



## ESCAPING A STAGFLATION TRAP

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First-quarter negative growth has led to the big recession debate, but the real challenge is that the SA economy has been caught in a stagflation trap. Stagflation is a term originating in the 1970s that applies when countries struggle simultaneously with persistently high inflation and stagnation.

The inflation rate stubbornly hugged the 6% upper limit of the target band over the past three years, while economic growth slowed to a below-par 1.9% in 2013 – and might not even reach that level for 2014. The post-2009 recession economic rebound had growth at 3.1% in 2010 and inflation at 4.3%. In 2013, Inflation was 5.9% and growth 1.9%. The gap between inflation and growth will widen in 2014.

Inflation and growth can be considered macroeconomic risk-reward measures. A healthy economy is one that grows consistently higher than inflation -- something not achieved in SA since 1970. However, the growth rate rose above the inflation rate for the three years from 2004 to 2006 as a combination of better fiscal and monetary policies helped to shift the risk-reward ratio into a favourable position.

The more recent slowdown comes with additional headwinds. The interest-rate cycle is in a trough, while normally, slowdowns occur at the peak of the cycle. The current account deficit has also been widening and is at record levels. Normally, widening current account deficits are associated with booms. In addition, countercyclical spending by National

Treasury has left government finances in tatters, with multiple credit-rating downgrades constricting fiscal flexibility. The twin deficits on the current account and budget have parachuted SA into the “Fragile Five” group of countries, which has Treasury and SARB officials spitting blood. This is compounded by a third deficit – a household deficit – that has resulted in a battle against high costs, especially from administered prices. The triple deficit means the growth drivers are weak. Normally, slow growth can be remedied by cutting interest rates, expanding government expenditure and allowing credit growth to boost demand. None of these options are now available. High inflation means interest rates must be increased as the economy slows. Government has to cut back and so do households. The credit-based, consumption-led growth model has reached a dead end.

Weak growth, along with the current account deficit, places pressure on the rand, which raises costs. This is the stagflation trap. Weak economic growth facing headwinds with strong upward inflationary pressure.

Labour unrest is an additional headwind for the economy, but the stagflation conditions that result in a drop in living standards provide fertile grounds for extremists to exploit.

Escaping the stagflation trap will require a period of possibly painful adjustment. However, the experience of the

1970s showed stagflation can persist and even deteriorate further. The only remaining growth driver that can be mobilised is investment. But not to create dead capital that many of South Africa’s loss-making prestige projects such as World Cup stadiums, Gautrans, GFIPs and Medupis has delivered. Well-allocated capital must produce returns that generate additional capital that extends the value chains. This means investment must primarily focus on the wealth-producing sectors of the economy. To fund this, the savings rate must be raised to close out the massive macroeconomic mismatch of a 19% investment rate against a 14% savings rate. Taxes on capital and investment viability have to go. The National Development Plan seeks to achieve a 30% investment rate, which must be backed by a similar savings rate.



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