BUSINESS CYCLE ANALYTICS

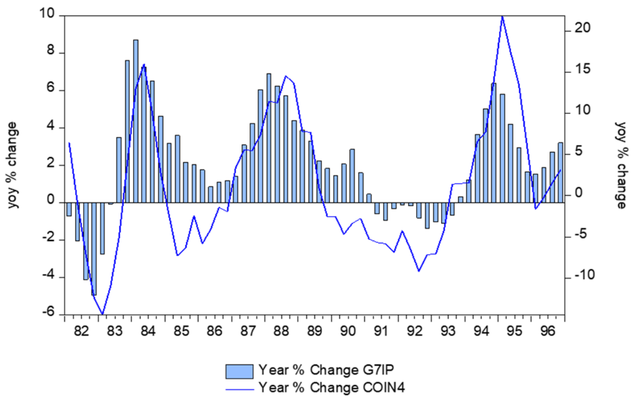
BUSINESS CYCLES

The 1989-1996 business cycle

The accompanying chart reveals the close correlation between the annual change in the SA Reserve Bank's composite coincident indicator (the blue line) and the G7-countries' industrial production cycle over the 1980s and early 1990s. For all intents and purposes, the SARB's composite coincident indicator can be regarded as the reference business cycle for the SA economy. Its correlation with the G7-countries' industrial production cycle over this period of tumultuous exogenous influences (socio-political unrest, the imposition of trade and financial sanctions, SA's political transition, etc.) is remarkable. Amongst other, this close correlation hints to a strong underlying continuity in SA's business cycle, which was not derailed by the dramatic exogenous influences on the economy over this period. The 1989-96 peak-to-peak business cycle spans the run-up to SA's first full democratic elections (April 1994) and the economic upswing (1993-96) which transpired thereafter.

On the one hand, the tumultuous political changeover seems to have dictated a prolonged economic downturn over the period 1989 to 1993, followed by a post-election economic expansion. On the other hand, the continuity between the business cycles of the 1980s and the 1989-96 business cycle is striking, giving credence to the view that ordinary endogenous business cycle forces were at work, and thereby explaining the cycle. In reality, the truth is that both forces were at play. This experience only underwrites the fact that one should be careful to underestimate the *'unceasing round of the business cycle'* (with apologies to Burns & Mitchell).

Figure 1: SARB composite coincident indicator vs G7-countries' industrial production cycle



Economic downturn: March 1989 to May 1993

The 1989-93 SA economic recession was sparked by the early 1990s world-wide economic recession, in turn, characterised by Japan's blowout and the recessionary impact of German unification. Apart from the contracting export sector, the domestic market was hit by a prolonged drought in agriculture as well as wide-spread socio-political unrest in the run-up to SA's first full democratic elections.

In many respects, the 1989-93 economic downturn resembled that of the 1980s. The onset of a somewhat protracted – and unsynchronised – 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. Real exports contracted by 11.2% from peak to trough. While the contraction in exports was sharp, it bottomed early in the economic downswing (early-1991) as US and other economies recovered. The recovery in world economic growth was unsynchronised due to the impact of German unification and the malaise of the Japanese economy.

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

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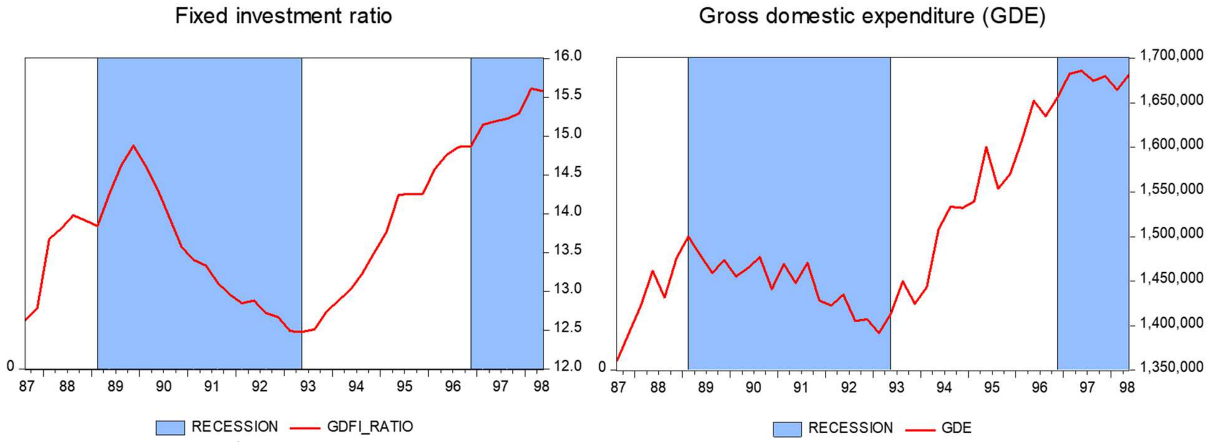
household consumption expenditure contracted by 3.4% and real gross domestic fixed investment by 19.1%, resulting in an overall contraction of no less than 7.2% in real gross domestic spending.

Therefore, both the export and domestic markets were under pressure. The economic recession became more protracted due to the lengthy world economic recession (as the business cycles of the G3 economies were unsynchronised) and was also deepened by a serious agricultural drought and the socio-political upheaval in the run-up to SA’s first full democratic elections (April 1994).

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 (5.1%) was nonetheless not as sharp as during 1981-83 (5.3%) and 1984-86 (3.2%). What made the recession bad though was that it came at the end of a period of poor secular growth coupled with major political uncertainty.



Source: SA Reserve Bank

Economic expansion: June 1993 to December 1996

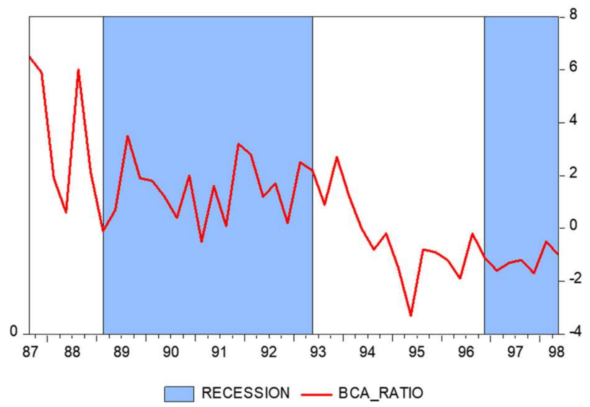
According to the SARB's dating of the domestic business cycle, the SA economy commenced on an upward phase of the business cycle during the second quarter of 1993. The economic upswing phase from 1993 to 1996 was very much in the "old style" (say the 1980's style) of the business cycle, even though the 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, March 1995) 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. This resulted due to financial deepening as many households entered the credit markets for the first time in the post-apartheid era. The monetary growth increased inflation expectations and interest rates were hiked in 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. big steel-related investments such as Alusaf and 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.

CPI inflation

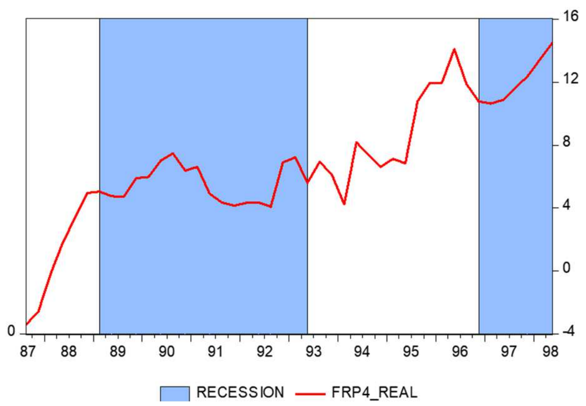
BoP: balance on the current account



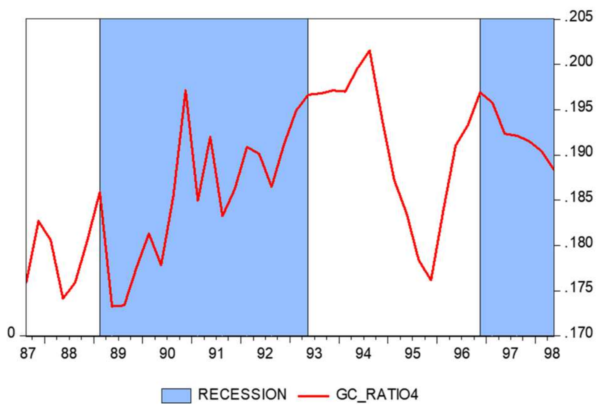
Source: SA Reserve Bank

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).

Monetary policy - real prime rate



Fiscal policy - ratio of government spending



Source: SA Reserve Bank

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. 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 signalled the end of the economic upswing - by 1997 growth slowed, inventory investment was down and real domestic expenditure slowed down.

In all, the domestic 1989-96 business cycle seems – both in terms of its amplitude 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 labelled as structural change; for this we had to be more patient as the 1994-95 current account deficit certainly signalled the beginning of new things to come. Whereas the fixed investment ratio merely recovered to its pre-recession level during the expansion phase of the cycle, this recovery continued even during the subsequent economic downturn (1997-99) and beyond.

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