BUSINESS
CYCLE
ANALYTICS

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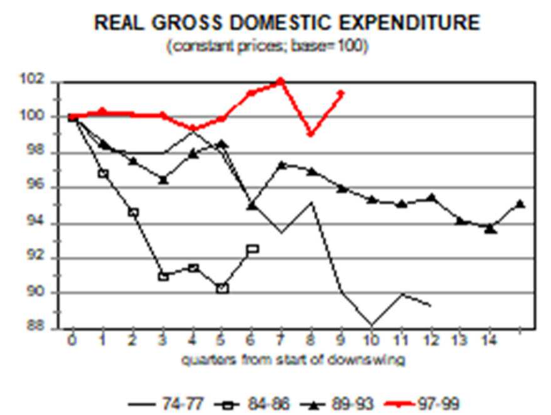
The 1997-2007 business cycle

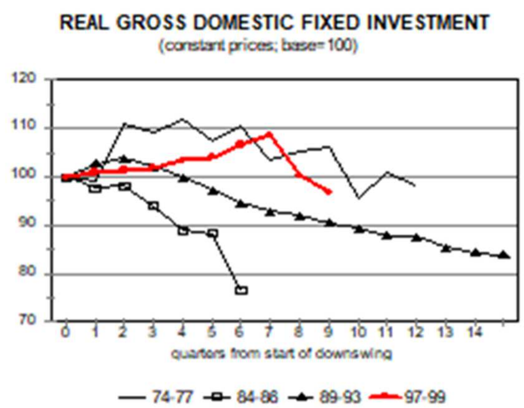
The SA economy underwent key structural changes from the early-1990s. Firstly, an aggressive trade liberalisation policy was implemented to comply with the 1994 GATT. This exposed SA industry to the winds of international competition. Secondly, the seminal political transition created a new economy where previously disadvantaged individuals obtained access to credit, employment and ownership and also opportunities to participate in the broader economic policy-making process. Thirdly, SA's financial integration with the world economy received a strong boost with the scrapping of the financial rand mechanism and the relaxation of exchange controls. Initially, capital inflows were slow; however, this changed in time and SA became a favoured beneficiary of international portfolio capital, including some inward direct investment. These structural changes were slow to permeate the economy and, as noted, the first post-apartheid economic expansion remained closely related to those of the 1980s. However, closer inspection of both the 1997-99 economic downturn and the 1999-2007 economic expansion provides some indication of the underlying structural changes taking hold in the SA economy.

Economic downturn: January 1997 to August 1999

Following the sharp growth in real domestic expenditure in the post-April 1994 election phase, running counter to both inflationary and balance of payments pressures, in turn, inviting restrictive macro-economic policies, 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 imminent 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 (with prime overdraft rates reaching 25 percentage points). According to the SARB *"[t]hese events delayed the recovery in general economic activity and prolonged the downward phase of the business cycle."*



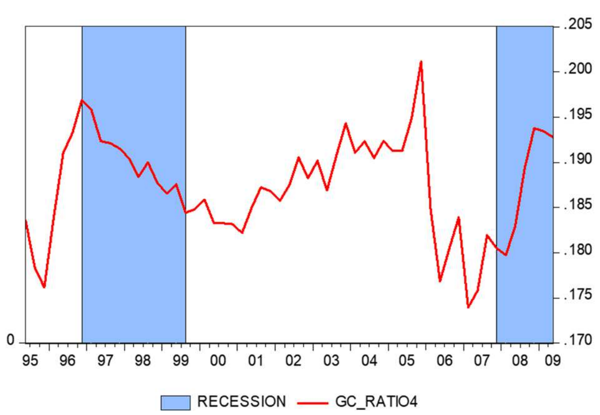


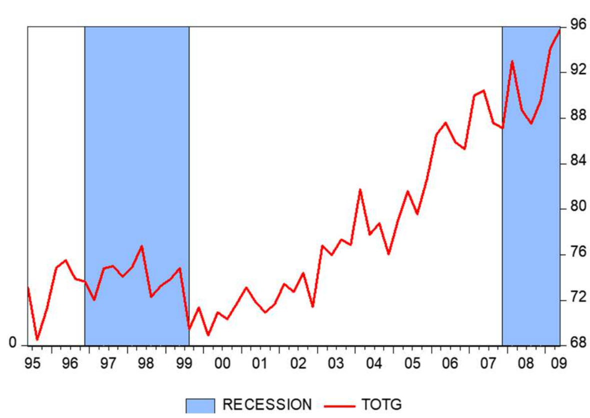
Source: SA Reserve Bank; own calculations

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

Tel: +27(0) 21 851 3285 **Mobile:** +27(0) 83 414 0260 **Email:** p.laubscher@mweb.co.za
Address: 1A Gabbro Place, Boskloof, Somerset West, 7130
Owner & Economist: P Laubscher

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 behaviour of real gross domestic expenditure compared to other economic downturns in the accompanying charts; fixed investment also proved 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 during 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.





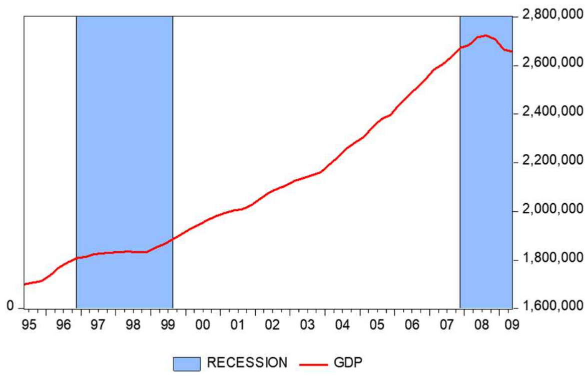
Source: SA Reserve Bank

The economic downturn which commenced towards the closing stages of 1996 and ended in August 1999 was the first post-apartheid economic downturn and was a noticeable period. It was the first growth recession since the 1970s, in other words, a recession during which the aggregate level of real GDP did not contract, it was only the growth rate that tapered off to below its long-term average (see chart below). A key reason why overall real GDP did not contract was because the biggest component of GDP, i.e. household consumption expenditure continued to rise, in turn, driven by a very strong uptake in household credit, which was a structural change in the local economy related to financial deepening. Following the elections in 1994 the new entrants to the local credit markets were not impacted by the higher level of interest rates in 1995-96 and the credit growth momentum was sustained driving consumer spending. The other key factor, was an increase in net exports. Again, due to SA's re-entry to the international economy during the 1990s, particularly manufactured exports to African countries performed very well during the second half of the 1990s – also part of a structural shift tied to the political change in the country. Real exports of goods and non-factor services continued to expand while imports declined, causing net exports to add to GDP growth. The terms of trade boosted growth further (see chart above).

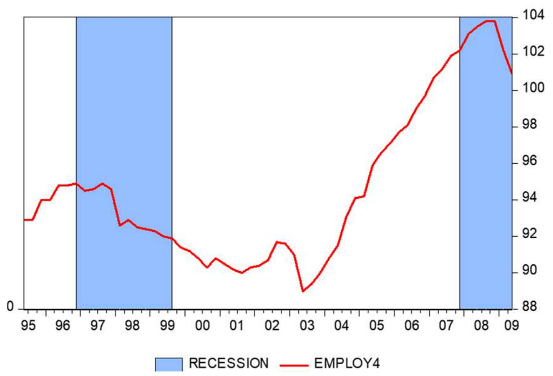
The other remarkable characteristic of the 1997-99 recession is the pro-cyclical fiscal policy at the time associated with the implementation of the GEAR economic strategy from February 1996, i.e. nine months ahead of the onset of the recession (see chart above). Real government consumption expenditure contracted by 3.8% between 1996Q4 and 1998Q4, which was very atypical for any recession experienced since the mid-1970s. The other component of GDP that contracted was gross domestic fixed investment due to a fall in business confidence – by more than 50 index points from the end of 1995 to 1998Q4, i.e. at the apex of the impact of the Russian LTCM bankruptcy in the wake of the East-Asian economic crisis. Poor business confidence levels and weaker domestic demand conditions led to an 11% contraction in real fixed investment spending.

The higher levels of uncertainty and reduced business confidence and fixed investment spending, the contractionary fiscal policy and structural changes in the local labour market combine in explaining a precipitous fall a formal sector employment, measuring 7½% over the course of the recession (end-96 to 99Q3; see chart below). However, the decline in formal sector employment began much earlier; in fact, the contraction amounts to 15% between early-1995 and mid-2003, i.e. two calendar years before the onset of the recession and four calendar years into the 1999-07 economic expansion. This adverse trend in formal (non-agricultural employment) is stark, but partly reflects a huge shift of employment from the formal to the informal sector. According the Quantec Research data on total employment including the informal sector, net employment creation occurred during calendars 1995 to 1997; only in 1998 jobs were shed on a net basis. However, even the total employment trend (i.e. including informal sector employment) shows a negative trend during the first four calendar years of the 1999-07 economic upswing, i.e. 1999 to 2003.

Gross domestic product (GDP)



Non-agricultural sector employment



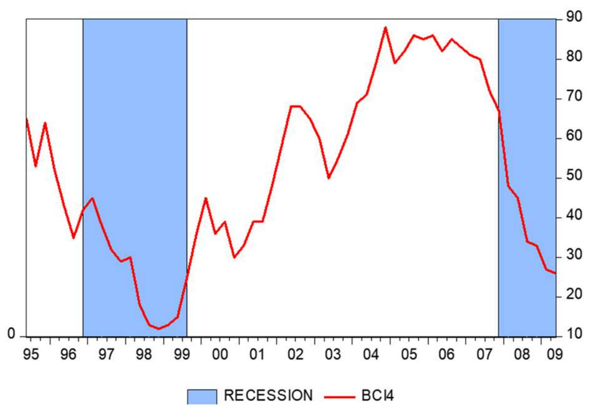
Source: SA Reserve Bank

The fact that employment tended to decline or shift from the formal to the informal sector typically involving some income loss, and real household consumption expenditure continuing to expand during the recession attest to the extent that consumer purchases relied on credit.

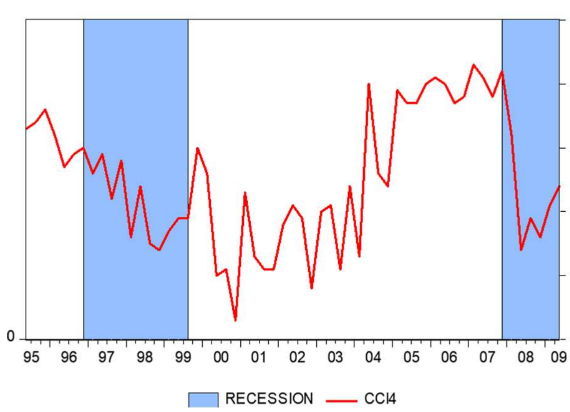
Economic expansion: September 1999 to November 2007

Despite its resilience, the growth in real domestic expenditure was lackluster, even during the initial phase of the ensuing economic expansion from the third quarter 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. It furthermore sensitised consumers and business to developments regarding interest rates. However, the constrained growth in real domestic expenditure was also the result of austere macro-economic policies. A new growth pattern emerged, characterised by a buoyant export sector, benefiting from the weaker rand and higher commodity prices, and contrasted with the constrained growth of the domestic market, being affected by financial volatility and austere economic policies.

RMB/BER business confidence index



Consumer confidence



Source: BER

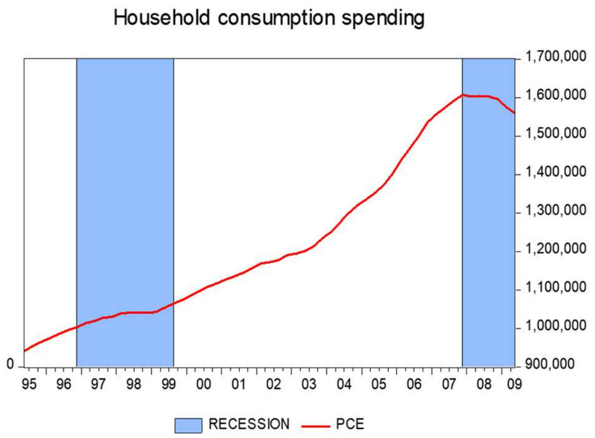
BUSINESS CYCLES

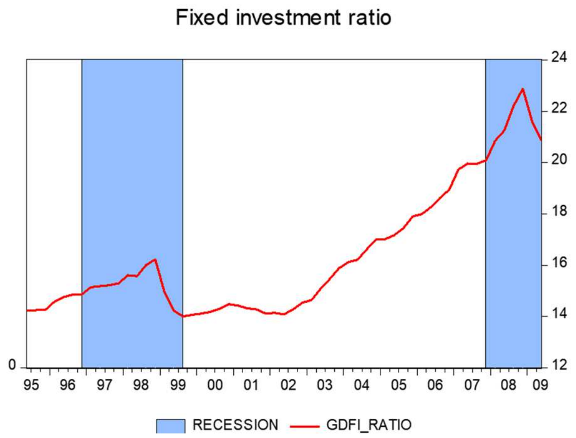
The second post-apartheid economic recovery, which commenced during the third quarter of 1999, developed momentum towards the end of 1999. The upswing was led by the decline in interest rates - by July 1999 prime interest rates were back to the level before the sharp hikes of 1998; and a sharp improvement 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. The initial phase of this economic recovery will be remembered for two developments:

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. In the end the real GDP growth rate for calendar 2000, i.e. 3.5% 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%.

Export growth did slow down in response to the world economic downturn during 2001, however, the eventual real GDP growth rate of 2.8% 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 (e.g. 1981-83 and 1991-93).

The growth in real domestic expenditure was weaker compared to previous business cycle upswing phases 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 signalled structural change – the domestic economy was slowly but surely acquiring its own legs to stand on.





Source: SA Reserve Bank

The steady recovery in real household expenditure is central in the current general economic recovery. Household's credit utilization picked up, however, 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 was under pressure from poor formal sector job growth. Nonetheless, it is evident that household's ability to spend was also 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, 2000-02) consistently exceeded the growth in credit extension to households (around 8% per annum)

Tel: +27(0) 21 851 3285 **Mobile:** +27(0) 83 414 0260 **Email:** p.laubscher@mweb.co.za
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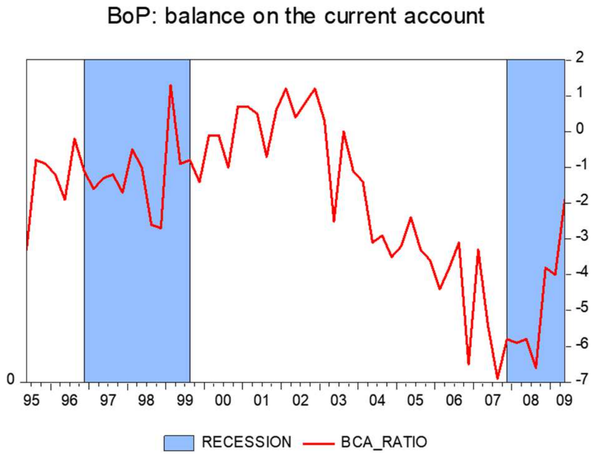
Owner & Economist: P Laubscher

over this period, leading to reduced household indebtedness[1]. This made consumers less vulnerable to the impact of the increase in interest rates during 2002.

The steady recovery in real household income and expenditure since 1999 also formed the basis for the recovery in real fixed investment. The fixed investment revival was supported by public sector capital spending plans (infrastructure fixed investment) and export growth and became the backbone of the economic recovery during calendar 2002. Improved profitability and productivity levels in the corporate sector following years of cost-cutting, downsizing and rationalisation were also boosting business confidence and fixed investment spending; from 2002 it appeared that the corporate sector embarked upon a period of "upsizing", which augured well for the economic upswing phase of the business cycle.

As the accompanying charts shows, both real household expenditure and fixed investment (reflected in the fixed investment ratio) gathered faster momentum from around 2001-02. This 'second' phase of the 1999-2007 expansion was characterised with strong growth, driven by appreciably higher business and consumer confidence, as well as supportive global growth conditions and commodity prices and easier macro-economic policies. Real GDP growth averaged above 5% per annum between 2003 and 2007.

The greater resilience in the domestic economy was 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 upon a more expansionary route. *This probably encapsulates the essence of the structural improvements in the domestic economy*. As it were, the SA economy registered it longest post-war business cycle upswing, measuring 99 months.



The external sector (reflected in the gyrations of the rand exchange rate) lagged this structural improvement. The rebuilding of the country's foreign exchange reserves was a longer-term process. SA benefited mainly from footloose portfolio investment inflows. Until more meaningful long-term capital inflows materialized, the balance of payments vulnerability remained, as well as the possibility of currency volatility. SA's international competitiveness also lagged as was evident in the rapid escalation of the current account deficit in response to the higher growth in the economy – see the accompanying chart, displaying a deficit in excess of 6% of GDP at the peak of the cycle.

In both the monetary policy and fiscal policy fields huge strides were made to stabilize the macro-economic conditions. Even the currency-induced increase in inflation during 2002 could not derail this new-found stability. The ensuing record economic expansion was, however, dramatically terminated by the USA sub-prime financial crisis, which sparked the Great Recession word wide. At home, the country's political leadership also changed.

[1] 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 51% (4th quarter 2002).

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