STRATEGIES FOR LONG-RUN DEVELOPMENT

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The problem of development in any country is how to produce sustainable, equitable, growth. In South Africa the development problem is to produce durable growth that will significantly reduce existing inequalities of income and wealth. Those inequalities run most significantly along racial lines, but there is also a gap between the employed and unemployed, which if not dealt with could become a major obstacle to development.

The basic development strategy that is most likely to succeed has three elements:

- the maintenance of macroeconomic stability;
- a market-friendly approach to the allocation of resources, in which private ownership and production predominate; and
- an active role for the state in key areas.

I. Macroeconomic stability

The maintenance of macroeconomic stability requires small budget deficits, moderate external deficits, and policies that produce low inflation.

The budget deficit has to be small enough so that it can be financed without continuously increasing the burden of the debt or pursuing inflationary policies to monetize the debt: countries that run persistently large deficits will ultimately be caught either by the deadly dynamics of rising interest payments that add to the deficit, or the inflation associated with monetary financing of the deficit, or both. By increasing the debt, budget deficits crowd out investment and reduce growth. In cutting the deficit, it has to be recognized that typically investment will rise more as a result of spending cuts than tax increases.

How big can the budget deficit be? There is no unique answer, nor is it optimal to run the largest deficit that can be sustained. The deficit can be larger and still sustainable the more rapidly the economy is growing and the higher the domestic saving rate. For a country growing at three percent, as South Africa is now, and with a low national saving rate, a

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1/ International Monetary Fund. These comments were presented in the concluding Round Table discussion at the conference on Transitional and Long-Term Development Issues in South Africa, Johannesburg, November 30 - December 1, 1995. The views expressed are not necessarily those of the IMF.

deficit of six percent of GDP is very large. It is increasing the debt to GDP ratio and the vulnerability of the economy to shocks.

There is similarly no unique answer to the question of how large the external deficit can be. The external deficit can be larger the more rapidly the economy is growing, and the greater the share of financing of the deficit provided by long-term inflows, especially foreign direct investment. Large foreign deficits financed by short-term capital flows -- deficits much in excess of 3-4 percent of GDP, depending on the growth rate of the economy -- leave a country especially vulnerable to shifts in confidence or world interest rates.

Inflation is a regressive tax, which is one reason to avoid it. While there may well be a short run tradeoff between inflation and unemployment in low inflation economies, there is no long-run tradeoff. There is though a more serious, negative, tradeoff between growth and inflation. Bruno and Easterly (1995) argue that inflation rates in excess of 40 percent per annum lead to stabilization crises. In his work, Barro (1994) finds that inflation and growth are negatively correlated except when inflation falls below eight percent per annum. In my own work (1993), I have found the negative relationship to continue even below that rate of inflation. In any case, there is very little good reason to permit double digit inflation, and many reasons to push for lower inflation. That means pursuing the monetary and fiscal policies that make low inflation possible.

Macroeconomic stability promotes investment and growth (Fischer, 1991), and needs to be attained and maintained. Of course, that is always politically difficult, but unless it is done, the country runs the risk that adverse macroeconomic shocks that would produce a short-run crisis if the underlying situation is sound, will turn into a longer run growth crisis.

II. The market-friendly approach

The market friendly approach to development2/ requires an appropriate legal system and the protection of property rights. It also requires opening the economy to international trade and promoting its integration with the world economy, particularly on the current account. Export-oriented countries have done particularly well, and export-orientation is bound to be an important part of a successful development strategy for South Africa.

Liberalization of the capital account may have to be slower than that of the current account. Liberalization of short-term capital movements before macroeconomic stability is assured and the financial system is sound, may promote a financial crisis. But while capital account liberalization may have to be phased in, the eventual goal of free capital movements is not in doubt. Foreign direct investment should be encouraged from the beginning even if overall capital account liberalization is gradual.

2/ The term is taken from the 1991 World Development Report, which sets out a comprehensive development strategy.

Preferential regional trading arrangements are attracting a great deal of attention in southern Africa. While South Africa can benefit from entering and promoting such arrangements -- provided they do not slow down multilateral liberalization -- the disparities in economic size in the region mean that regional arrangements will be of proportionately more benefit to their non-South African members. There are many good reasons for South Africa to promote regional economic integration, but South Africa will probably benefit more from the agreements it is now discussing with Europe than from its regional arrangements. That is no reason not to pursue both tracks.

In opening to world trade, a country needs also to liberalize its domestic goods and factor markets. On the capital markets side, the need is for a fundamentally healthy and private sector oriented financial system, with a sound banking system at its core. This requires an independent central bank and a well-designed supervisory system, with international capital adequacy standards, and a minimum of direct credit allocation.

It is common for governments to provide incentives for investment, with the goal of creating jobs and importing foreign technology. While increases in investment typically do create employment, it is job creation, rather than investment in machinery, for which incentives should be provided if the goal is to generate more employment of labor.

Labor market flexibility is critical to the development of a dynamic economy. South Africa is currently a high cost producer by international standards, and the scale of foreign direct investment will remain limited until that changes -- which means that both absolute and relative wages will have to become more flexible.

Countries have taken different approaches to the tradeoff between the level of the real wage and the volume of employment. Europe has explicitly chosen a higher real wage, higher unemployment combination than has the United States. European countries sustain and compensate for the higher unemployment by paying more generous unemployment benefits, financed through higher taxes.

That choice is not available to South Africa. With the unemployment rate in excess of 40 percent, it is not possible to compensate the unemployed by providing generous benefits. The real wage issue in this country will have to be faced. Given the role the unions played in defeating apartheid, that will be politically difficult, as it should be. But it cannot be beyond human ingenuity to find ways of making the labor market more flexible without penalizing the currently employed.

In most countries, including South Africa, economic efficiency would be increased by privatizing some state-owned enterprises. A privatization program would not only increase efficiency, but would also help attract foreign investment and the technology that accompanies it.

III. An active role for the state

The market-friendly approach to development is sometimes derided because its main prescriptions require the state not to do things that come naturally, like protecting domestic industry and providing subsidies to good causes. However government has a very active role to play in any successful development strategy. It has in the first instance to create and sustain the legal framework and atmosphere of security necessary for business to be carried out successfully.

The structure and efficiency of government spending are critical to the development process. Increasing the stock of human capital is the single most important development need in the new South Africa. That means that more has to be spent on education. It also means that the spending has to be directed to creating the right sorts of human capital, through broad-based primary and secondary education, and through technical and business training. It is common in developing countries to subsidize university education in general. While that is the direction political economy points, it is possible to reduce the overall subsidy to tertiary education by requiring those who can pay to do so, while supporting those who qualify but would not be able to afford a university training.

Investment in human capital is not only economically efficient, it will also go a long way towards improving social justice. The tax and transfer system too can play an important role in promoting both efficiency and equity.

Government's role in providing physical infrastructure is well accepted. At the same time, the possibilities of allowing the private sector to participate in the provision of infrastructure has continually to be reassessed. In some countries it is taken for granted that certain activities, such as telecommunications, are a public sector responsibility, even though they are private sector run in other countries. This is one of many areas in which foreign experience, particularly in Latin America and Asia, repays careful study.

South Africa's saving rate needs to increase, to the point where eventually the investment rate can reach the 25-30 percent range. That requires continued budget discipline. Governments can also encourage saving through compulsory retirement saving plans. In Chile, individuals are required to save a certain percentage of their income, with registered mutual funds. In Singapore, the compulsory saving is directed through a public sector investment authority. But in both cases compulsory retirement saving is fully funded, and is funnelled into the capital markets rather than financing the government.

Given South Africa's history, there is a strong case for affirmative action, requiring the private sector to both hire and train non-whites.

All this--and there is of course much more, including the promotion of competition within the private sector--provides a heavy and demanding agenda for government action. In pursuing its agenda, the government needs also to set out the overall framework of policy and its rationale, and to maintain a

consistent course of action. That time-consuming route is is the only way credibility and confidence can be built.

IV. Concluding comments

While the overall strategy is clear, tactical questions of the optimal sequencing and speed of reform have also to be dealt with. Virtually all reform programs that start from crises begin with macroeconomic stabilization, and then turn to trade liberalization, domestic goods market reform, public sector reform, factor markets, and then the financial markets. However, there are many exceptions and few general rules. Two stand out: first, it is not in general desirable to delay reforms to get the sequencing right--opportunities to reform should be taken as they arise; but second, it is dangerous to liberalize the external capital account before macroeconomic stability and financial sector health have been secured.

The optimal speed with which to reform depends on political and economic conditions. Some reforms, such as those of the financial system, or public enterprises, are bound to take a long time, though decisions may nonetheless be made quickly. In other areas, while it is often tempting to delay reforms to reduce pain over the next year, slow reform inflicts pain for longer, and is less likely to be completed. The present consensual approach to policy-making in South Africa is extremely important in ensuring broad-based support for policy changes. However, the consensus will not last forever, and there are advantages to moving ahead more rapidly, to help make reforms irreversible.

The more slowly reforms are undertaken, the greater the risk that they will be blown off course by shocks. For instance, consider the present very gradual approach to reducing the budget deficit from its current six percent of GDP. Pressures on the budget are bound to increase in future years and the economy is bound to encounter adverse shocks: economies always do. The capacity of the economy to deal with such pressures and shocks will be greater if more rapid progress is made in consolidating the fiscal position.

While the strategy recommended here works, it leaves ample room for variety in the role of government and the structure of the economy. All the members of the G-7 can be described as following the strategy, but the range of their experience, as well as the approaches followed in many other market economies, is evidence that countries can map out their own routes to development within a broad economic framework.

One final comment: the strategy set out here works; and there is no other basic strategy that has been successful over long periods. But it takes time. It takes time to establish credibility; investment takes time to recover; it takes several years of stability before foreign direct investment flows on a significant scale; export markets take time to develop; human capital takes at least a decade to create; and so on.

It is during the period between the institution of reforms and sustainable increases in growth that political pressures to reverse course and go for populism are most intense. That perspective--that reform yields

its fruits slowly--was missing during yesterday's discussion of the Reconstruction and Development Program (RDP), which was criticized 18 months after the new government took power for not achieving all its goals. But it is a perspective that must be remembered as South Africa sets out on its path to economic development, a path that appears to be fully consistent with the approach outlined here.

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