The 1974-1981 business cycle

The 1970s will, amongst other, be remembered for its oil price shocks. There were two shocks, the first at the end of 1973, with the US oil embargo (when the US dollar price of crude oil jumped by 175%) and then during the course of 1979 (when successive increases saw the price another 165% higher by the middle of 1980). Both these shocks induced recessions in the major industrial countries – the USA witnessed an economic downturn between November 1973 and March 1975 and again a short-lived one between January and July 1980. G7-countries' real GDP was down more than 2% between late-1973 and early-1975; and again down 1.5% during the first three quarters of 1980.

These oil price shocks effectively brought the era of sustained high economic growth, i.e. the so-called 'golden era' during the post-war period, to an end. The 1974-75 global recession is being described as particularly severe, also introducing a structural break in the trend growth rates of the major industrial countries. While the recession was triggered by the first oil price shock, the reality was that earlier changes (between 1968 and 1971) left the industrial countries in a vulnerable position. When the first oil embargo arrived at the end of 1973, the impact was substantial. The earlier changes refer to the creation of a free gold market and the end of the Bretton-Woods era of fixed exchange rates, which introduced substantial strains in the pricing and production processes of the major industrial countries during the course of 1974 (Smit & Van der Walt, 1981: 43).

It is generally agreed that the onset of recessions in most countries during the mid-1970s also announced the onset of a downward phase of a so-called Kondratief 'long wave' of economic activity. Trend growth moved appreciably lower after 1975 from that over the 1961-75 period when it averaged 4.8% per annum; the average real GDP growth rate over the post-war period, i.e. 1946-75, amounted to 4.6% per annum (Smit & Van der Walt, 1982: 45).

These global developments were of great significance to SA. The country was impacted directly by the higher crude oil price (and a substantial deterioration of the non-gold terms of trade throughout the 1970s), as well as being impacted indirectly due to SA's close trading links with the major industrial countries. Real exports dropped sharply by 18% from the end of 1972 to early 1975, which mirrored the close to 15% contraction in mining real value added over the period 1973Q1 to 1975Q3. The non-gold terms of trade also deteriorated by 15% between the end of 1973 and the end of 1975. The downturn phase of the business cycle was also lengthened by the adverse impact of the 1976 Soweto uprisings as resistance to the apartheid political system gathered momentum amongst the non-white population groups.

Economic downturn: September 1974 to December 1977

An interesting feature of the 1974-77 economic downturn was that overall real economic growth only weakened moderately during the initial period (74Q3 to 75Q4). The early adverse external impact was countered by buoyant real domestic expenditure, which expanded strongly during 1973-74 (with year-on-year growth averaging in double digits). While the prime overdraft interest rate increased over this period, it remained in negative territory throughout 1974-75; the nominal increase mainly compensated for the oil-induced (and demand-pull) rise in inflation.

Fiscal policy also remained strongly expansionary throughout the recession period, both consumption expenditure (driven, amongst other, by defence spending) and capital expenditure. The expansionary nature of fiscal policy lasted well beyond the recession as this period witnessed major public sector investment projects (e.g. the development of the Richards Bay and Saldanha Bay harbours, the expansion of Escom's electricity supply capacity, the start of the second and third phases of the Sasol coal-to-fuel plants, the building of the Sishen-Saldanha and Richards Bay railway lines, the containerisation programme of the transport sector and various water infrastructure developments by the Department of Water Affairs (see Smit & Van der Walt, 1981: 48).

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Therefore, while SA's main trading partner economies experienced a deep recession in 1974/early-1975, SA continued to experience rapid growth; the recession impact arrived later. Firstly, the external impact worked with the usual time lag through to the domestic economy and, secondly, it took external and internal political shocks to stop the buoyant domestic market in its tracks. August 1974 was regarded as the peak of the cycle, however, the big adjustment only arrived in 1976-77. Real GDP growth receded sharply from above 6% in 1974 to 2.3% in 1976 and -0.1% in 1977 (real GDE contracted by more than 5% during 1976-77).

Domestic political developments, namely the independence of SA's neighbouring countries (1975) and the 1976 Soweto political uprising, impacted general business confidence and the economy. Fixed investment and inventory investment declined sharply (Figure 1 and Figure 2)[1]. The former contracted by 17% between the end of 1975 and the end of 1977, while the lagged adjustment in cumulative inventory investment amounted close to 50% over the three year period, end-1975 to end-1978. The contraction in fixed and inventory investment was accompanied by a 47 index point drop in the RMB/BER business confidence index.

Figure 1: Gross domestic fixed investment

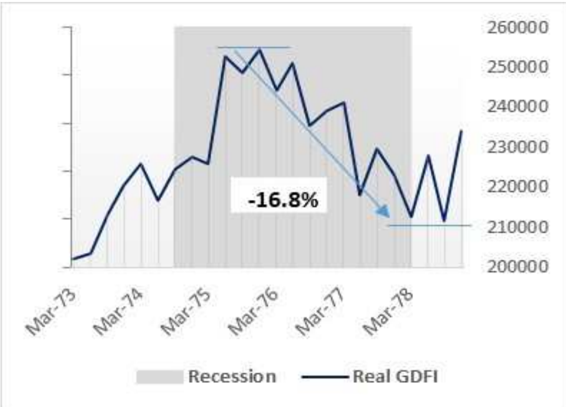
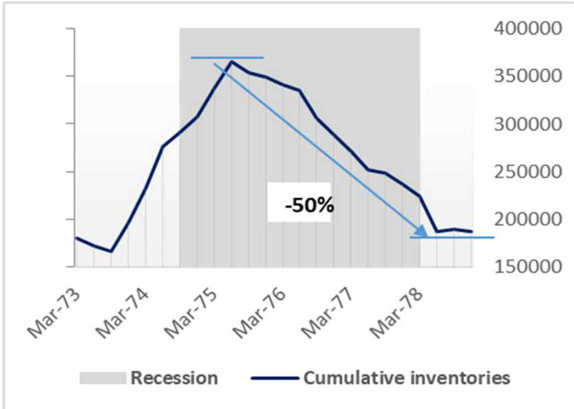


Figure 2: Cumulative inventory investment



Source: SA Reserve Bank

Whereas the prime overdraft interest rate drifted 4.5 percentage points higher between the end of 1973 and during the course of 1974, this was not sufficient to compensate for the oil-induced (and demand-pull) increase in inflation over this period – real prime rates were significantly negative over the 1973-75 period. Real consumer spending did contract eventually (by close to 4% over the 18-month period, end-1975 to middle-1977); however, the main driver of the economic downturn was the contraction in fixed and inventory investment, which also saw a precipitous drop in real imports (37%, peak-to-trough).

This, in turn, drove an improvement on the current account of the balance of payments, with a surplus registered during 1977 at the trough of the business cycle. The subsequent increase in the gold price (from around $200 in 1979 to above $600 in 1980) drove the current account surplus further, reaching 14% of GDP by the first quarter of 1980. Hereafter, the current account deteriorated sharply again as fixed and inventory investment recovered (1980-81), imports surged and the gold price and terms of trade collapsed – by the end of the economic expansion (1978-81) the current account deficit measured above 8% of GDP. Exports (and the mining sector) were also hit by the second oil price shock (1979) sending the major industrial countries into recession (early 1980s).

Therefore, the economic downturn traversed two phases – during the initial phase (1974Q3 to end-1975) growth slowed down notably and during the second phase (1976-77), a full-blown recession unfolded. The economic downturn lasted 40 months, exceeding the post-war average of 14 months (Smit & Van der Walt,

[1] Angola and Mozambique received their political independence from Portugal in 1975. The apartheid state regarded these developments as a major threat and the Angolan war on the Namibian border ensued. The defense spending associated with this war and the spending tied to domestic security concerns became a key source of relentless growth in government consumption spending and a drain on SA's fiscal resources.

1981: 54). The lengthened economic downturn hinted towards a structural break in the post-war economic growth trend; this is indeed what transpired. An important reason for the prolonged recession was the balance of payments constraint induced by the oil price increases and the global economic recession, as well as the adverse political developments, which impacted inward capital flows (see Smit & Van der Walt, 1982: 54).

Economic expansion: January 1978 to August 1981

The late-1970s upswing began as the world emerged from the recession induced by the oil price shocks of 1973-74. As noted, South Africa experienced a recession from August 1974 to November 1977. The domestic economic recovery from the recession was led by the upturn in the wider world economy and it lasted 44 months, i.e. slightly shorter than the average of four calendar years (considering SA's business cycles between the mid-1970s to date). The expansion reached an inflection point mid-1979. Before that point, i.e. the first 18 months of the recovery, growth was weak; it accelerated notably afterwards (second half of 1979 to end-1981).

Apart from the general revival (more forcefully from the middle of 1979), the sharp deterioration on the current account of the balance of payments over the 1980-81 period is best explained by the combination of a drop in the gold price and SA's terms of trade, the impact of the early-1980s global recession and a sharp deterioration in SA's international competitiveness. The latter was caused by the flat nominal (and overvalued) exchange rate over this period and the sharp increase in inflation (peaking over 15% in 1980-81). As noted, the demand for imports also ratcheted upwards from early 1979 as both fixed and inventory investment recovered strongly.

To put the 1978-81 expansion in perspective, it was the first recovery in what was identified as a period of structurally weaker growth from the mid-1970s. This meant that at the peak of the expansion, i.e. August 1981, the level of activity still remained below that at the previous peak of the business cycle (i.e. August 1974). This was very different to the pattern during the post-WWII period of structurally strong growth, 1961-75.

Figure 3: Real domestic expenditure

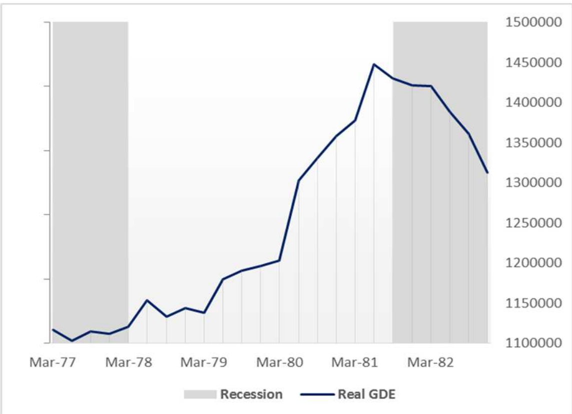
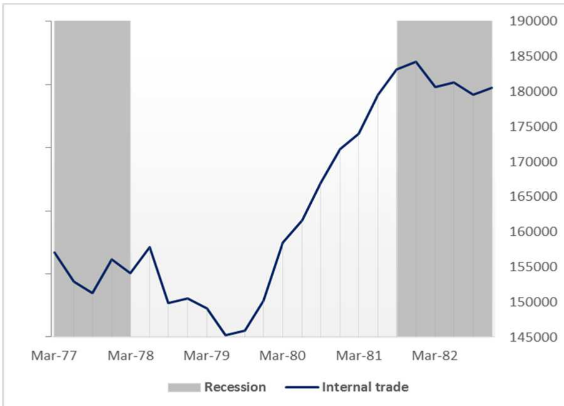


Figure 4: Retail, wholesale & accommodation real GDP



Source: SA Reserve Bank

Firstly, gold output expanded strongly as the gold price was boosted by the increase in oil prices; the higher gold price (and that of substitutes for oil, i.e. uranium and coal) countered the adverse terms of trade impact tied to the higher oil price; the government pushed infrastructure spending – in fact, earlier projects began bearing fruit by boosting SA's export capacity, for instance; import replacement policies also stimulated the manufacturing sector. Manufacturing real value added expanded by close to 40% from trough-to-peak, i.e. much stronger compared to the corresponding expansion of real GDP (22%).

The 1978-81 economic expansion can be divided into three phases, i.e. two phases (one at the beginning of the upswing, January 1978 to mid-1979; and one at the end of the upswing, i.e. 1980Q4 to August 1981) when growth was moderate and equal to the long-term trend growth rate; and a third being the period in between, i.e. from mid-1979 to the third quarter of 1980, when growth accelerated above trend. The acceleration in the growth of real domestic expenditure was quite dramatic, increasing from 3.2% per annum over the period 1978 to mid-1979 to double-digit levels subsequently up the to the third quarter of 1980.