 1980s *(chart 4 above)*. The external transmission of the business cycle via the trade route remained in place and probably got stronger given the trend in the export/GDP ratio, however, the combination of austere fiscal, monetary, trade and industrial policies and the adverse impact from international financial contagion suppressed the growth in real domestic expenditure *(chart 7)*. <u>The poor employment performance of the economy is obviously key the development in this regard</u>. *We return to this theme in section 5 below.*

However, it was argued above that the real domestic expenditure was more resilient in the face of the 1998 interest rate shock compared to earlier business cycle downturns. Similarly it would appear that despite a less than robust growth performance, real domestic expenditure proved more resilient during the 2000/1 world economic downturn. Text: Normal, TNR, 12, Justified .

3.4 The 1999 economic upswing: greater resilience affirmed?

The present economic recovery, which commenced during the third quarter of 1999, developed rapid momentum towards the end of 1999. However, this economic recovery will be remembered for two developments, which tended to counter optimistic expectations regarding the business cycle prospects. *Firstly*, the notable decline in business and consumer confidence levels during calendar 2000 as markets reacted negatively to a number of non-economic factors (e.g. the Zimbabwean political-economic crisis, the HIV/AIDS debate). *Secondly*, the sharp depreciation of the rand exchange rate from the beginning of 2000, but more substantially towards the end of 2001 following the September 11 events in the USA *(see the section on the capital account of the balance of payments below)*. In the end the real GDP growth rate for calendar 2000, i.e. 3,4% came in at the higher end of the spectrum mainly due to a strong export performance at the peak of the global business cycle. The growth in real domestic expenditure was weaker at slightly below 3%. <u>This growth pattern, i.e. buoyant export growth coupled with less than robust growth in real domestic expenditure therefore clearly continued during 2000</u>.

Export growth did slow down in response to the world economic downturn during 2001, however, the eventual real GDP growth rate of 2,2% for 2001 came in at the higher end of expectations, particularly in a global context where most industrialized countries and many leading developing economies experienced recessionary economic conditions. The resilience in domestic economic growth in the face of the world economic recession was in sharp contrast to earlier periods of equally weak world economic conditions. Apart from strong – and it would appear – autonomous growth momentum in exports, amongst other benefiting from trade agreements (e.g. the SA-EU FTA, AGOA), it was encouraging to witness the steady and unperturbed growth in real household consumption expenditure and private fixed investment over this period of otherwise unsettling financial developments, a highly uncertain world economic environment and troubling regional turmoil (Zimbabwe). The stronger than expected growth performance during calendar 2000 despite the lapse in confidence levels and the sustained growth in the real domestic expenditure during 2000/1, even developing more rapid momentum during the first half of 2002, once more underline the endogenous driving forces in the upward phase of the business cycle. This endogenous business cycle momentum signifies a key change from the 1993-96 economic upswing and has the potential to take the economy on a higher growth path – *see section four below.*

The growth in real domestic expenditure was weaker compared to previous business cycle upswing phases (chart 7 above) due to the impact of austere macro-economic policies and poor formal sector job creation. *However, its sustainability in the face of the world recessionary economic conditions also signaled structural change – the domestic economy is slowly but surely acquiring its own legs to stand on*, which is heartening in the face of major uncertainty on the global economic scene (e.g. worries of a double-dip recession in the USA, the post-911 geo-political climate, the extreme tensions in the Middle East, etc.).

The steady recovery in real household expenditure is central in the current general economic recovery. Household's credit utilization picked up, however, chart 11 shows the growth remains mild compared with the credit-spending boom of the 1994/96 business cycle upswing. As noted above, the 1998 interest rate shock at a time of peak household indebtedness had a major impact on consumer behaviour, amongst other, affecting their willingness to commit to credit spending. Furthermore, the growth in personal disposable income is under pressure from poor formal sector job growth. Nonetheless, it is evident that household's *ability to spend* has also been improving, particularly for the tax-paying middle to higher income groups. The combination of steady growth in household income, low inflation and personal tax relief contributed to firm *real growth* in personal disposable incomes since the middle of 1999. The growth in personal disposable incomes (around 10% per annum, 2000/1) consistently exceeded the growth in credit extension to households (around 9% per annum) over this period, leading to reduced household indebtedness[7]. This made consumers less vulnerable to the impact of the increase in interest rates during the first half of 2002.

Chart 11

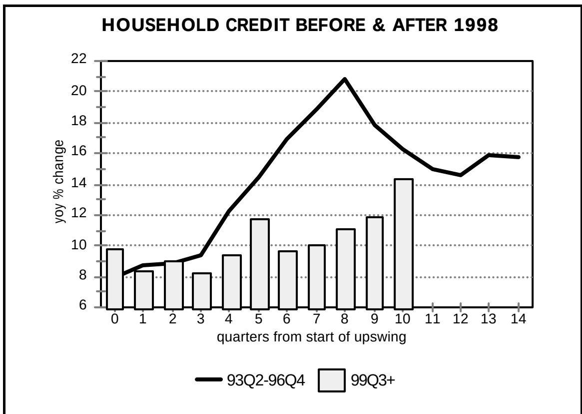
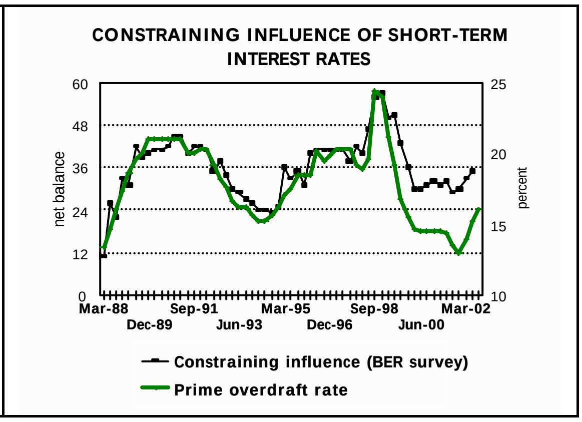


Chart 12



[7] According to the June 2002 SARB *Quarterly Bulletin*, the ratio of household debt to personal disposable income declined from 61,2% (1st quarter 1998) to 53,8% (1st quarter 2002).

The gradually improving domestic demand conditions, currently supported by mild expansionary fiscal policy, is also driving private fixed investment, which grew at a steady pace since the end of 1999. As with real household consumption expenditure, the growth in private fixed investment is moderate compared to the earlier economic upturns *(chart 13)*. Export growth is also supporting the fixed investment drive. SA's increased penetration of export markets mirrors the improved international competitiveness of SA's industrial exports. *Manufacturing exports as a percentage of manufacturing output increased from 14% in 1994 to 28% currently*. The combination of moderate growth in real domestic expenditure and healthy export growth has led to net exports being less contra-cyclical in the current economic upswing phase – *see chart 14*.

Chart 13

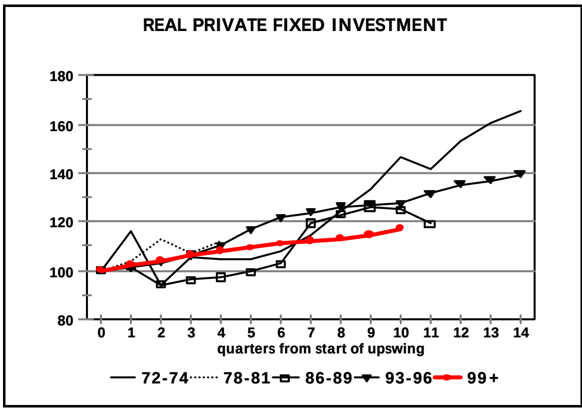
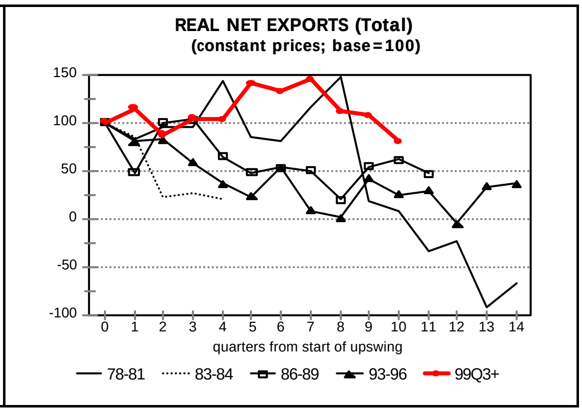


Chart 14



The greater resilience in the domestic economy therefore appears to be embodied in a reduced contra-cyclical contribution to GDP growth from net exports, as well as a more stable macro-economic environment enhancing steady growth in after-tax real disposable incomes and affording the fiscus to embark on a more expansionary route. <u>This probably encapsulates the essence of the structural improvements in the domestic economy rendering the business cycle less vulnerable to external shocks</u>. The external sector (reflected in the gyrations of the rand exchange rate) is lagging this improvement. The rebuilding of the country's foreign exchange reserves is a longer-term process. Until more meaningful long-term capital inflows materialize, this vulnerability remains and the possibility of currency volatility. However, in both the monetary policy and fiscal policy fields huge strides have been made to stabilize the macro-economic conditions. At the time of writing, the currency-induced increase in inflation posed some threat to inflation, but is expected to be a one-off affair.

4. SA’S CHANGING BALANCE OF PAYMENTS

South Africa is a small, open developing economy firmly embedded in the so-called emerging markets group of countries. With 48% (i.e. the average over the period 1994-2001) of its GDP being traded globally and possessing well-developed capital markets it is to be expected that the economy’s performance will be heavily influenced by events abroad.

SA's sensitivity to external developments, however, does not end there. At the time of the 1994 elections, the economy was – and continues to be – faced with formidable structural deficiencies due to historical imbalances, all of which impact on risk perceptions (e.g. the high levels of unemployment and poverty) and some of which contributes directly to the economy's vulnerability to external developments, particularly SA's dependence on foreign savings and the weak external liquidity position. The low level of reserves embodies the age-old balance of payments constraint on economic growth.

Chart 15

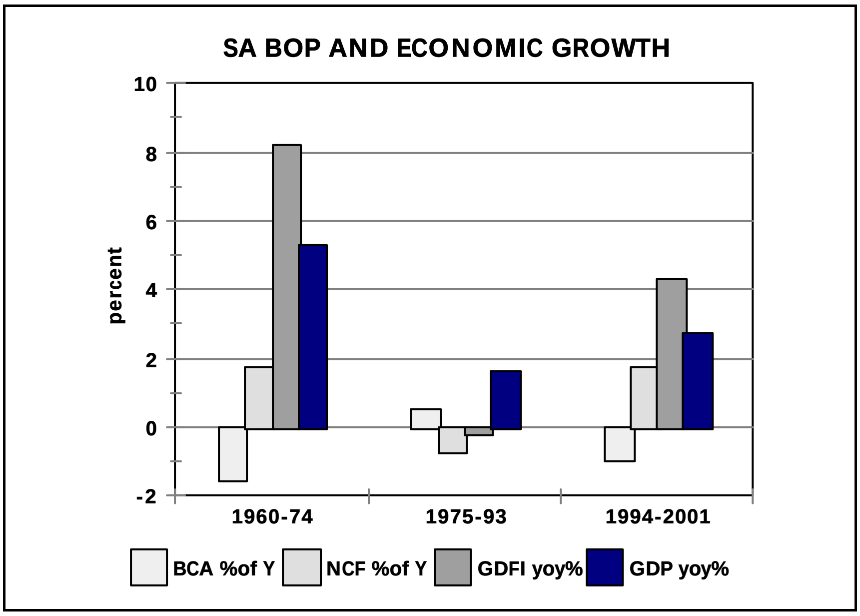


Chart 15 provides an interesting perspective on how SA's balance of payments has changed over the post-WWII period. During the immediate post-War period (1946-74) the current account deficit averaged 1,5% of GDP and was more than matched by net capital inflows of 1,7% of GDP on average. The growth in real gross domestic fixed investment averaged 8,2% per annum over this period and real GDP growth 5,3%. This changed over the subsequent structural period (i.e. 1975 to 1993), characterized by intensifying financial and economic sanctions. A current account surplus measuring 0,5% of GDP realized as net capital outflows amounted to no less than 0,7% of GDP over this period. Real fixed investment actually contracted by 0,1% per annum on average and real GDP growth averaged a mere 1,6% per annum. Since SA's re-integration with the world economy, the balance of payments constraint on economic growth lifted. The current account of the balance of payments was allowed to go into deficits (averaging 0,9% per annum over the period 1994-2001) as net capital inflows returned to erstwhile levels measuring 1,7% of GDP on average. Real fixed investment growth accelerated to 4,3% per annum over this period and overall real GDP growth to 2,7% per annum.

The rebuilding of the country's foreign exchange reserves is a long-term process and the overall balance of payments no doubt continues to exercise a constraint on domestic economic growth and the country's vulnerability to financial volatility remains. However, it is interesting to observe some stabilizing influence via the trade route. While domestic economic policy issues are at stake and SA's incremental progress with structural reform, increased export penetration of foreign markets have contributed to this resilience in the real economy, particularly in the manufacturing sector. During calendar 2000 most analysts downgraded economic growth forecasts once the financial volatility took hold, however, the actual outcome for the year surprised many. This may be explained by exceptionally buoyant export growth (total non-gold export volumes growing in excess of 10% and real manufactured exports growing by 12,5%); the performance of real domestic expenditure (2,9%) was more in line with expectations, reflecting the negative impact of the financial factors noted above. Concurrent with the episodes of financial volatility and contrary to their local impact, evidence emerged of a more resilient domestic real economy demonstrating an improved capacity to absorb external shocks. The first evidence in this regard emerged considering the growth performance in the wake of the 1998 interest rate shock; however, more meaningful evidence came to the fore during 2000/1 (and the first half of 2002) that the domestic business cycle is possibly deviating from well-entrenched patterns. More importantly, the economic resilience appears not only to be restricted to the large and rapidly growing services sector in SA, but also manufacturing, typically a very cyclical sector in line with the domestic retail sector.

Unfortunately the structural change on the balance of payments comes with a price tag. The capital inflows, which SA succeeded to attract since 1994, have been very volatile, causing great financial volatility with adverse real economic affects. An overview of the recent developments on capital account of the balance of payments is provided below.

4.1 Capital flows: the impact on the business cycle from financial contagion

One of the most glaring structural shortcomings of the SA economy relates to its weak external liquidity position, i.e. the overall level of gold and foreign exchange reserves. At the time of the country's first democratic elections, i.e. April 1994, the level of net gold and foreign exchange reserves (i.e. gross reserves, minus short-term reserve-related loans by the SA Reserve Bank and/or government) stood at zero. Since then, this number has improved immensely to a level above R60 billion. This is no mean feat, however, even at this substantially improved level, net reserves are only sufficient to finance 9 weeks' worth of imports. This leaves the overall balance of payments at a very vulnerable position, particularly during an upswing phase of the business cycle. Since 1996 in particular, we have witnessed successive bouts of currency weakness, which took a toll on the economy's real growth performance.

The typical pattern of these capital account shocks is that the cessation or reversal of capital inflows forces a large and relatively abrupt current account adjustment and depreciation of the exchange rate, which usually have adverse real economic effects. The channels along which these adverse effects are transmitted are (IMF, 2002: 126).

- To the extent that capital outflows cannot be met by existing reserves, the adjustment on the current account mainly occurs from import compression, i.e. higher interest rates and a consequent decline in real domestic expenditure. Contractions in household consumption expenditure and business fixed investment are to some extent mitigated by an improvement in net exports.

- The depreciation of the currency also contributes to the current account adjustment, however, typically has an adverse impact on business confidence, partly due to its cost-raising effects.
- On the supply side of the economy, the adverse impact on output stems from the import content of production and companies' exposure to exchange rate and interest rates changes.

The adverse supply shocks are met by contractions in domestic demand, which aggravates the situation. Somewhat of a vicious circle is created in that the contractions in demand are aggravated by worker lay-offs and mounting uncertainties.

4.1.1 A re-cap of SA's experience through the 1990s sheds more light.

- Early during 1996, the economy experienced a relatively robust economic upswing, which commenced mid-1993 and gained more substantial momentum during 1994/95 after the successful first democratic elections. As is typical during an economic upswing phase, the level of import demand increased sharply leading to a higher deficit on the current account of the balance of payments (i.e. the extent to which imports and payments for services exceeded the value of exports and service receipts). The increasing deficit was financed by confidence-sensitive portfolio investment inflows, which reversed when foreign investors sensed increased risk. Investors were furthermore sensitized due to the fact of Trevor Manuel's then appointment as the Minister of Finance and his infamous "amorphous market forces" speech. The reversal of capital flows forced the SA Reserve Bank to tighten monetary policy, also in an attempt to defend the rand exchange rate. In the event, by the end of 1996 the economy entered a downswing phase of the business cycle, i.e. the economic recovery was aborted. Following 1996's real GDP growth rate of 4,2%, calendar 1997 registered a growth rate of only 2,5%; *the rand depreciated by close to 22% between January and December 1996 against the US dollar*. Whilst comparatively true to the typical South African business cycle pattern, the 1996 financial volatility was a sure wake-up call in terms of things to come.
- Early during 1998, the economy was starting to move beyond the recessionary phase; the decline in business confidence stabilized, interest rates declined and the most economic indicators pointed to an immanent economic recovery. The events which followed – and being ignited by the Southeast Asian financial and economic crisis – have been well documented. International investors' appetite for risk declined sharply and SA experienced a sharp reversal of portfolio investment inflows. The rand plunged and interest rates increased sharply – prime overdraft interest rates to a level of 25,5%; *the rand depreciated by close to 28% between July 1997 and August 1998 against the US dollar*. The result was that the immanent economic upswing was aborted and the economy's growth performance deteriorated; a real economic growth rate of 0,8% was registered during 1998, accelerating to a mere 2% in 1999.
- *The latest episode is fresh in our memories*. From the middle of 1999, a robust general economic recovery took hold in SA, with annualized growth reaching a pace of 3,6% during the fourth quarter of that year. The agricultural sector made a significant contribution and the growth in value-added in the manufacturing sector

reached a pace of close to 7%; business confidence surged. Most analysts were forecasting 3%-3,5% (and higher) real GDP growth for calendar 2000. In the end a real GDP growth rate of 3,4% was registered, however, the actual economic growth performance contradicted the general economic picture during 2000, which was characterized by declines in business and consumer confidence, the rand's renewed weakness (*the rand depreciated by close to 20% between January and December of 2000 against the US dollar*) and a number of developments weighing on sentiment. The end result was anemic growth in real domestic expenditure (in line with the revised expectations, i.e. 2,9%), however, with a particular strong showing of net exports at the peak of the global business cycle explaining the higher than expected overall economic growth rate.

The weakness of the rand exchange rate persisted in 2001, particularly during the second half of the year with the rand experiencing an extraordinary plunge (*the rand depreciated by close to 37% between January and December of 2001 against the US dollar, most of which occurred after September 11*). As international financial markets became unsettled by uncertainties pertaining to the US stock exchange and interest rates in the course of 2000, they became averse to emerging market risk and this developed a climax following the September events in the USA. Substantial net sales of domestic bonds by non-residents (the accumulated outflow measuring R20 billion in 2000 and R25 billion in 2001) contributed to the pressure on the rand exchange rate already being affected by the strength of the US dollar. To add insult to injury, the Zimbabwean political-economic crisis and what the markets perceived to be an inappropriate domestic political response and the HIV/AIDS debate affected sentiment, contributing to the rand's depreciation, as well as increases in long-term interest rates at times. Both business and consumer confidence – across all population and income groups – declined during 2000, however, tended to recover during 2001. *Real domestic expenditure grew by a mere 1,8% during 2001 and the domestic market is currently faced with considerable risks tied to the currency-induced price and interest rate hikes (early 2002) and in the offing*.

At first glance these three episodes illustrate the vulnerability of SA's balance of payments; when foreign investors become risk averse and/or external liquidity deteriorates, the rand exchange rate comes under pressure, domestic interest rate patterns are affected, business confidence typically deteriorate and real economic prospects suffer to the extent that particularly the domestic market (i.e. real domestic expenditure) is affected. This suggests a destabilizing external financial transmission to the domestic business cycle, at least over this short period since SA's financial re-entry into the world economy.

Compared to other emerging market countries, the adverse output shocks appear to be relatively mild. <u>SA's disciplined macro-economic policies (low inflation, low budget deficits, openness to trade with the export sector compensating and benefiting from the exchange rate depreciation) go a long way to explain this performance</u>.

5. THE PROPAGATION OF THE DOMESTIC BUSINESS CYCLE: WHAT DO WE LEARN FROM THE 1990S?

Traditionally SA's economic recoveries were export led. A sharp improvement in world economic activity also made an important contribution to the current economic recovery from the third quarter of 1999. However, what is interesting is that the synchronized world economic slowdown from the second half of 2000 and through 2001 have as yet not induced the "traditional" domestic economic slowdown. Domestic real GDP and export growth did slowdown in response to the world recessionary conditions and the latter may not be over yet[8], however, from the previous section, two issues can be summarized:

- The slowdown in export growth seems to be countered by the increased penetration of export markets and the manufacturing sector is central in this regard; the current export slowdown is less serious compared to the world recessions of the early 1980s and early 1990s.
- The domestic leg of the economic recovery, led by real household consumption expenditure and business fixed investment, appears to an important extent to be "insulated" from the export slowdown in that it has an endogenous dynamic. The cumulative steady growth in real after tax household incomes since the third quarter of 1999 (i.e. the trough of the current business cycle) is contributing to the sustenance of the recovery. Although less robust compared to past ("stop-go") cycles the current upturn appears to be more sustainable and able to counter the impact of weaker export growth in the face of the weaker world economic conditions.

At this stage a key proviso needs to be stated. The charts (7, 8 and 13) above clearly shows that the current revival in real household expenditure, private fixed investment and overall real domestic expenditure is weaker compared to earlier business cycle upturns – *witness the trajectory of the SARB's composite coincident indicator during the current economic upturn compared to earlier business cycles, chart 16.* Furthermore, job shedding in the formal sector of the economy continues *(chart 9)* and we know that a shift from the formal to the informal sector is accompanied by a loss of income on the macro scale. The improvement in business confidence levels also proved initially to be weaker compared to previous cycles *(chart 17).*

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8 At the time of writing many analysts were fearing a second leg of the US economic recession, which would obviously have a negative impact on world economic growth, including SA.

Chart 16

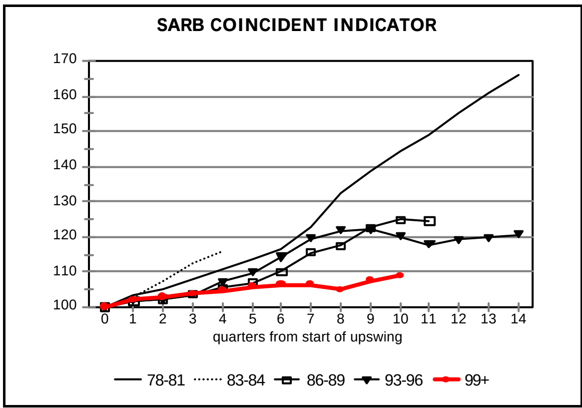
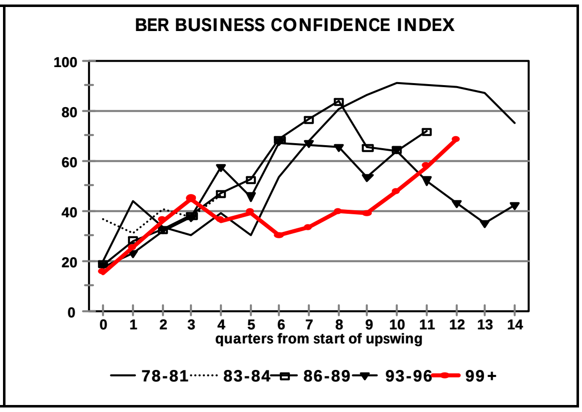


Chart 17



On the other hand developments during the first half of 2002 (i.e. very close to the trough in the world economic recessionary conditions) have been surprising. Particularly the surge in business confidence, which took the BER business confidence index to a higher level compared to the 1993-96 cyclical peak *(chart 17). This leaves us with a puzzle*. On the one hand the domestic demand indicators are trending at weaker levels compared to earlier cycles, tempting one to conclude that the domestic economy is in worse shape compared to previous business cycles. On the other hand, business people have become quite optimistic (more so compared to the previous business cycle upswing, which - as motivated above - was a cycle very much of the 1980s style) regarding the business conditions they experience, which are also reflected in retail and manufacturing economic statistics. *What do we make of this?*
It was noted at the onset of this paper that in order to assess any structural changes in the domestic business cycle conclusions run the risk of being of a speculative nature due to the short historical track record available. *Be that as it may, the analysis point to the following:*

- The steady recovery in real household consumption expenditure is fuelled by a number of supporting factors, i.e. cumulative after tax income growth, lower inflation and more stable interest rates (ignoring the impact of the one-off currency-induced increase in inflation for the moment), improving consumer sentiment and - most importantly more stable employment conditions. The point is that personal tax cuts, lower inflation and more stable interest rates can go only so far in stimulating consumer spending; the critical missing variable remains formal sector job growth. Real income growth tied to improvements of labour productivity is another supportive factor, however, to the extent that employment growth remains absent, the multiplier effect of the growth in real household consumption expenditure will remain limited. This in turn will cap the improvement in business profits and confidence, which at some stage will affect fixed investment intentions. Growth is likely to slow sooner rather than later. Production capacity utilization will come under pressure, causing upward pressure on prices and interest rates. The more robust the credit spending cycle, the earlier these bottlenecks will appear. The improvement in business operating surpluses tied to the restructuring efforts of the past decade (downsizing, cost-cutting, unbundling, etc.) - as important as that may be in the business fixed investment equation - can go only so far in boosting business confidence. The more important factor is the relative buoyancy in demand conditions, which impact on businesses' profit margins and growth, which, in turn, boost fixed investment intentions and yet higher confidence levels and more than likely the increased hiring of workers. It was shown in the second section of the paper that SA's business cycle, both in recession and recovery, is driven mainly by household consumption expenditure; in the major industrial countries household consumption expenditure is the key driver during economic recoveries (IMF, April 2002).

- It is possible that SA is currently in the early stages of the second leg of what Zarnowitz have described as "[an] allocative shock". The first phase of downsizing and rationalization in the domestic economy causing higher unemployment and improved productivity levels and corporate profitability may be nearing maturity phase, *inter alia*, explaining the high business confidence levels at the time of almost extreme international economic uncertainty. Zarnowitz (1999:70), however, suggests that the second leg of such an "allocative shock" is likely to be a phase during which the companies want to grow, i.e. obviating a cycle of "upsizing". One should therefore be expecting improved formal sector job growth going forward; alternatively policy makers need to be attentive to this issue. The question is to what extent SA will experience a phase of "upsizing" born from the endogenous dynamics of the business cycle and to what extent the authorities should play an initiating/supportive role. SA runs a risk that the imperatives of international competition and constrained domestic market growth undermine companies ability to "upsize"; exports have been the central transmission channel of this "allocative" business cycle. *Will the export sector create the necessary jobs?*

- In short, as real household consumption expenditure is the central driver of recoveries, it will require improved employment creation in the formal sector of the economy for a more robust business cycle. Without this, the current general economic recovery is likely to peter out in an unimpressive manner.

- With the achievement of macro-economic stability and all intentions from the policy authorities to stay this policy course, credit cycles have more potential to be comparatively stable affairs. This has certainly been the pattern since the developments in 1998 and the subsequent change in interest rate policy. While one can never underestimate the amplitude of credit cycles in market-driven economies, central banks have come a long way in managing/influencing these processes (see Basu & Taylor, 1999). However, it is also necessary to heed the warnings from Zarnowitz as far as the "unceasing round" of the business cycle is concerned. *Firstly*, wrong/ mistimed or bungled stabilization policy has significant destabilizing potential. *Secondly*, even a more robust business cycle does not mean the end of economic fluctuations as "*… high [consumer and business] confidence easily shade into over confidence, which breeds misdirected and excessive investment …*" (Zarnowitz, 1999: 72). It would be interesting to see what the domestic credit spending and fixed investment cycle will look like in the coming years.

Three years into the current economic upswing phase, the current account of the balance of payments is in a surplus. This is unheard of in SA's post WWII economic history. As discussed above, this is partly the result of less than robust domestic demand conditions, import compression via the weak exchange rate and - more importantly - SA's improved export performance. <u>This points to the lifting of one of the most binding constraints on domestic economic growth the past couple of decades</u>. What SA's balance of payments history of the 1990s have demonstrated clearly, is the country's vulnerability to sharp swings in capital flows. Unfortunately SA cannot as yet bank on a stable inflow of foreign capital and currency risk dictate against too substantial recourse to long-term foreign finance. However, SA's improved trade performance should ease the pressure on the exchange rate and interest rates as the domestic business cycle matures. *This, in turn, should allow for a more sustained economic growth cycle*.

5.1 Current business cycle prospects

The SA business cycle is currently in an upswing phase, *but how strong will the growth be, what will end the upswing and how soon?* While one cannot profess to have the answer to this question, suffice to suggest that the following structural factors could induce a more sustained growth cycle over the short to medium term.

- *Firstly,* the current account of the balance of payments being in a surplus almost three years into the recovery phase of the business cycle.
- *Secondly,* the opening up of the economy to international competition has changed the inflation dynamic in SA. While excess demand in the economy is likely to lead to higher inflation, the cyclical increase could be limited by productivity growth and the relentless pressure on profit margins instilled by competitive forces. On the other hand continued currency volatility could damage business cycle prospects.
- *Thirdly,* fiscal policy is stable and moderately supportive of growth and unlikely to be the cause of business cycle instability given current government economic policies. There could indeed be scope to implement more stimulatory fiscal policy, however, staying well short from being populist and potentially destabilizing.

All three these factors will reduce the need to tighten monetary policy towards the mature phases of the business cycle, which implies more stable economic growth. We know that all business cycles in the past have come to an end; the freshest in our memory is the awesome growth cycle experienced in the US economy over the second half of the 1990s. Domestically the current upswing phase of the business cycle could last beyond 2003; growth is likely to be steady rather than spectacular, but has the potential to move to a higher plane. The key factor likely to determine the strength of this growth will be the measure of formal sector job growth. *Will we see a cycle of corporate "upsizing"?*

6. ECONOMIC POLICY CONSIDERATIONS

The government's current economic policies, i.e. the Growth, Employment and Redistribution (GEAR) strategy had one of its central aims as the achievement of macro-economic stability in SA. In this regard GEAR was a success as reflected in the decline in inflation levels (bar the recent currency-induced shock), the healthy financial state of the fiscus and SA's increasing capacity to withstand the onslaught of both internal and external shocks. However, it has to be conceded that the strategy has thus far not succeeded in terms of its lofty growth and employment promises. This does not mean the strategy is fundamentally flawed. It is true, however, that the emphasis currently needs to increasingly shift to achieving higher growth and - more importantly - to improve the labour absorption capacity of the economy.

The following tentative conclusions/ policy suggestions can be drawn from the current paper:

- The adverse impact from external financial shocks needs to be countered; this possibly suggests a slower approach to liberalizing the capital account of the balance of payments and/or intervention in the currency market. Furthermore, in order to reduce SA’s vulnerability to financial contagion recourse to foreign finance need to be restricted.
- Trade liberalization has induced increased international competitiveness, productivity levels in manufacturing and export success is buoying business confidence, which is gradually bolstering industrial fixed investment plans. It is, however, crucial that the structural improvements in the export sectors lead to improved formal sector job creation. We have tentative evidence that the sharp rate of retrenchments in the industrial sector of the economy over the second half of the 1990s is bottoming out and employment conditions are more stable in the successful exporting sub-sectors. It is important that this improvement in the economy be sustained; otherwise the multiplier effects of the growth in the export sector will not materialize to the desired extent. Trade policies therefore need to be sensitive to any adverse employment effects. The export propensity of a number of employment intensive manufacturing sub-sectors is relatively low (e.g. food, beverages, clothing and textiles), suggesting export potential and the export drive in these sectors is picking up. It is possible that increased exports in these sectors lead to a further wave of formal sector job losses, which could become problematic from a macro perspective, particularly should we not experience the fruits of the “first phase” of the broader industrial restructuring process in SA.

Beyond the industrial sector, it may be necessary to consider policy options which can augment the job creation process, e.g. public sector work programmes.

7. CONCLUDING REMARKS

The domestic economic resilience and the surge in business confidence during 2001 and the first half of 2002 at the time of a synchronized world economic slowdown and major uncertainty on global financial markets hints at fundamental change in the domestic business cycle. This paper sought to uncover some of these chances by studying the business cycles over the 1990s, particularly since SA’s reintegration with the world economy and the country's seminal political change. *The following concluding remarks are in order:*

- Somewhat surprisingly the 1989-96 (peak-to-peak) business cycle corresponds closely to those of the 1980s, both in terms of its main characteristics and content. The rapid external transmission to domestic economic fluctuations is an overriding characteristic borne out by the close correlation between the domestic business cycle and the G7 countries industrial production cycle over this period.
- The 1997-99 economic downswing phase of the business cycle presents the first evidence of meaningful structural change, being the first growth (as opposed to level) recession experienced since the second half of the 1970s. A key feature is the resilience in real economic growth in the face of major financial volatility sparked by the East-Asian economic crisis.
- Likewise, the current economic upswing phase of the business cycle commencing in 1999 affirm meaningful change. Whereas the 1993-96 economic upturn and improvement in business confidence levels were very much of a mere cyclical nature (and argued in this paper surprisingly similar to the economic upturns during the 1980s), the current upturn carries the seeds of a more fundamental lift in business confidence levels signified by the BER business confidence index surpassing its 1996 peak despite major uncertainty on the world economic scene.
- This seems to be paradoxical in that the domestic demand components of GDP are actually trending at weaker levels compared to previous cyclical upturns. Furthermore, SA's business cycles are mainly household consumption driven, both in recession and recovery phases.
- The economic policies introduced during the 1990s were always going to exact a price over the interim. This paper, however, finds clear evidence of economic resilience in the 1997-99 economic downturn as well as in the economic upturn commencing in 1999 and compared to the business cycles of the previous two-and-a-half decades. Low inflation, low budget deficits, openness to trade and compensating exports allow SA to absorb external shocks.
- Unfortunately the financial volatility SA attracted upped the economic price we have to endure to correct structural imbalances in the economy. This paper provides some evidence of the adverse real economic effects tied to the financial volatility of the 1990s in that either economic upturns were delayed and/or downturns exacerbated. SA policymakers need to introduce policies which will safeguard the country in this regard. A more prudent approach to the phasing out of exchange control, intervention in the currency market and limited recourse to foreign finance are but some policy suggestions.
- The increased domestic economic resilience reflects a stronger endogenous growth momentum in the SA economy being less dependent on the global economic cycle. This resilience come on the back of improved productivity and profitability levels in the corporate sector, buoyed by steady cumulative growth in real after-tax personal incomes, moderately stimulatory fiscal policy and more competitive exports. Borrowing from Victor Zarnowitz, SA may currently be experiencing the maturation of the first phase of an "allocative shock" business cycle, i.e. the cost-cutting/ downsizing/ rationalization drive of the 1990s is bearing fruit and is likely to be followed by a cycle of growth and "upsizing".

As the export sector has been central in this process it is imperative that jobs be created in this sector and its linked sectors. Beyond the export sector, policy options need to be considered which will augment job growth in the domestic economy (e.g. public works programmes). While we have evidence of a bottoming-out in the high rate of retrenchments in the formal sector of the economy during the second half of the 1990s it remains a question whether the export sector will deliver the required job creation, which can generate the multiplier effects to bolster the business cycle and economic growth. From the demand side of the economy, personal tax cuts, lower inflation and more stable interest rates can go only so far in stimulating consumer spending; the critical missing variable remains formal sector job growth. On the supply side improved profitability can only go so far in boosting business confidence – the more important factor is the relative buoyancy in demand conditions, which can boost fixed investment intentions. Current business cycle prospects are promising and it is possible that the SA economy has embarked on a higher growth path, but this will crucially depend on the future job growth performance.