MEDIUM TERM BUDGET POLICY STATEMENT 97 - MACROECONOMIC POLICY & PROSPECTS

Macroeconomic policy framework

Government has adopted a macroeconomic policy framework which will deliver job creation, better export performance, more investment, greater efficiency and equity of government spending and enhanced human resource development.

Challenges

This is a policy framework that takes into account the structural challenges the economy must confront:

- Economic expansion in South Africa tends to lead to a rapid growth of imports, putting the balance of payments under pressure and constraining the prospects for sustained growth.
- Investment and savings levels, which have been uncharacteristically low in recent years, will need to be substantially increased if strong growth is to be sustained.
- Unemployment remains a major economic weakness, contributing both to the high degree of income inequality and social fragmentation that characterise South Africa. Not enough jobs are being created as the economy grows.

The macroeconomic dimensions of Government's response to these challenges were outlined in the *Growth, Employment and Redistribution* framework published in June 1996.

Real output and expenditure trends

Gross domestic product

The economy is currently in its fifth year of economic expansion. For 1997, total real national income was 2,2 per cent higher in the first half of the year than in the corresponding period of 1996. Average growth of around 2 per cent is expected in 1997/98. This is somewhat less than anticipated at the time of the last Budget, reflecting both lower levels of agricultural output and slower growth in gross domestic expenditure. However, manufacturing output has been boosted by strong export demand, in part prompted by the sharp real depreciation of the rand during 1996.

Consumption

Sluggish growth in private consumption has been the primary reason for the slowdown in domestic expenditure in 1997. Household spending has been constrained by high levels of private indebtedness and relatively high interest rates. Having risen by an average of 3,9 per cent annually between 1993 and 1996, private consumption grew by 2,2 per cent in the first half of 1997 compared to the first half of the previous year.

Investment

The growth in gross domestic fixed investment slowed to 2,6 per cent in the first half of 1997, after expanding by 8,6 per cent a year over the previous three years. This is in part because several large projects have reached completion. Government aims to promote a marked improvement in the investment trend over the next three years.

Inventory levels appear to have been reduced in 1997 in response to the slowdown in domestic expenditure.

Prospects for growth

The continuation of the policies outlined in Government's macroeconomic strategy will lay the foundations for stronger economic growth. However, domestic economic growth has slowed in 1997, and emerging markets worldwide have experienced increased financial uncertainty.

Structural transformation of the economy takes time to impact favourably on growth and development. Recognising the uncertainty in future economic trends, the budgetary projections for 1998/99 to 2000/01 incorporate more cautious economic assumptions than the integrated scenario set out in the 1996 *Growth, Employment and Redistribution* framework.

Over the next three years, GDP is expected to accelerate as a result of further export growth, a recovery of domestic demand and continued investment in productive capacity. Real GDP is projected to grow by about 3 per cent in 1998/99, 4 per cent in 1999/00 and 5 per cent in 2000/01.

Inflation and monetary policy

Objectives

The main objectives of monetary policy continue to be the maintenance of financial stability and the reduction in the rate of inflation. Monetary policy contributes to attracting foreign investment, preventing the outflow of domestic savings and reducing price distortions within the economy.

Inflation trend

Inflation has exhibited a declining trend since 1993, fluctuating between 5 and 10 per cent, well below the average for the previous two decades. Although inflation increased to over 9 per cent for the first eight months of 1997, this was a comparatively muted response to the exchange rate depreciation in 1996, indicating that inflationary pressures within the economy remain firmly on a downward trend.

Consumer price increases averaged 9,3 per cent for the first eight months of 1997, after recording an average 7,4 per cent increase in 1996. The year-on-year inflation for October was 7,5 per cent, confirming a declining trend that is expected to continue into 1998.

Money supply

Having declined significantly in the early 1990s, the growth of broad money (M3) increased rapidly after 1993 and has averaged over 14 per cent for the last three years, primarily as a result of private credit growth. This has contributed to the need for a cautious monetary stance.

For the first eight months of 1997, M3 growth averaged 15,1 per cent in comparison to 13,6 per cent for 1996. M3 growth for 1997 will exceed the previous year's level, as a result of the continued growth in domestic credit and substantial net capital inflows, which have increased foreign reserves. In the second half of the year a declining trend has been evident.

The slowdown in M3 and private sector credit growth enabled the Reserve Bank to announce a reduction in the bank rate from 17 per cent to 16 per cent on 17 October 1997.

Prospects

For the next three years, real wage increases in line with productivity growth, a stable real exchange rate and the fiscal policy stance should contribute to a further moderation of inflation and associated downward adjustments in interest rates. A GDP inflation rate of 7½ per cent is envisaged for 1998/99, declining to 6½ per cent in 1999/00 and 6 per cent in 2000/01.

Balance of payments and the exchange rate

Current account

Faster growth of demand than supply over the past two years has resulted in persistent deficits on the current account of the balance of payments. For the first half of 1997, the current account deficit was 0,9 per cent of GDP. For the year as a whole, the deficit is expected to be 1 per cent of GDP or approximately R6 billion. The lower deficit for 1997 is the result of accelerated export growth as envisaged in the macroeconomic strategy, and lower import demand as a result of slower domestic expenditure growth.

Tariff reform

Further improvements in the current account depend in part on the elimination of the bias against exports that tariff protection has imposed upon the economy. The macroeconomic strategy suggests that the average customs duty expressed as a share of total imports should be reduced from 10 per cent to 6 per cent by 2000. The envisaged acceleration of the tariff adjustments to which South Africa is committed in terms of World Trade Organisation agreements will encourage additional investment and job creation in competitive sectors of the economy. Tariff liberalisation is a complex process, however, involving large numbers of individual tariff lines and many stakeholders, including South Africa's regional SADC partners. Trade reform is being pursued through both ongoing domestic consultation and international negotiations.

Exchange rate

Government recognises that stability in the real exchange rate is an important foundation for sustained development of export industries. The real effective exchange rate depreciated by an average of 8,2 per cent in 1996, after a 0,2 per cent appreciation in 1995. Government accepts that the depreciation in 1996 represented a necessary improvement in the competitiveness of the currency. The 1996 depreciation was partly reversed during the first four months of 1997, in a context of substantial capital inflows. The exchange value of the rand is expected to continue to depreciate in line with South Africa's somewhat higher inflation rate than that of our major trading partners.

Capital account

From the third quarter of 1994 to the first quarter of 1997, capital inflows of some R35 billion flowed into South Africa, while the cumulative current account deficit over this period amounted to R22,9 billion. Net capital inflows were particularly strong in the first half of 1997. The substantial inflow has raised the country's foreign reserves well beyond past records. At the end of September, foreign exchange reserves were more than double their level at the time of the 1994 elections.

Exchange controls

Exchange controls discourage foreign investment and undermine domestic investor confidence. Government is therefore committed to the gradual removal of exchange controls. These have been relaxed in several steps, aiming towards the complete abolition of restrictions on foreign exchange transactions.

Adjustments to the exchange control regime in 1996 included an enhancement of the access of foreign investors to domestic credit, an increase in the limit to which institutional investors are subject in acquiring foreign assets and adjustments to various quantitative restrictions.
Exchange control relaxation in 1997 has included provisions allowing limited transfers of capital abroad by individuals and measures aimed at encouraging corporate investments in the SADC region.

Implementation of exchange control reforms has proceeded smoothly, with no adverse consequences for exchange rate management.

Prospects for the balance of payments

During the next three years, current account payments should continue to exceed receipts by between 1 and 2 per cent of GDP. Strong expenditure growth and higher investment levels will lead to rising imports, but it is expected that domestic capacity expansion and export growth will keep the current account deficit within moderate bounds.

Large and unpredictable capital movements are a feature of the global economy. It is anticipated that net capital inflows will match or exceed the current account deficit over the 1998-2000 period, including increased levels of direct foreign investment. Fiscal policy is sound, real interest rates are attractive and the projected growth creates profitable opportunities for foreign investors. Government's overall macroeconomic framework continues to contribute to confidence in the rand and the South African economy.

Investment and savings

Gross domestic fixed investment

Gross domestic fixed investment reached 16,8 per cent of GDP in the first half of 1997. Investment has averaged under 17 per cent of GDP since 1995, after falling to just 15,5 and 16 per cent of GDP in 1993 and 1994. As anticipated in the macroeconomic strategy, foreign capital inflows continue to be an important factor in securing an adequate level of domestic investment.

Public sector investment

The national accounts indicate that gross domestic fixed investment by public authorities in the second quarter of 1997 had increased by 4½ per cent in real terms over the same period in 1996, and by 8½ per cent over the 1995 level.

As Government delivers its RDP objectives, several areas of public investment spending are gaining momentum. The housing programme has accelerated and significant investments are being made in community water supply projects, electrification and telecommunications infrastructure. Progress has also been made in identifying public-private partnership arrangements in water supply, municipal infrastructure and prison construction, in effect transferring demand for capital from the fiscus to the private sector.

Substantial backlogs in education and hospital infrastructure will remain areas of priority spending for years to come. Government investment spending will focus on redressing social and economic backlogs, particularly in townships and rural areas.

Savings

Gross national savings have declined from 17 per cent of GDP in 1995 to 16 per cent in 1996 and to 15,5 per cent in the first half of 1997. Dissaving by general government amounted to 3,7 per cent of GDP in 1996, highlighting the importance of fiscal deficit reduction in the overall macroeconomic strategy.

Government's macroeconomic policy aims to achieve a substantial increase in the level of domestic savings available to finance investment, a sustained increase in public sector investment spending and continued growth in direct foreign investment.

Encouraging growth and employment

Employment trends

Rising levels of output since 1993 have not resulted in equivalent increases in total employment in the formal sector. Formal sector employment statistics have shown a disappointing trend, with job losses continuing in many sectors. The recorded employment series do not fully reflect labour market developments, but it is clear that job creation is not keeping pace with the growth of the labour force.

Elements of a growth strategy

Increasing the rate of job creation requires a structural reorientation across several fronts of the South African economy. Government has initiated a number of spatial investment projects, aimed at building a dynamic interface between infrastructure investment and industrial expansion. Tourism promotion generates jobs across a broad spectrum of services. A range of export support programmes are in place, and industrial investment is encouraged through tax incentives and several supply-side schemes. Land and agriculture policies are aimed at achieving social stability as well as strengthening income-generating ventures. Education and skills development programmes are designed to put longer term employment and productivity enhancement on a sound footing.

Government's direct efforts to reduce unemployment include increased public investment and support for labour-based development schemes, enhancement of employment services and policies focused on the first time entry job market.

Economic outlook

GDP growth

Economic growth is expected to strengthen over the next three years, building on the structural transformation of the economy that is in progress.

Demand

Steady increases in private consumption expenditure and significantly stronger investment will underpin the expansion in domestic demand. Private consumption should grow by 3 to 4 per cent a year and gross domestic fixed investment by 5 to 9 per cent a year.

Balance of payments

The positive export trend of 1997 is projected to continue over the next three years, reinforced by robust world economic output trends and the response of domestic industry to improved competitiveness and export opportunities. Increased domestic demand is expected to lead to continued growth in real merchandise imports.

Sufficient capital inflows are anticipated to accommodate the envisaged deficit on the current account of the balance of payments of up to 2 per cent of GDP. The nominal average effective exchange rate is expected to depreciate by around 4 per cent per year.

Financial stability

Growth in consumption expenditure is expected to be an important source of overall growth in demand, but this should allow for a modest improvement in domestic savings. The realisation of a healthy net capital inflow, including both direct investment and portfolio flows, is an important pre-requisite of the projected improvement in economic performance. Capital inflows not only raise the level of investment, but are also needed to provide liquidity to money and capital markets and ease upward pressure on market interest rates. The continued maintenance of sound fiscal policies is also important in sustaining a stable financial environment and improved economic prospects.

Macroeconomic projections: 1998/99 to 2000/01

Key macroeconomic projections for 1998/99 to 2000/01 are set out below.

GDP growth and inflation

Real GDP growth is expected to improve from about 2 per cent in 1997/98 to reach 3 percent, 4 per cent and 5 per cent over the 1998/99 to 2000/01 period. GDP inflation is projected to fall to 6 per cent in 2000/01 from about 9 per cent in 1997/98.
There projections will be revised in the light of current economic performance and additional information before finalising the 1998/99 to 2000/01 medium term expenditure framework.

Table 3.1 Macroeconomic projections 1998/99 to 2000/01

Year-on-year growth	1998/99	1999/00	2000/01
Real GDP growth	3,0 %	4,0 %	5,0 %
Real private consumption growth	3,0 %	3,6 %	3,7 %
Real gross domestic fixed investment growth	5,0 %	7,0 %	9,0 %
GDP inflation	7,5 %	6,5 %	6,0 %