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TREVOR MANUEL AND THE MARKETS[1]

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Is the glass half full, half empty or both?

(Anon)

In this essay we review the reactions of the financial markets to the economic policy leadership provided by Trevor Manuel since he was appointed finance minister in April 1996. We examine the market in SA companies, as represented by share prices on the JSE, and we review the market for SA government bonds - the market most directly affected by fiscal policy. We also look closely at the most problematic of the SA financial markets - the currency market. We will attempt to explain why the markets have reacted as they have done, and the degree to which Manuel and the policies of National Treasury can be held responsible for them.

A Brief Summary of the Outcomes in the Markets

- **The bond and equity markets**

We can summarize the market outcomes between April 1996 and September 2003 as follows. The annual returns from the bond market, calculated monthly, averaged 19,2 percent over the period, while the share market delivered 9 percent, which may be compared to the annual average inflation rate of 6,98 percent. Thus the bond market offered very impressive real returns that averaged over 12 percent per annum while the share market delivered only about 2 percent per annum after inflation on average. That is to say, the returns were a little less than the average dividend yield over the extended period. This can hardly be regarded as helpful to SA savers who on average unfortunately remained much more dependent on what happened in the share than in the bond market.

Over the Manuel years neither the volume of national savings nor the returns generated by them, clearly not independent of each other, can be regarded as at all satisfactory. Since the finance ministry is most directly responsible to its bondholders, Manuel and his colleagues can take great credit for delivering to them in this spectacular way. The poor performance of the JSE, given the implications these returns have for aggregate savings and investment, must be a cause of concern. We will attempt need to explain why bonds did so well, while equities did so poorly.

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[1] Trevor Manuel and the Markets, in Manuel Markets and Money. Essays in Appraisal, Edited by Raymond Parsons, Double Storey Books, Cape Town. 2004.

- **The currency market**

The behaviour of the currency market can only be regarded as particularly hostile to the growth and stability of the SA economy over the Manuel years. The real value of the rand has declined by 14 percent over the same period. That is, the rand fell significantly more than would have been justified by declining differences between SA inflation and the average inflation rate of our trading partners. Moreover, the real exchange rate has been especially volatile over the period - thus adding to the risks of doing business in SA. These outcomes in the currency market can only be regarded as unsatisfactory for the real economy and its progress. We attempt to explain why the currency market has behaved as it has under Manuel's watch.

A Review of Savings and Investment in SA

The gross savings ratio in SA, total savings as a percentage of GDP has remained fairly stable at a rate of about 15 percent since 1996. Private corporations account for the great of these savings in the form of undistributed profits and depreciation and other reserves accumulated. Thus the more profitable the corporations, the more savings they are likely to retain (that is save) and apply to investment purposes. Profitable companies are also likely to deliver higher returns and more wealth for their shareholders. We show below that the returns realised were not at variance with the underlying growth in earnings reported by JSE companies over the period.

SA households, or at least those with strong ties to the formal economy, tend to contribute a significant proportion of their pre-tax income to retirement plans, mostly private pension plans organised by their employers. A typical plan would be to contribute about 15 percent of gross pre-tax incomes to such plans. The flows into pension and retirement funds account for the great bulk of the savings managed on behalf of the savers and future pensioners by institutional fund managers, who invest mostly in equities listed on the JSE.

These financial institutions own, or rather control and manage, a very large proportion (over 90 percent) of the equities issued by public companies in SA. An increasing proportion of the shares issued have come to be acquired by foreign institutions as SA funds were allowed to diversify partially off shore. However, the contributions households make to retirement funds of one kind or another and gross savings are off set by household borrowing. SA households mostly borrow to own their homes and cars.

When household spending is subtracted from recorded household incomes, very little seems left over. Household savings rate nets out at a very low rate that has averaged a fraction over 1 percent of GDP between 1996 and 2003. When combined with negative government savings the dependence of the capital market on corporate savings is very obvious. Gross savings averaged 15,2 percent of GDP between 1996 and 2002, while gross private corporate savings ran at an average rate of 12,95 percent of GDP over the same period.

Government dis-saving is defined as the difference between government consumption spending and tax and other government income. Government investment spending is therefore treated as part of savings. The rate of dis-saving has declined with the conservative fiscal policies adopted under Manuel (a point to which we will, of course, return below) but not by enough understandably to increase the aggregate savings rate that has remained highly dependent on corporate cash flows. It should, however, be noted that household saving is always measured as the residual difference between recorded incomes and recorded. If incomes are under-reported relative to expenditure, then so will savings. These unrecorded savings may end up under the mattress or laundered in one way or another, including in offshore bank accounts.

Given these inadequate savings rates it is clear why SA would wish to encourage capital inflows to supplement domestic savings. There is clearly a case for wishing to encourage domestic savings but little extra encouragement has been provided by Manuel for South Africans to save more. Indeed, the opposite may be asserted. Pension funds came to be taxed by Manuel on their gross interest income, though this rate of tax was reduced from 25 percent to 18 percent in 2002. Manuel also introduced a CGT on the income of individuals and companies that reduces the rewards from private saving. A review of the tax treatment of savings that may help to reverse these policies has been called for by the finance ministry.

A Comparison with the Period 1990-1996

It is perhaps worth comparing the Manuel record with that of his predecessors over the five and a quarter years between 1990 and April 1996 - clearly also years of transition to the new democratic SA and also very much affected by the risks of a transition to a new order. The bond market did well, if not *as* well as under Manuel, over this period. Bonds returned an average 16,9 percent per annum compared to inflation that was on average significantly higher, 11,6 percent over this period than since, when it has averaged a much lower 6,98 percent per annum.

The stock market, however, did only comparatively better over this earlier period. Annual returns from the JSE were an average 14,8 percent per annum between 1990 and March 1996 and so provided a very moderate average real return of 3,2 percent per annum between 1990 and 1996. That is only slightly up on the real 2 percent per annum earned after 1996.

The exchange rate, however, was much better behaved in the pre-Manuel period. On average the trade-weighted real exchange rate appreciated by 1,3 percent per annum on average between 1990 and April 1996, while since then has depreciated by an average 3,2 percent per annum. Perhaps more importantly, the real rand was much less volatile in the preceding five year period, with a SD of 3,4 percent per annum compared to the 11,75 percent SD of the real exchange rate recorded between April 1996 and September 2003.

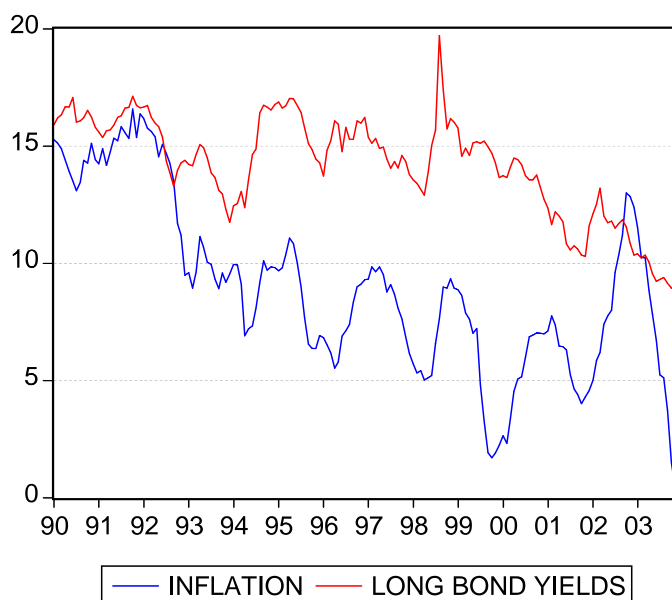
Interpreting the Reactions of the Bond Market

The bond market reluctantly came to award very high marks to Manuel for bringing down inflation unexpectedly, and by so doing handsomely rewarding those who had faith in his very sound and conservative fiscal policies. We say "unexpectedly low inflation" advisedly, because, if the market had been convinced of the conservative and long-term fiscal plans that Manuel committed himself too so clearly and transparently from the outset of his tenancy, bond yields would have declined much sooner than they did. If so, interest rates on government bond issues and so the expected and actual returns from the bond market would have been much lower. This would have been advantageous to taxpayers or the beneficiaries of other more tangible forms of government spending, and would also have brought additional private investment activity.

It is interesting to recognise how far declining bond yields lagged behind the inflation rate. It may be seen that the bond market began to react favourably to lower inflation only after 1999. Yet the inflation rate had begun to fall significantly by 1993 (see below) This implied a lack of belief by fund managers in the anti-inflationary credentials of the government that was only very gradually and reluctantly overcome by the evidence of lower actual inflation.

This lack of faith in the economic credentials of the ANC government - and in the growth prospects of the SA economy - also revealed itself in the flows across the balance of payments accounts and in foreign exchange market, as we will explain below. Overcoming the scepticism of the markets has been a major, yet still incomplete, task for the government.

Long Bond Yields and Inflation in SA 1990-2003



Source: *Investec Securities*

Inflation-sceptical investors preferred inflation-protected equities to inflation-exposed bonds. By so doing they kept up rates of interest to the disadvantage of investment spending in SA. Yet in defence of the sceptics it should also be appreciated that, while the inflation trend has been on the way down, the inflation rate has hardly been a stable one since 1996. While on the one hand the inflation rate has been significantly lower on average after 1996 than before (6,98 percent compared to 11,61 percent), on the other the volatility of the inflation rate has, if anything, increased rather than declined over the years. The SD of the annual average inflation rate was 3,16 percent between 1990 and April 1996 and 2,45 percent since then. But if we standardise the SD of the inflation rate by its mean, and calculate the coefficient of variation (SD/mean) to measure volatility of inflation, this can be shown to have increased from a low 0,27 between 1990 and 1996 to a higher 0,35 since then.

It is not the inflation rate that matters for the real economy as much as its variability. Lower inflation is meant to improve the predictability of the general level of prices. By so doing lower inflation can reduce business risk and encourage investment to the benefit of the real economy and its growth potential. The SA economy, however, is still to benefit from not only lower inflation but consistently lower inflation.

The Case has Been Made for Investing in SA but is Still Regarded as Not Proven

It has obviously not proved easy for the government to convince the investment community of the economic case they have been making for SA with their “mix” of essentially market-friendly and investor-friendly policies. These essentially conservative fiscal policies, by holding down government expenditure and so the average tax rate, have also been very encouraging for high income earners and wealth owners to be enterprising participants in the SA economy. The tight discipline over government spending practiced by the National Treasury, coupled with its good management of revenue collections and controls exercised over public budgets, has kept down the overall burden of taxation.

The burden of taxation is probably best measured by the ratio of government expenditure to GDP. The lower this share, the more room for the private sector to grow. By exercising very good restraint over its share the government has kept the room wide open for the private sector. Government spending has stabilised at a rate of about 26 percent of GDP, with all government revenues equivalent to about a stable 24 percent of GDP. The plans of the government going forward aim to keep to these ratios, as is very clearly set out in the MTEF.[1]

The private sector has not been “crowded out” of the goods or the debt markets by the government. The declining ratio of government debt to GDP as well as the stable government to GDP expenditure and tax ratios is full testimony to this. Government debt as a percentage of GDP was 47 percent in 1996 and is now down to 39 percent. Yet the issue of whether these policies have worked well for the economy to date is an open one, as we suggest below.

The Performance of the Real Economy – the Most Important Measure of the Success of Fiscal Policy

The success of the economic policies adopted by the government over the Manuel years must surely, in any final analysis, be judged primarily by the performance of the real economy. Clearly the objective of economic policy must be to in some way optimise the rate of growth of the economy consistent with some "ideal" distribution of the extra output produced. All the economic policies of the government, be it monetary policy or the regulation of the labour market, or competition policy etc, must be regarded as means to the end of growth and distribution.

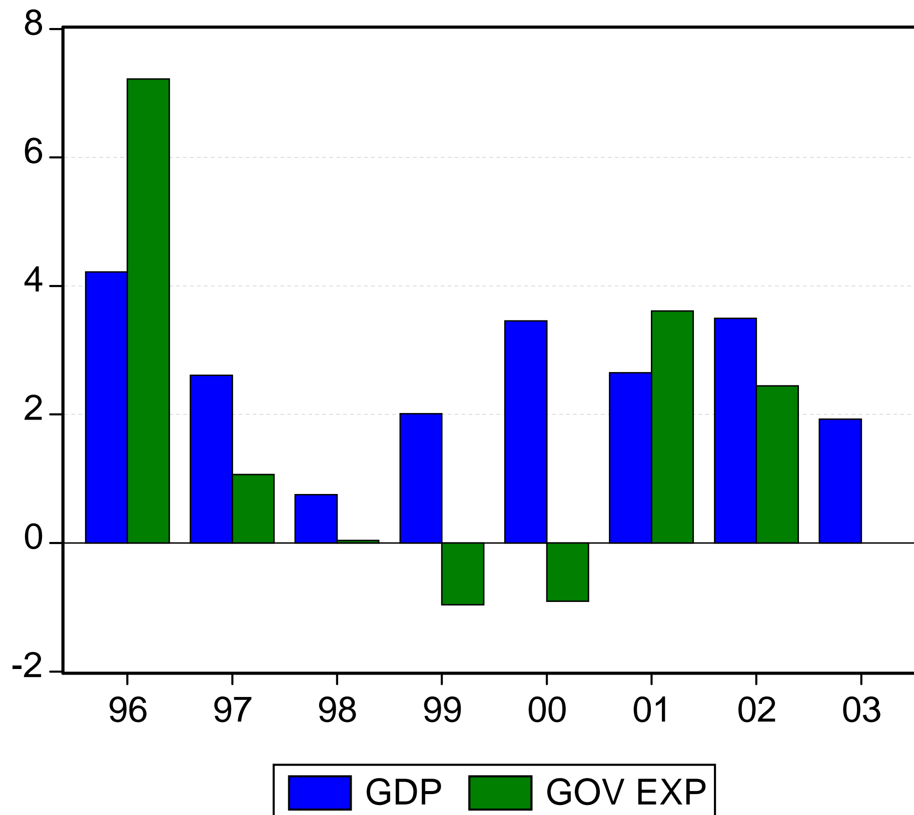
The RDP and GEAR have been the titles of the economic programmes initiated by the ANC government over the years. Manuel has played a very important role in both the formulation and implementation of these policies over the years, firstly, as head of the ANC's department of economic planning, responsible for the shaping of ANC economic policy between 1991 and 1994; and secondly, as minister of trade and industry in the first ANC led government (1994 to 3 April 1996) and after that a spell of duty as finance minister.

If Manuel is to be judged in terms of the performance of the real economy his tenure at the finance ministry cannot be regarded as an obvious success story, or at least so far. The real GDP is now only about 19 percent higher than it was when Manuel assumed office in April 1996. This represents an average growth rate of only 2,7 percent per annum. These are not impressive growth rates for an economy with an abundance of labour currently employed in low productivity work.

The opportunity to absorb this labour into more productive employment, with huge advantage to the individuals involved, which would have been be reflected in much faster rates of growth, has not been realised.[2] The only moderate performance of the corporations listed on the JSE, upon which savers are so dependent, is in part a reflection of these moderate growth rates realised by the SA economy. We look closely at the relationship between GDP and earnings below.

The SA economic problem to date is that not only have the growth rates been only moderate on average, but that they have also been highly variable since 1996. (see below) It should be recognised that it was mostly the poor performance of the economy in 1998 that drags down the average over the period from 1996 to 2003 and raises the variability of the growth outcomes. It is also of interest to note that real government expenditure fell over the period 1998-2000. This trend could hardly be regarded as helping to stabilise the economy in 1998 and 1999. We return to this point below.

Real Growth in GDP and Government Expenditure 1996-2003



Source: *SARB*

Some Important Qualifications about the Moderate Growth Rates Realised

Yet given the difficulty in even sustaining - let alone growing an economy - when the distribution of political power and so the power to control the economy, has been completely transformed, should perhaps be regarded as no mean achievement. Transformation and growth is not easily achieved given the inherent uncertainty of any transformation process and the economic policies that will accompany political transformation.

Thus even the most sincere long-term commitment to policies that will surely lay the foundation for sustained and impressive rates of promote economic growth over the long-term has to be proven by deeds, rather than words. A more appropriate assessment of the success or otherwise of the polices adopted, including the fiscal policy stance, is that the economy has in fact performed much better than it was or could have been expected to perform.

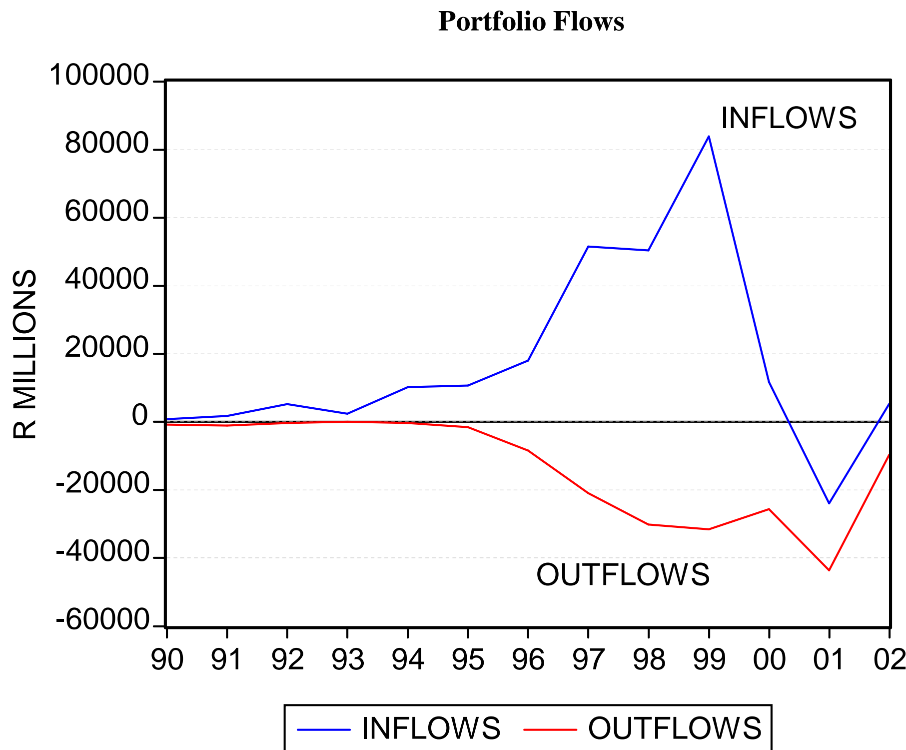
Had the economy been expected to perform more strongly, or rather had there been greater confidence in the policy directions chosen, the economy would have grown faster. Scepticism about the sustainability of economic policies that have tempered the demands

for immediate redistribution of wealth, often argued to have been unfairly acquired wealth, with all its damaging consequences, was perhaps understandable and perhaps even predictable. Not for nothing do we refer to the SA "miracle" of racial reconciliation. This disbelief, or lack of conviction, has become part of the problem as we have indicated above. Perceptions, even false ones, become part of the reality.

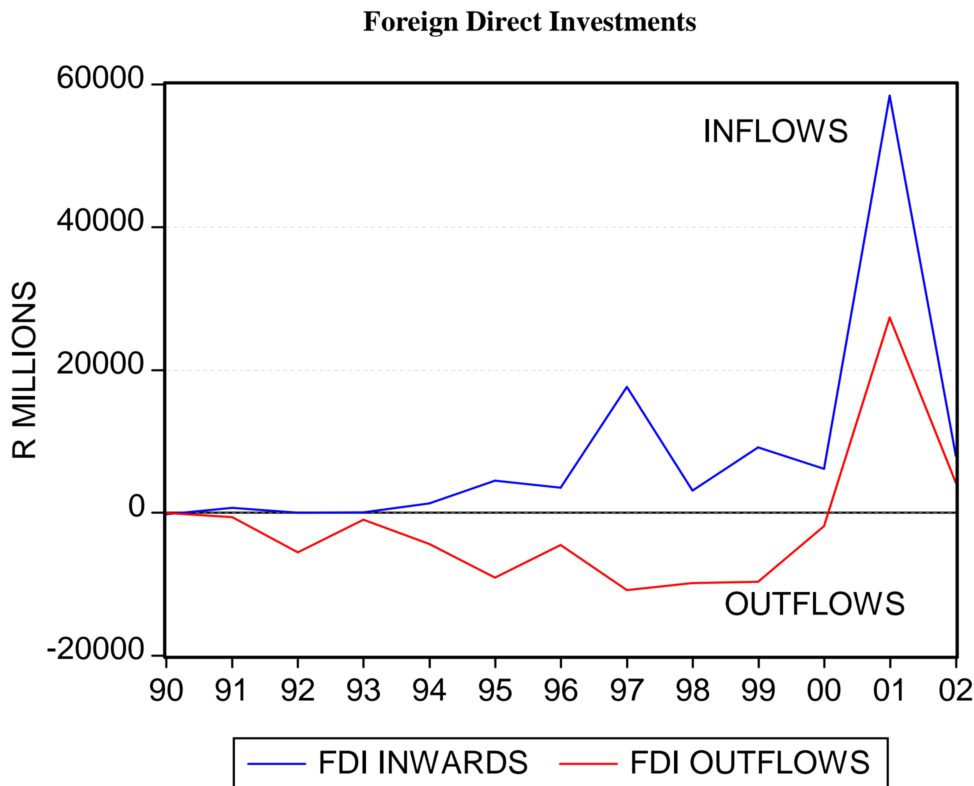
And so the room opened up by fiscal policy for faster economic growth in SA to be led by the private sector has yet to be filled. The rewards for fiscal conservatism and investor-friendly policies in the form of faster growth, requiring a sustained higher rate of investment, financed necessarily through a much stronger inflow of foreign capital, have not yet at all been fully realised. This must be a source of great frustration to Manuel and his colleagues.

Yet it should be appreciated that capital has flowed into the economy from abroad but has also flowed out in almost equivalent volume in much increased volumes since the mid-1990's. The statistics for 2001 are complicated by the treatment of the De Beers Company which became a foreign controlled company, largely owned by South Africans that year

Capital Flows to and from SA 1990-2002[3]



Foreign Direct Investments



Source: *SARB*

Was the Balance Right?

It can therefore be argued that the conservative fiscal policies adopted, particularly the degree of tight control over aggregate government spending that was exercised, while clearly and admirably the "right stuff" for the long-run performance of the economy, represented too much of a good thing and has limited the rate of economic growth in recent years. That is, the argument can be made that the balance erred too much on the side of conservatism in the circumstances.

A little more government spending (especially on infrastructure rather than salaries of government officials) or perhaps better still, less revenue extracted form income earners, especially perhaps from middle to low income earners where average income tax rates have remained very high, would have served the growth requirements of the transforming economy better. And more growth might well have encouraged more capital to flow in, and less to flow out.

Monetary policy – which is only indirectly influenced by the finance minister - has also had an important part to play in preventing the economy from realising its growth potential as we indicate below. Our issue therefore is not with the supply-side policies of the finance minister but rather with demand management that has been restrictive to a fault.

Scepticism and the Cost of Capital

We show above how long it took the bond market to "buy into" the prospect of permanently lower inflation in SA. This scepticism, as reflected in high real yields in the bond market, has meant higher costs of capital for SA investments, and so less investment and less growth. The bond market sets the benchmark for expected returns in all markets and so determines the cost of capital, or the required returns, for all classes of investment. Thus the lower the cost of capital or the required returns the better for the economy. This is why the contributions of fiscal policy to reducing the required real return on capital are so important.

The most notable and conspicuous recent financial successes of the government have been achieved in the market for foreign currency-denominated SA government bonds. The sovereign risk premium attached to SA bonds has come down dramatically - both absolutely and relatively to the emerging market peer group. By the end of December 2003 the sovereign risk premium measured as the difference between a government US dollar denominated bond issued in July 2002 and its US Treasury equivalent had declined from about 300 basis points in mid-2002 to a current premium of less than 100 basis points.

These developments mean that the real or US dollar cost of capital for SA investments have declined significantly in recent years under the impetus of Manuel's conservatism and the soundness of the government sector's balance sheet. The real cost of capital that represents the required return or hurdle rate of any investment made by a SA corporation must take their cue from the benchmark yields on US government bonds The lower the sovereign risk premium, the lower the cost of capital, and the greater the volume of investment that will be regarded as worth undertaking. The declining risk premium and the decline in the real cost of capital or required returns from investing in SA assets represents a major achievement of the government.

However, as indicated above, the volume of investment spending is a function of the demand for as well as the potential supply of capital. It is the demand to invest capital in SA that needs the encouragement of faster rates of growth. The hurdle rates have been reduced, but the sense of opportunity to leap over the hurdles is lacking. It seems clear to us that faster growth must lead investment flows to SA, and will help to limit capital outflows. It is unrealistic to expect investments made as an "act of faith" to lead faster growth.

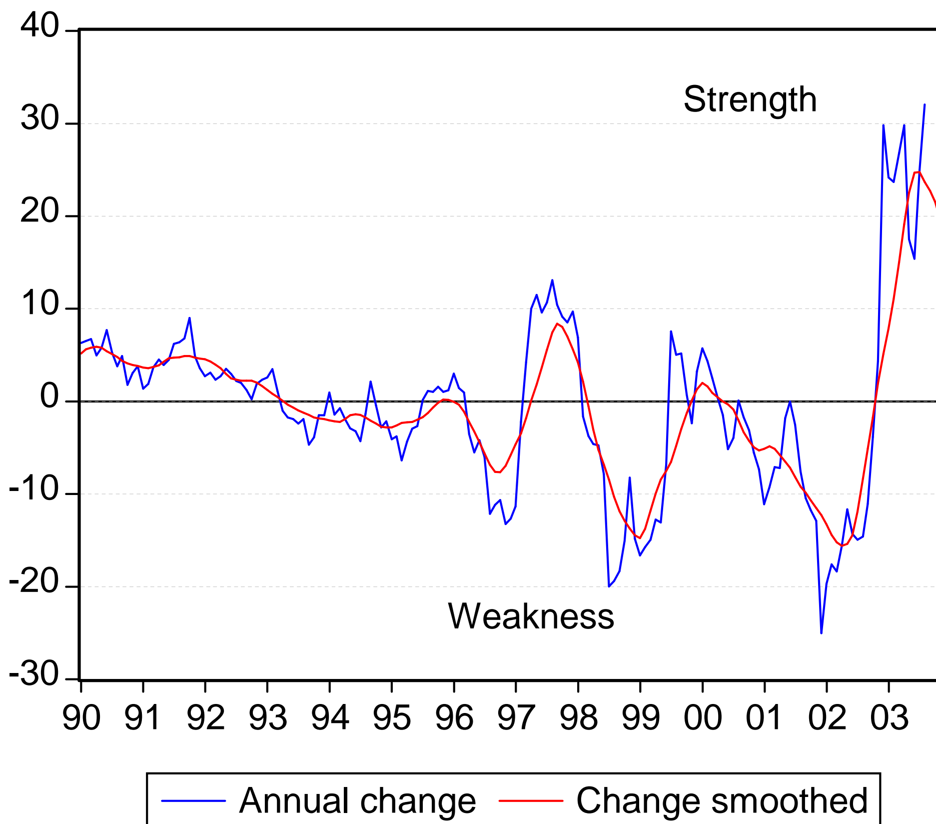
Coping Badly with Exchange Rate Turbulence

Despite these financial successes, major problems for the real economy and its growth prospects have been caused by the behaviour of the exchange rate for much of the period during which Manuel has been finance minister. The unstable rand exchange rate has its causes that we will try and identify. It has had very serious effects on the economy. The SA economy will not be able to sustain consistently good, even if only moderately good growth, until either the exchange rate becomes much more stable or the SA authorities learn to manage exchange rate volatility much better.

Exchange rate shocks clearly feed into the inflation rate, though with something of a lag through the impact of the prices of imported and exported goods on domestic prices. Exchange rate shocks can be measured by sharp fluctuations in the real exchange rate, that is to say, sharp deviations of the nominal exchange rates from their "equilibrium" purchasing power value.

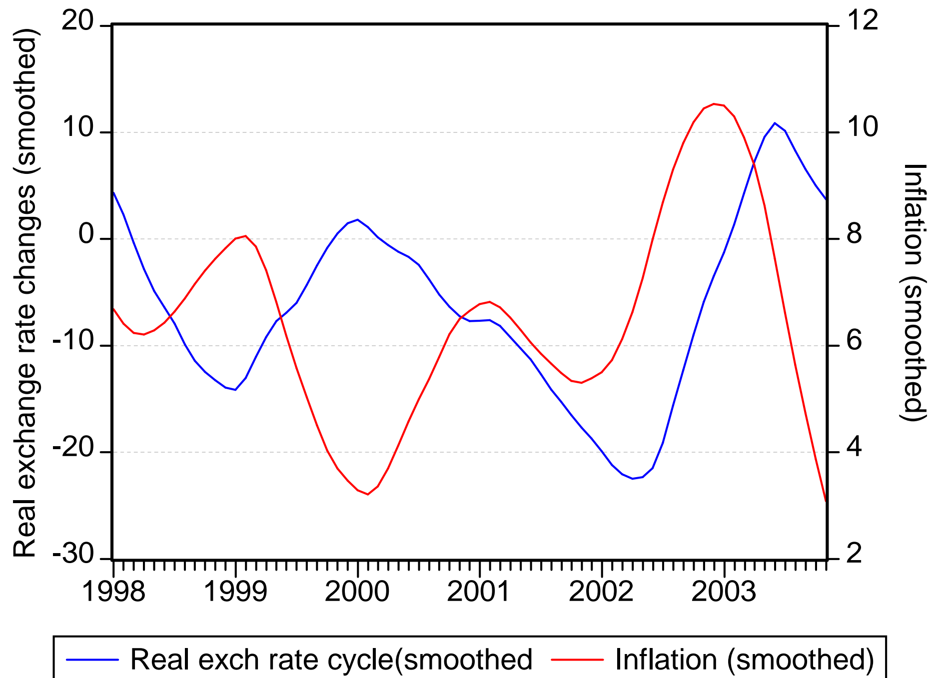
We show the real exchange rate cycle below, with 1995 taken as the base year. As may be seen, there are two significant shocks to the real rand exchange rate that can be identified. These are the shocks of 1998 and the larger shock of 2001. We also show how these real exchange rate movements have impacted on the inflation rate. The persistent bias towards a weaker real exchange rate between 1996 and 2001 should also be noticed.

Real Exchange Rate Movements 1990-2003



Source: *SARB* and *Investec Securities*

Real Exchange Rate Changes and Inflation



Source: *SARB* and *Investec Securities*

The Misjudgements of Monetary Policy

The responsibility for the shocks that affected the real value of the rand is not necessarily that of the government. The shock of 1998 was linked to an international liquidity crisis that had its proximate cause the collapse of the Russian rouble, but was much more directly the result of the demise of Long Term Capital Management - the dominant New York hedge fund of that time. The prices of all assets, especially assets issued in risky emerging markets, came under pressure as investors sought liquidity. The SA bond stock and currency markets proved no exception, as foreign investors sold their SA assets for cash to be converted into US dollars or other safer currencies. The currency crisis of 2001 had its origins inside SA, even though its cause remains more than a little obscure despite the efforts of the official Myburgh enquiry into this episode.

While exchange rate crises may be beyond the control of the officials and politicians responsible for monetary and fiscal policy, they do call for the most careful management. They call for appropriate monetary policy responses that soften the blow and moderate the real effects of sharp fluctuations in the real cost of imports and the real value of exports. If they can help do this, business and investment risks will have been reduced to the longer-term advantage of the economy after the shocks have subsided. A flexible exchange rate is a very helpful absorber of shocks to the capital account of the balance of payments. It is an indispensable aid to economic management in a country as vulnerable

to exchange rate shocks as is the SA economy. But a weaker exchange rate does, as we have shown, lead to temporarily higher inflation.

Trying to cope with capital flight by defending a fixed exchange rate for the purpose of holding down inflation would usually mean very high interest rates. These lead to recessions that can become politically intolerable. The net result of which is that the exchange rate has to give anyway, despite the best or worst efforts of the central bank.

Unfortunately, in response to the 1998 crisis, the independent SARB, under Governor Chris Stals, chose to defend the rand to prevent higher inflation that he had been fighting so hard - and with considerable success, as we have shown. The bank attempted to defend the rand with a most unfortunate mixture of much higher short-term interest rates and extraordinary interventions in the currency market. The results were disastrous for the real economy. The defence of the currency failed at huge cost to the SA taxpayer, who was left to pick up a bill of no less than R31bn that is still apparently counting. R25bn has been recognised in the form of governments bonds given to the SARB to shore up its balance sheet.

Living Badly with Negative Foreign Exchange Reserves

Given the lack of foreign exchange reserves available to the SARB at the time, these interventions took place in the forward rather than the spot market for foreign exchange. The original contracts entered into by the SARB, on a very large scale, were to deliver US dollars in the future at agreed forward exchange rates set close to prevailing spot rates, and intended to support the spot rate. The problem was that as these contracts matured, the spot rand at which the bank was able to acquire its US dollars for delivery, was much weaker than the rate implied in the forward contracts.

These very large operations in the forward market were intended to support the spot rate but they failed to do so. By August 1998 the rand, despite the intervention, had lost 32 percent of its US dollar value of a year before. In 2003 these forward obligations were finally paid off out of the proceeds of surpluses on the balance of payments, including a significant proportion of foreign debt raised by the SA government with the express purpose of acquiring the US dollars to meet the liability.

However, this was not the first time the SARB had acted in this way. During the elections that transferred power to the majority of South Africans in 1994 - the consequences of which were clearly feared by investors - the rand received equally massive support in the forward market. The scale of these interventions was, however, kept highly secret at the time. These interventions proved highly stabilising, because they helped support the rand and so investor confidence at a time of great uncertainty. The success of the election process and the economic policies that followed them then helped strengthen the rand. This meant that the positions undertaken in the forward market around the election of 1994 could be closed off without significant losses or profits. These operations were an undoubted success that contributed to the successful political transformation.

What worked in 1994-1995 clearly failed in 1998, with disastrous implications for the economy and its subsequent growth. Raising short-term interest rates so severely at the time to over 20 percent, moreover, had a very negative impact on the real economy that slowed down completely in response, as we have indicated above. The sharp increase in borrowing rates, moreover, proved much more than many new entrants into the credit market were able or willing to bear. This episode severely complicated the efforts to extend credit and banking services to the mass market so helpful for raising living standards.

The incubus of a huge US dollar liability, and hence large negative levels of foreign exchange reserves, has inhibited monetary policy ever since. Interest rates have probably been kept higher, and spending lower, than they would have otherwise have been. For the government to raise foreign loans for the purpose of paying off foreign debt incurred previously in an abortive defence of the currency, rather than to improve the productive capacity of the economy, was a particularly heavy cross to bear. The government took the advice of the international investment banking community to get rid of the forward book as fast as possible.

It was often argued that the exchange value of the rand would continue to be depressed by what was effectively large negative foreign exchange reserves. Of course, eradicating the negative open position also led to fees for these bankers from issuing foreign currency -denominated government debt that was proving to be in such strong demand. It is not clear that forcibly eliminating the forward book had any obvious positive influence on the value of the rand.

The Crisis of 2001 - Can we Blame Inflation Targeting?

The lessons of this unfortunate episode with the rand in 1998 were well-understood when the next exchange rate crisis hit SA in 2001. No explicit defence of the rand was offered, though interest rates were raised to defend not so much the rand but the inflation targets that had been imposed upon the SARB by Manuel and the National Treasury since 2000. The SARB, with its by now well-established independence from the finance ministry, chose not to exercise the escape clause that was written with the danger of exchange rate shocks to inflation targets very much in mind. Had it been exercised, it could have been used to justify not raising interest rates, given a supply side shock to the economy.

Clearly higher inflation would have to follow a much weaker exchange rate as occurred in 2002. The SARB, however, argued that by raising rates it was fighting inflationary expectations, and by so doing would dampen inflation over the longer term. The contribution higher interest made to holding down actual inflation was inconsequential, given the force of higher import and export prices. And the contribution these higher interest rates made to permanently lower inflation by demonstrating the anti-inflationary resolve of the Bank is impossible to determine. What higher interest rates did do was to again take something out of the growth potential of the economy in 2002 and 2003. The caution with which the Bank has subsequently lowered interest rates in 2003 after the

inflation rate came down with the dramatic recovery of the rand has also held back the real economy.

The degree to which Manuel must take accept responsibility for what we suggest were serious mistakes made by the SARB is surely debatable. After all, Manuel and his government had accepted the case for a highly independent central bank as part of investor-friendly approach. The case for such independence is very clearly part of the conventional financial wisdom and Manuel and the government generally has been scrupulous, to a fault perhaps, in respecting this independence.

Whether it was a good idea to couple this independence with an explicit inflation target, as Manuel has done, was not a good idea in our judgment. Low inflation, or rather as we have suggested *predictable* inflation, is a means to the end of a stronger economy, not an end in itself, and some circumstances may call for a trade off between unexpectedly low inflation and economic growth. There will be unusual circumstances in which the central bank is surely required to exercise good judgment about the short-term trade offs between growth and inflation and to win the respect of the financial markets for this.

A central bank is surely not to be judged only by how well it meets the objective of low inflation, but also how the economy gets there. It is not at all helpful to the economy when, after an exchange rate shock or rather a shock to the capital account of the balance of payments that causes the exchange rate to move sharply away from its purchasing power parity equilibrium, inflation targeting becomes exchange rate targeting by default.

A small open economy, particularly one undergoing a dramatic political transformation and therefore highly vulnerable to exchange rate shocks, must be able to deal with these shocks in a highly flexible way. It is not at all clear that the practice of explicit inflation targeting in SA, or its implicit targeting as under Stals, has helped the economy cope with inevitable exchange rate turbulence. Indeed, the responses of the SARB may well have added to rather than reduced such turbulence itself. There may be a better way to practice inflation targeting in SA but if there is, the case for it has still to be proven.

Has Exchange Control Reform been Well Managed?

Complicating the behaviour of the rand exchange rate, and also the performance of the JSE, has been the process of exchange control reform in SA, for which the finance ministry bears the primary responsibility. As we have shown, the process of gradual exchange control reforms initiated after 1995 have been associated with very large swings in capital flowing into and out of the economy. Foreign investors were allowed the full freedom to buy SA assets from or sell them to South Africans, as well of course as each other, in February 1995 when the financial rand mechanism was abandoned.

Since then, exchange control reforms under Manuel’s direction have proceeded consistently and gradually providing South African individuals, SA corporations and financial institutions and ex-residents, with greater freedom to move their savings and assets across the exchanges. Complete freedom from exchange control is still to be

achieved, though this would still appear to be the entirely laudable ultimate objective of the reform process.

Whether a “big bang” approach to exchange control reform would have worked better is a relevant but another essentially untestable hypothesis. Our view is that a “big bang” would have worked much better and avoided some of the inherent biases of partial exchange control reform. Only with the removal of all exchange controls can a “fair market value” be established for a currency. Until then the exchange controls must imply a degree of overvaluation. The sooner, we would argue, such perceptions are overcome, the closer the currency market will be to achieving stability.

The aesthetic appeal of gradual reforms is an attractive one and is strongly recommended by the IMF, among other authorities on the issue. It is also a low risk strategy for the officials and politicians involved. The impact of gradual reforms is unlikely to be dramatic, and therefore unlikely to lead to political repercussions. Exchange control reforms in SA have had to “unblock” a logjam of frustrated transactions to acquire foreign exchange for investment outside SA.

Slowly breaking up these logjams was bound, in and of itself, to give a consistently weaker bias to the exchange rate. With comprehensive reform the rand may well have depreciated in a once-and-for-all way, with its subsequent direction much less obvious than it was assumed to be, given only partial reforms. Partial exchange control reforms can have a dynamic of their own and can lead to perverse “herd-like” behaviour, particularly if it is believed that the opportunity to export capital may be limited or reversed. Such would appear to be the case in 2001, when panic demands for large but limited asset “swop” facilities by retail investors helped take the rand to the extraordinary weak levels it reached that year.[4]

Asset “Swops” and Foreign Listings

For the financial markets in SA two features of the exchange control reforms have been of particular interest and importance. These are the asset ”swop” mechanism and the permission provided to qualifying SA companies with major offshore assets to list abroad and to essentially take them out from SA jurisdiction. The asset “swops” were intended to be exchange rate neutral in that for every SA institution or corporation or individual making an investment offshore there would be an identifiable foreign purchaser making an equivalent investment in SA.

As we have learned and presumably should have known in advance, there could be no compulsion on the offshore investor to keep these SA assets and not to sell them back to South Africans, to the subsequent disadvantage of the balance of payments, and presumably the exchange rate. The asset “swops” were therefore not necessarily neutral for the currency market. What the arrangements ensured that large fees would be paid to the financial intermediaries facilitating the asset “swops” - and that such fees were bound to hurry the process along and encourage the belief that these were unlikely to be repeated opportunities to diversify SA wealth.

The irony of all this expensive fee-enhancing activity, for which SA savers came to pay so dearly when the rand recovered, was that foreign investments made in this way do not represent any escape from SA exchange control regulations, as may have been believed by those seeking asset "swop" facilities, but are very much a part of them. Most importantly, if the purpose of these investments was to protect the investor from expected weakness in the rand, which appeared to be the main driving force for them, then rand hedge or better rand-leveraged companies quoted on the JSE would have served even better as protection against rand weakness.

We cannot help coming to the view that the asset "swop" mechanism helped promote the panic demands for hard currency assets and represented a very poor way to go about exchange control reforms, for which Manuel and the finance ministry must bear full responsibility. The extreme fluctuations in the real value of the rand that followed the panic have been damaging for the real economy. We are therefore pleased that the asset "swops" have now been abandoned and replaced by straightforward limits on offshore investments.

It is also very doubtful whether the dual listings have in practice served the interest of SA's balance of payments as intended. Indeed, the evidence suggests very clearly that they have not done so.[5] Perhaps a more serious criticism is not of the permission given to SA shareholders to list their companies offshore, but of the outcomes for shareholders. Only in the case of the Anglo-American Corporation have SA shareholders unambiguously benefited from the offshore listing.

Two other large companies to list offshore - Old Mutual and SA Breweries, now SAB-Miller - have made large foreign acquisitions with the aid of capital raised on offshore markets and capital and dividends withdrawn from SA, without in any way to date benefiting SA shareholders n the form of an enhanced share prices. The share price of dual listed Dimension Data - once the IT "darling" of the JSE - collapsed with the pricking of the international IT bubble. Investec, the last of the dual-listed that was reluctantly given permission to list its off shore assets in London, also cannot yet claim any benefits for its SA shareholders. One of the important reasons for the poor performance of the JSE in recent years has been the underperformance of the large dual-listed companies.

The Share Market also Tells a Similar Story

The performance of any share market as measured by some market index is clearly dependent on the performance of the real economy to which the companies listed on an exchange are exposed. The JSE taken as a whole can be expected to reflect the performance of the SA economy, provided that the JSE represents the companies that make up the economy. There is an obvious connection between the size of the economy and the share of it produced by the corporate sector. There is also likely to be a fairly stable relationship between corporate output and the corporate profits that are of value to shareholders. The share of corporate profits in corporate output will be affected by taxes

and the stage of the business cycle. The share of profits is likely to increase in the upswings of the business cycle and decline when the economy grows more slowly.

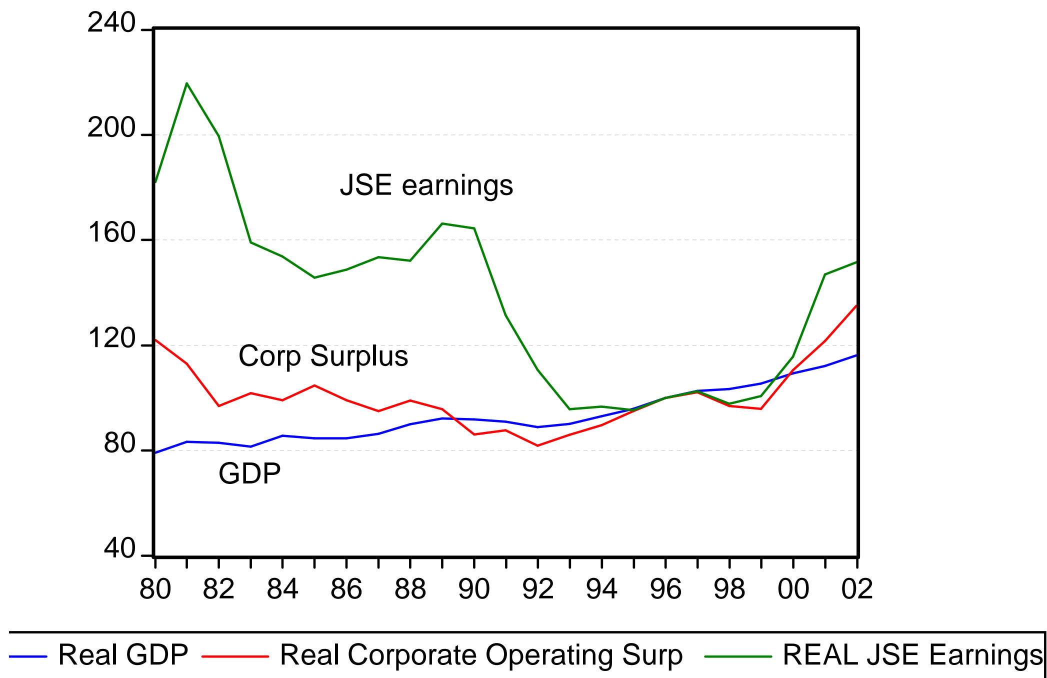
The other influences on share market valuations are interest rates in the bond and money market that reflect the "opportunity cost" of investing in the share market. A further influence on any share market in the global capital market will be valuations realised simultaneously in other share markets, particularly the major markets that set the pace for all share markets. In other words, there are income and substitution effects that drive the prices of shares as they drive all prices.

We have indicated above that the dual listed companies (other than the long-established dual-listed Richemont) have mostly held back the JSE in recent years. The dual listed do much of their business outside SA and intentionally have become less dependent on the SA economy. This therefore has loosened the ties between the JSE and the economy, as well as helped hold back reported earnings and valuations.

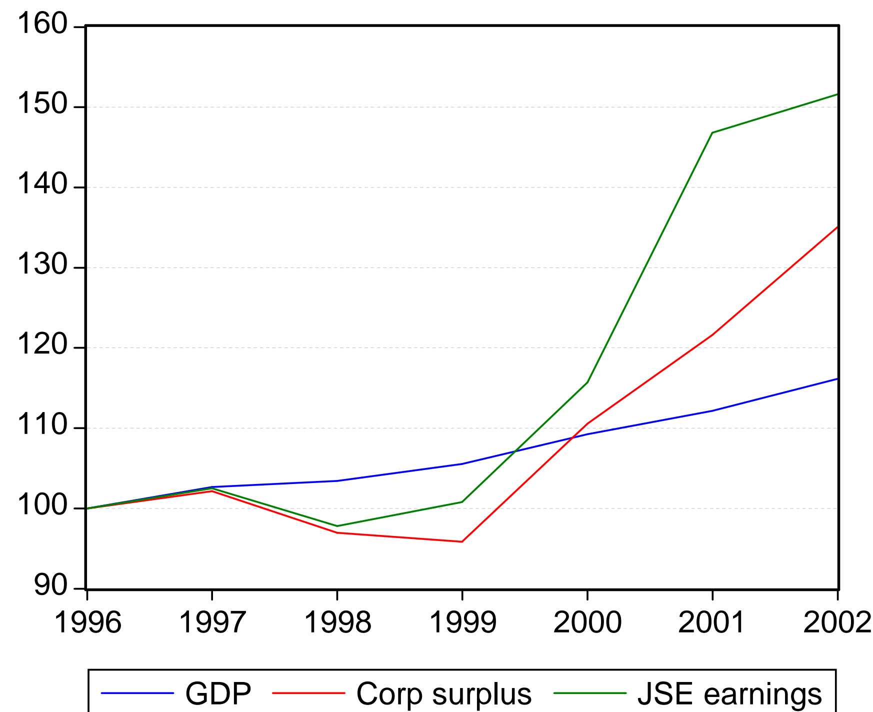
Another factor of importance in this regard is the large share of the JSE taken up by resource companies. The share of resource companies is much larger in the JSE than it is in the economy. Resource companies, including the largest company listed on the JSE, the dual listed Anglo-American, account for approximately 50 percent of the JSE by value and at most 10 percent of the SA economy by share of GDP. And so JSE profits or earnings are likely to run ahead of corporate profits generally when resource companies perform well, and vice-versa when they do badly.

We show the relationship between real JSE reported earnings after taxes and the real gross corporate profits after taxes as revealed in the national income accounts below.[6] These series are compared to GDP. The ratio of corporate taxes to corporate operating surpluses has not changed significantly since 1996 averaging about 17 percent over the period, despite lower nominal corporate tax rates.

Real GDP and the Real Performance of SA Corporations 1996=100



Real GDP and the Real Performance of SA Corporations 1996=100 : The Manuel years



The conclusion we come to is that SA corporations have not been burdened with higher levels of taxation. This is consistent with the generally conservative stance adopted by fiscal policy in SA. Furthermore, there is evidence that the economy as a whole - and the corporations that make up the economy - have on average performed better than the JSE. In other words, the JSE has become less representative of the economy, and that this explains in part why it performed less well than the economy did between 1996 and 2003. It would appear that the JSE will outperform the corporate sector when resource companies are doing well, and vice-versa.

The resource sector of the economy and the JSE were under the very negative pressure of declining resource prices between 1990 and 1998. The recovery of resource prices and resource earnings on the JSE since then is also apparent. Clearly also the collapse of the rand in 2001 had a very helpful influence on corporate profits and taxes in 2002.

It should, however, be noted that JSE earnings in real terms are still far below levels reached in the halcyon days of the early eighties. They are also still below the levels attained in the early nineties. As may be seen they suffered a major set back in the early nineties. SA corporate profits as a whole are now above the real levels attained in the early eighties, and as may also be seen, have advanced strongly and well ahead of GDP in recent years. Real rand weakness has had an important role here.

When the performance of the SA economy and its corporate sector is viewed in this way it becomes apparent that the economic case for SA corporations is not an overwhelmingly powerful one. Profits have come back from very low levels and the valuations accorded SA companies in the share market are not irrationally low. Our own models of the JSE that rely on earnings combined with interest rates and world markets to indicate fair value suggest that the JSE is now about 10 percent undervalued. Our sense is that the impact of lower interest rates - and the lower cost of capital this implies - are not fully reflected in these valuations.

But fundamentally the share market really needs higher levels of real earnings to justify higher valuations. These higher earnings can hopefully come from the higher levels of sustained economic growth that have proved so elusive – notwithstanding the very sound foundations laid for growth by fiscal policy. The recent history of the JSE would appear to support our argument that faster economic growth must *lead* and, if so, higher profits and valuations and additional investment will then follow.

Concluding Remarks

The SA economy can claim to have performed very well in the circumstances of great uncertainty about what the new SA would bring by way of economic policies. Fiscal policy settings have played a very valuable role in promoting stability and growth. It would be only realistic to have expected the economic uncertainties inherent in a transforming society to be resolved or rather addressed by way of actions rather than words. Actions naturally take time to impress, and so the benefits of very sound fiscal

policy settings are still to be fully appreciated. The stage is now well set for the government sector to make a larger direct contribution to economic growth, particularly by raising its own spending on the economic infrastructure. But great care must be taken to ensure that over the next few years, unlike the past few years, while laying the economic foundations for faster growth over the long-term, growth in the shorter term should not be needlessly sacrificed by unnecessarily severe monetary and fiscal policy settings.

The uncertainties about the future course of economic policy in SA have had their most obvious influence on capital flows to and from SA, and in the foreign exchange market. Exchange rate shocks have complicated the task of economic management. But as we have shown, the inadequate monetary policy responses have added to the difficulties faced by the economy. Exchange control reforms, while appreciated for themselves, have not in our judgment been well-designed to manage the difficult process of adjustment to years of very strict controls - and have probably added to the uncertainty and the exchange rate volatility.

Hopefully much has been learned from the experiences of the years of understandably difficult transition. Hopefully, too, the major adjustments to wealth portfolios allowed for by exchange control reforms are behind us. If so, South Africans can look to a period of much less financial market turbulence, especially in the exchange market. This would make the task of managing the SA economy for stable, consistent growth easier to achieve. The continued application of sound, but not unnecessarily severe, fiscal policies - coupled with inflation-conscious but hopefully not anti-inflation-obsessed monetary policy - can then bring its rewards in the form of faster and consistent growth.

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1. The web site of the Department of Finance gives full access to these plans as they have evolved over the period. See www.finance.gov.za.
2. Of course, the policies adopted for the labour market which cannot be regarded as encouraging employers to hire more labour have had a large part to play in these outcomes.
3. Portfolio flows refer to flows without management control. FDI implies a degree of management control. Inflows mean a supply of foreign currency to the rand market and outflows the opposite.
4. The flavour of the exchange control reform process as well as some of the important detail especially about permission to dual list is well captured in this extract of the budget speech made to Parliament in February 2000. See www.finance.gov.za.
5. See in this regard two studies published by the Reserve Bank. S.S.Walters and J.W.Prinsloo, “The impact of offshore listings on the South African economy”, *Quarterly Bulletin*, September 2002. Also Michael A Kock, “A note on changes in income and asset values of long-term insurers”, *Quarterly Bulletin*, December 2003.
6. We have added corporate capital consumption to the reported net operating surplus to generate the gross operating surplus from which corporate taxes have been deducted. The GDP deflator has been used to deflate these measures of corporate performance.