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Fiscal and Monetary Policy Considerations:

Restoring Growth in the South African Economy

Discussion Paper prepared for a Bureau for Economic Research Seminar on Macroeconomic Policy and Inclusive Growth

4 December 2019

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Summary

Against the background of weak economic growth, rising unemployment and a deteriorating fiscal position, South Africa's macroeconomic policy options have come under renewed scrutiny over the past year. Though it is widely accepted that "structural" factors account for the persistence of slow growth, high unemployment and severe inequality, there are divergent views on the underlying causes and what should be done. This paper reviews current fiscal and monetary policy considerations, with a view to identifying options for stronger and more inclusive growth in the medium term.

The central argument below is that an improved growth performance requires a coordinated "boost" to investment and the financing of development, higher savings and fiscal support for labour-absorbing sectors. In political economy terms, the structural shifts required to "ignite growth" imply a new co-operative understanding of public and private sector roles and responsibilities – an understanding that recognises complementarities between public and private finance and capacity, between fiscal, industrial, trade, financial and labour market policies and between established and emerging enterprises and between local and regional or global value chains, rather than substitution of one for the other, as the organising principle of inclusive growth. This kind of coordination effort is immensely difficult to achieve – "lifting" an economy out of a low-growth trap is an extreme political effort.

Four substantial coordination failures in South Africa's present growth path are illustrative:

- The balance between government revenue and expenditure and the trajectory of government debt are unsustainable,

[1] Prepared by Andrew Donaldson on behalf of the Association for Savings and Investment SA. Earlier drafts were prepared for Business Unity South Africa (BUSA) as background papers for NEDLAC discussions on macroeconomic policy. Opinions reflect those of the author and should not be attributed to ASISA, BUSA or their affiliated members. The paper benefited from discussions with Stephen Smith, Nazmeera Moola, Arthur Kamp, Marie Antelme, Tertia Jacobs and staff of the Bureau for Economic Research, University of Stellenbosch. A compilation of statistical trends in the South African economy by Harri Kemp of the Bureau for Economic Research, and helpful comments on earlier drafts by Arthur Kamp, Rowan Burger and Johann van Tonder are gratefully acknowledged.

- Eskom and several other state enterprises or government-sponsored undertakings require recapitalisation and restructuring,
- The economy's growth path does not generate sufficient employment,
- Spatial patterns of investment and development, particularly in cities, reproduce inefficiencies and inequalities that have long historical legacies.

An elevated level of government debt to GDP, the financially distressed state of Eskom, sluggish revenue performance and rising personnel spending pressures combine to constrain the room for fiscal manoeuvre. The public finances are under stress in part as a consequence of slow real economic growth, exacerbated by a negative GDP inflation shock and rising real interest rates.

Slow economic growth, in turn, reflects a severe deterioration in business confidence after the 2009 recession, private sector deleveraging and persistently low levels of investment.

Consolidation of the public finances is likely to be the dominant theme in fiscal policy for several years ahead, with the refinancing of Eskom the main challenge. However, there are several strengths to South Africa's public finances on which to build, including the fully funded standing of the GEPF, largely rand-denominated debt, reserve holdings of the National Revenue Fund and an established institutional framework for bringing private finance into infrastructure investment.

Although government's debt position has deteriorated over the past decade, private sector credit extension has remained moderate and household indebtedness has fallen relative to GDP. In these circumstances, fiscal policy has to incentivise private investment in industry and infrastructure if it is to promote growth sustainably. A substantial expansion in co-funding of infrastructure and residential development is needed, supported by a larger balance sheet and expanded mandate of the DBSA. Urban development, housing and support for employment-intensive industries and promotion of agriculture are important sectors for targeted fiscal and blended finance support.

Tax incentives for low-wage employees, child allowances and adjustments to the tax deductibility of retirement savings would improve the fairness of the tax structure and could be phased in as revenue neutral reforms. Alongside appropriate tax reforms, measures to improve non-tax revenue collection are needed, especially in respect of municipal service charges.

In government's expenditure allocations, there is little room for reform in the medium-term. Infrastructure investment and maintenance have to be prioritised for stronger growth in future. Fiscal adjustment will require a substantial moderation in government personnel spending. However, it is also important to expand employment and improve wages, currently below the national minimum, in government's public works and community employment programmes, which serve substantial developmental and redistributive roles.

Both fiscal consolidation and expanded mobilisation of private finance are likely to require an accommodative financial environment for an extended period ahead. Structural change and institutional adjustments to new co-operative development strategies will take time before their momentum becomes self-propelled.

Monetary policy is currently focused on lowering inflation to the mid-point of the 3-6 per cent target range. But pricing power is weak throughout the economy, and demand-side inflation is not a significant risk. In the circumstances of slow growth and benign inflation in 2019, there is scope for further reductions in the repo rate. This would assist in accommodating stronger financing of housing and business investment. Manufacturing and more labour-intensive industry would also benefit from a more stable and competitive real value of the rand.

Private sector credit extension has not yet regained momentum since the 2009 recession, although there has been a substantial improvement in households' debt to disposable income ratio. Of particular concern is the continued deterioration in lending for property development and home improvements, as this is central to social and economic development and improved living standards.

Access to credit has become more expensive for middle-income households, as mortgage lending has fallen and lending criteria have become more stringent. Levels of debt relative to income are comparatively low in middle-income cohorts, however, where welfare gains associated with access to affordable long-term credit for improved housing would be considerable. Improved access of middle-income households and small enterprises to credit for investment purposes is a key element in both growth recovery and a broader financial inclusion agenda.

Alongside the downturn in private investment in recent years, there has been a marked deterioration in municipal infrastructure spending. Although the consolidated local government accounts reflect substantial cash surpluses from operations and capital transfers from the national budget have continued to grow, capital spending by municipalities has declined in real terms. Even major metros and larger cities, which face rising urban populations and major infrastructure backlogs, are under-spending their capital budgets. Alongside improved revenue management, South Africa's cities should be investing far more, financed in part by borrowing.

South Africa's macroeconomic policy framework cannot be focused only on containing public debt and lowering inflation, it also has to support the structural changes needed to improve growth performance: higher investment, more labour-intensive industry, urban investment and housing, industrial diversification and trade competitiveness.

The changes required, the structural shifts necessary to build momentum in growth, employment and broader economic participation, are unlikely to emerge from separate programmes of fiscal, industrial, monetary, financial, urban and labour market policy adjustments, from supply- or demand-side efforts alone, or from government and business operating on separate tracks. A slow-growth trap is a many-person prisoners' dilemma, in which coordinated action is required and no single player can be expected to take the steps required in the absence of collective assurances and a shared strategy.

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Fiscal and Monetary Policy Considerations:

Restoring Growth in the South African Economy

> *…(W)e are all familiar with the possibility of many Nash equilibria and of some of them being Pareto inefficient… (A)gents have chosen their best strategy given the strategies of others. (There are… therefore…) co-operative equilibria which Pareto dominate the non-co-operative outcome of a market economy. The theory that the latter can have bad or unsatisfactory equilibria is at the centre of Keynes. Government policy can here be considered as a kind of surrogate for co-operation – for internalising the intrinsic externalities. It can also be considered as a device to induce the economy to pick one equilibrium rather than another…*
>
> Frank Hahn, *Equilibrium and Macroeconomics,* Basil Blackwell, 1984, p. 16.

Background

Since 2014, the South African economy has grown more slowly than the population. Income per capita has declined by nearly 5 per cent. Unemployment has increased from 5 million to 6.7 million. Government debt has increased from 40 per cent of GDP to nearly 60 per cent. Private fixed investment has declined to 12 per cent of GDP and government investment remains weak. Despite sluggish demand, the current account of the balance of payments has remained elevated.

These outcomes indicate a macroeconomic trajectory that is "structurally" depressed. The economic outlook calls for decisive growth-enhancing interventions, together with shifts in policy towards labour-absorption and trade competitiveness.

But the scope for fiscal stimulation is limited, and the financial environment is vulnerable.

Substantial increases in the effective tax burden have been implemented, but the budget deficit remains uncomfortably high. Eskom and other state-owned companies have large borrowing requirements but are unable to access capital markets without fiscal support. Both consumer price inflation and GDP inflation have declined to their lowest levels in a decade, yet long-term interest rates have trended upwards. Although the JSE all-share index has recovered somewhat from a disappointing 2018, there have been catastrophic collapses in several major corporate groups, including a number of South Africa's leading construction companies.

Consumer and business confidence levels are low, and the implicit risk premium in the exchange rate and the capital market is high.

The deterioration in South Africa's public finances over the past decade reflects both the persistent weakness in *real* economic growth and the impact of an unexpected negative *GDP inflation shock*, first revealed in the March 2019 GDP estimates.[2] The decline in GDP inflation contributes directly to

[2] The dataset accompanying Statistical Release P0441 (Statistics SA, 5 March 2019) shows nominal GDP growth of 4.7 per cent and real growth of 0.8 per cent in 2018, yielding implicit GDP inflation of 3.9 per cent. The previous December 2018 release, on which the February 2019 Budget was based, had indicated average nominal growth for

the rising debt-GDP ratio, and also coincides with an upward trend in the real interest rates at which government and the private sector borrow.

Macroeconomic room for manoeuvre is constrained not just because revenue raising options are limited and financial markets are sensitive to rising debt levels. There is also limited scope for raising growth in the medium term because investment has been so low for so long, the electricity constraint is binding and the current account of the balance of payments is negative.

Off-balance sheet considerations also weigh heavily on the outlook for the fiscus.

The most immediate of these is Eskom. Without its sovereign underpin, Eskom's debt would now be near-worthless. The contingent cost of the Medupi and Kusile contracting process is now apparent – if the new power plants had been undertaken through properly structured "turnkey" contracts, the cost-overruns and design faults would have been for the account of private shareholders, not taxpayers. Eskom's total debt is some R450 billion, approaching 10 per cent of GDP, perhaps half of which will have to be taken over by the fiscus.

Three other large liabilities are for the account of the fiscus and are unfunded. The first is the actuarial shortfall of the Road Accident Fund, which is now over R200 billion. The second is the post-retirement medical assistance liability of some R70 billion – the obligation to subsidise medical scheme membership of retired civil servants. The third is the rapidly rising aggregate of medico-legal claims against provincial health departments.

These are dire fiscal circumstances – not just in their magnitude but most worryingly in their trends. Annual budget announcements have seen repeated upward adjustments in the deficit and debt projections. The off-balance sheet liabilities are all rapidly deteriorating.

Against this, several strengths of South Africa's fiscal system should be noted.

- The public service pension benefit is funded. On a pay-as-you-go basis this would be a near-R2 trillion unfunded liability. In the 1980s, by comparison, the GEPF was less than 50 per cent funded. The PIC, investing on behalf of the GEPF, has for long been a substantial holder of government and parastatal debt, and is now also a major investor in equities.
- Government debt is largely rand-denominated, the bond and treasury bill markets are highly liquid and public debt management is sound.
- Sub-national governments hold little debt.
- Government accounts are generally reliably recorded, transparent and subject to rigorous audit.
- National government revenue, although falling short of budget estimates in recent years, has held up well relative to GDP and national income.
- Reserve holdings of the National Revenue Fund include cash balances of about R150 billion and approximately R180 billion in unrealised gains on the Gold and Foreign Exchange Contingency Reserve Account.
- The legal and institutional capacity required to bring private finance into infrastructure investment is well established.

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the first three quarters of 2018 of 7.0 per cent, real growth of 0.8 per cent and GDP inflation of 6.2 per cent. The downward revision in nominal GDP growth has not been explained.

These conditions perhaps allow fiscal support for a growth strategy to be accommodated, though its focus has to include mobilisation of private investment and stronger savings over the longer term if sustainability is to be preserved.

More important: in assessing fiscal and monetary policy options, the *overall* debt position of the South African economy is the fundamental point of reference. While government debt has increased markedly over the past decade relative to national income, credit extension to the private sector has moderated. Total private sector credit extension amounts to about R3.8 trillion, or about 75 per cent of GDP. Household debt is about 45 per cent of this total and has declined from 85 per cent of disposable income in 2008 to just over 70 per cent currently. Neither corporate nor household debt is unduly high relative to national income, though high rates of distressed debt or non-performing loans are cause for concern.

Following a rapid rise in private sector credit extension during the 2002-2008 boom years, South Africa has experienced a "balance sheet deflation," in which the negative shock of the 2009 recession and subsequent collapse of mining and property stocks as the commodity super-cycle ended, and the household and corporate deleveraging that followed, have combined to hold back confidence and economic activity.[3]

Domestic expenditure has nonetheless continued to exceed production and income, resulting in a persistent current account deficit. South Africa's gross external debt is about USD 180 billion (R2.7 trillion) and has doubled in USD terms over the past decade. Just under half of government debt is foreign held, though less than 20 per cent is foreign currency denominated.

In summary – under conditions of very slow investment and economic growth, government debt is rising relative to GDP while household and corporate debt levels are stable or declining in real terms. Both private sector liabilities and government debt are increasingly owed to the rest of the world – international investors are important *stakeholders* in the South African economy.

In the 2019 Budget, National Treasury projected a consolidated budget deficit of 4.5 per cent of GDP in 2019/20, substantially up from 3.6 per cent recorded in 2016/17. Fiscal consolidation has been deferred, in the context of slower growth and rising SOE financing requirements.

The February budget projections were based on nominal GDP growth of 7.2 per cent in 2018/19, and 7.0 per cent, 7.4 per cent and 7.5 per cent over the subsequent three years. However, GDP inflation has declined from around 6 per cent over the previous three years to below 4 per cent in 2018. Nominal GDP growth in 2018/19 therefore has to be revised down to about 5 per cent, lowering the base for subsequent years. If GDP inflation remains around 4 per cent, then nominal growth over the period ahead will fall well short of budget projections and both revenue and spending estimates will need to be reconsidered. The budget deficit in 2019/20 will be substantially higher than the February estimate of 4.5 per cent, and it may remain around 5-6 per cent of GDP for the next three-year period.

Slow economic growth constrains fiscal options for the period ahead, and the adjustment is more difficult because of the unexpected downward shift in GDP inflation.

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[3] "Balance sheet recession" refers to the unwillingness of households and firms to borrow, despite comparatively low interest rates and inflation. See Appendix.

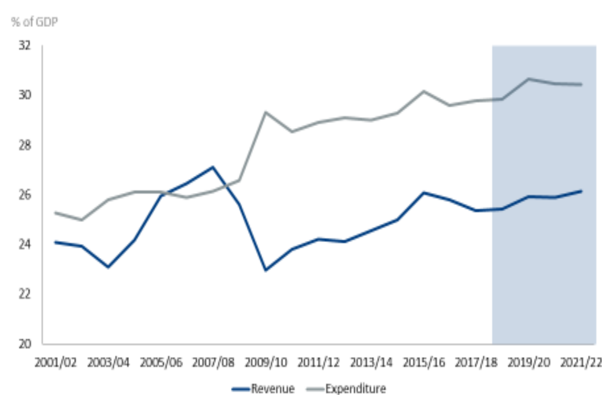
Fiscal policy considerations

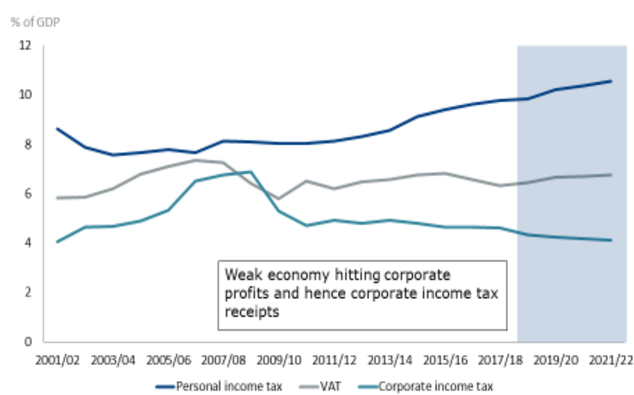
Taxation

There have been several upward adjustments in the overall tax burden over the past decade:

- PIT has not been fully adjusted for inflation over the past five years
- The maximum marginal PIT rate was increased from 41 per cent to 45 per cent in 2017
- Capital gains inclusion rates were increased in 2012
- VAT was raised from 14 to 15 per cent in 2018
- Taxes on fuel have been raised, notably the RAF levy increase in 2015
- Transfer duty rates were made more steeply progressive in 2015
- Estate duty and the donations tax rate were increased in 2018
- The carbon tax has been introduced with effect from June 2019.

Nonetheless, revenue has lagged behind budget estimates substantially in recent years, partly as a result of lower growth but also because the expected tax buoyancy has not been realised. Personal income tax is carrying a rising share of the overall tax burden and the tax-GDP ratio has increased by about 2 percentage points over the past decade.





BER, July 2019. Source: National Treasury.

Higher revenue is needed to meet government's spending requirements and lower the budget deficit, but a higher tax burden would put both households and businesses under further strain in an already distressed economic environment. Within the consolidated fiscal framework, revenue averages 29.3 per cent of GDP over the next three years, 0.5 per cent of GDP higher than in the past two years.

Taking into account the low growth outlook, it seems likely that higher tax rates would be self-defeating – negative impacts on economic activity offsetting higher tax rates.

There may be some scope for broadening the tax base, though many of the more effective base-broadening steps have already been taken – the shift to taxing worldwide income, introduction of capital gains tax, removal of tax exemptions and allowances and strengthening of indirect taxation. In the longer term, the most likely tax base broadening measure would be a payroll or social insurance contribution phased in as part of an agreed social security and health financing reform. There is still considerable work to be done on these policy proposals, currently before NEDLAC.

Internationally, there has been a drift towards lower corporate tax rates. This will have to come under consideration in South Africa with a view to supporting investment and business competitiveness.

However, the crisis in employment calls for tax measures targeted at job creation and vulnerable workers. There are at least three compelling candidates:

- Extension of the current youth employment tax incentive to include targeted special economic zones and labour-intensive sectors, in effect providing a basic income subsidy to vulnerable low-wage workers, complementing the newly introduced minimum wage. The extension of the employment incentive to SEZs and targeted sectors is provided for in the enabling legislation but has not yet been implemented.
- Extension and deepening of the urban development zone tax incentive (currently due to expire on 31 March 2020).
- Investment incentives for export-oriented agriculture and food processing and other labour-intensive sectors, to support expanded employment and improvements in working conditions.

A tax policy stance for the 2020 Budget has to be sought which will encourage investment and job creation, without excessive loss of revenue.

This means that there is unlikely to be scope for further PIT relief, in real (after inflation) terms. However, several revenue-neutral reforms could be implemented to improve the distributional fairness of the PIT. These include adjustments to the rebates to take child dependants into account and a revised structure of retirement savings deductibility to shift the fiscal subsidy to favour lower income contributors. If the PIT is to continue to be the main revenue source, it is important that its horizontal fairness should be improved.

Non-tax revenue

Concerted efforts are needed to boost non-tax revenue, particularly of municipalities where payment arrears for services contribute both to municipal dysfunctionality and to the financial distress of Eskom, national and regional water authorities, public transport providers and housing agencies. The accumulated debt to municipalities, mainly by households, amounted to over R160 billion in mid-2019.

Progress towards improved public health services and national health insurance also requires enhanced billing systems and revenue management in public hospitals.

There is a difficult balance to strike between revenue enhancement and appropriate relief for low-income households. In broad terms, the fiscal system aims to provide support for basic services through conditional grants and the equitable division of revenue. The targeting and effectiveness of these spending programmes is undermined, however, if appropriately structured service charges are not collected from those who can afford to pay.

Expenditure priorities

Following more than two decades of prioritisation of government programmes, policies and spending in support of social development, there is little scope for "shifting" funds from lower to higher priority activities. The broad functional distribution is spending cannot be expected to change significantly over the period ahead, though some adjustments to strengthen economic and employment-related services may be needed.

In the consolidated medium term expenditure framework of the 2019 Budget, total expenditure in 2019/20 is R1 827 billion, rising to R2 089 billion in 2021/22, or just over one-third of GDP.

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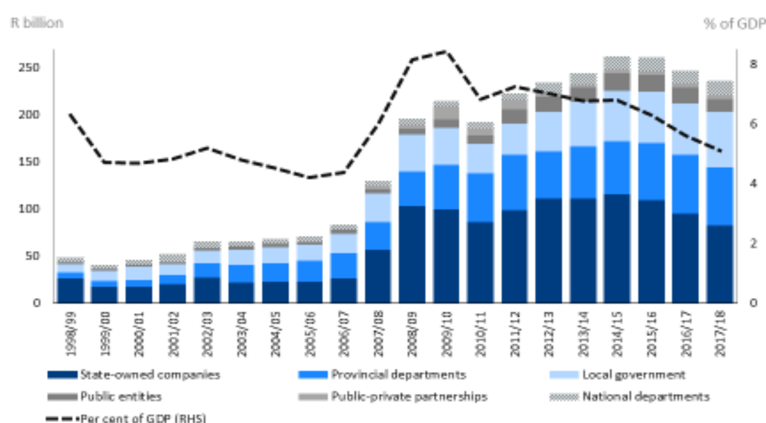
Education together with arts, culture, sport and recreation accounts for 24 per cent of allocated non-interest spending, health services 14 per cent, social development (mainly social grants) 17 per cent and community development (housing, public transport and municipal services) 13 per cent. This comprises the "social wage" of about 68 per cent of allocated expenditure.

The fastest growth, within these functions, goes to student financial aid, subsidies for TVET colleges, public transport (including commuter rail) and the HIV, TB, malaria and community outreach programmes of health departments. The core education, health and social protection programmes are budgeted to grow by around 7 per cent a year, within a budget framework that projects nominal GDP growth of between 7 per cent and 7.5 per cent a year.

Economic development and infrastructure spending amounts to about 13 per cent of the total; defence, police, justice and home affairs also about 13 per cent. These are set to grow more slowly than social functions – defence just 1.5 per cent a year, and police 5.9 per cent.

Alternative configurations are possible, but the room for manoeuvre is clearly limited while most spending functions are constrained to increase at or below population growth in real terms.



BER, July 2019. Source: National Treasury.

The constraint arises in part from slow economic growth, but it also follows from the allocations of about R30 billion a year in "payments for financial assets", mainly to Eskom.

The economic classification of spending similarly reflects little room for adjustment. Compensation of employees is just over a third of total spending, rising by just under 7 per cent a year. Transfers to households are 17 per cent of spending and transfers or subsidies to municipalities, higher education institutions, public enterprises and departmental agencies are 16 per cent of the total. Payments for capital assets are just 5.4 per cent of spending, projected to grow by 9.6 per cent a year.

Apart from machinery and equipment (just 1.3 per cent of the total), interest on debt the fastest growing category, at 10.7 per cent a year, averaging 11.5 per cent of total spending.

The shifts between spending categories are not dramatic, symptomatic of a consolidation rather than a reprioritisation budget. Faster economic growth would require a larger allocation to infrastructure and capital assets, a moderation of personnel spending and perhaps greater subsidies for agriculture, industry and enterprise development.

In practice, government spending on infrastructure and procurement of goods and services tends to lag behind budget allocations, particularly in municipalities and weaker departments. There are institutional capacity problems, but there are also administrative barriers to efficient implementation in the complexity of procurement regulations and conflicting objectives.

Consolidated spending

R million	2006/07	2017/18	Annual growth	% of 2006/07 spending	% of 2017/18 spending
	Outcome				
Current payments	**317 280**	**939 735**	**10.4%**	**61.2%**	**60.6%**
Compensation of employees	170 288	546 194	11.2%	32.8%	35.2%
Goods and services	91 506	223 521	8.5%	17.7%	14.4%
Interest and rent on land	55 486	170 020	10.7%	10.7%	11.0%
Transfers and subsidies	**171 241**	**507 740**	**10.4%**	**33.0%**	**32.8%**
Payments for capital assets	**28 491**	**81 746**	**10.1%**	**5.5%**	**5.3%**
Payments for financial assets	**1 435**	**20 318**	**27.2%**	**0.3%**	**1.3%**
Total	**518 447**	**1 549 538**	**10.5%**		

BER, July 2019. Source: National Treasury.

Public service remuneration

The Budget Review signals that "controlling growth in employees' salaries is central to government's efforts to increase productive investment and improve service delivery." Funds are set aside for early retirement costs as part of this commitment.

Public service remuneration for the 2019/20 and 2020/21 years is already agreed as part of the 2018 three-year wage agreement. Cost-of-living increases are set at 1 per cent above CPI inflation for salary levels 1-7, 0.5 per cent above CPI inflation for levels 8-10 and CPI for levels 11-12. The wage agreement also provides for pay progression for educators and police and corrections personnel at the same rate of 1.5 per cent as applies to the rest of the public service, and for improved housing benefits. The Treasury's estimate was that the cost of the agreement relative to the 2018 MTEF allocations was R7 billion in 2018/19, R10 billion in 2019/20 and R13 billion in 2020/21. Stringent measures have been required to meet these adjustments in the 2019 Budget, including an effective freeze on new appointments across much of the public service and some shifts of funding towards remuneration. Within the health service allocations, for example, R2.8 billion over the new MTEF period has been shifted from the NHI grant to cover intern and community service posts.

The public service wage bargain reflects a strong commitment of organised labour to protecting and improving the conditions of service of professional and administrative personnel. In the context of slow growth over the past decade, average earnings in the public service have increased somewhat faster than in the private sector.

Moderation in public sector wage setting is necessary over the period ahead, particularly if adequate real growth in education, health, policing and other services is to be achieved.

Two other public remuneration issues need to be flagged:

- At this stage the national minimum wage does not apply to EPWP and CWP workers. The cost of compliance with the minimum wage in government employment programmes would be about R4 billion a year, which would benefit some 500 000 households. These programmes should continue to be expanded, together with improved earnings, both as constructive development initiatives and as a redistributive and employment-enhancing fiscal adjustment.

- The public service post-retirement medical scheme benefit is manifestly unfair in its present form and is a rapidly rising unfunded liability. It should be incorporated into the funded pension dispensation on equitable and sustainable terms.

Extra-budgetary liabilities

Several substantial off-budget liabilities have to be dealt with, or they will remain barriers to both confidence and improved risk assessments of the South African economy.

- As much as half of Eskom's debt may need to be taken over by the fiscus. For long-term sustainability and an effective turnaround of the electricity sector, it is imperative that this should be accompanied by a restructuring of the industry that brings competition into the generation market and restores discipline in the collection of revenue from consumers and municipal distributors.
- The legislative reform of the Road Accident Fund has still to be completed. The unfunded liability of the RAF will still have to be funded alongside the new RABS arrangement. Greater certainty is needed on the way forward.
- Progress towards NHI will be endangered if a more cost-effective approach to medico-legal liabilities is not adopted.

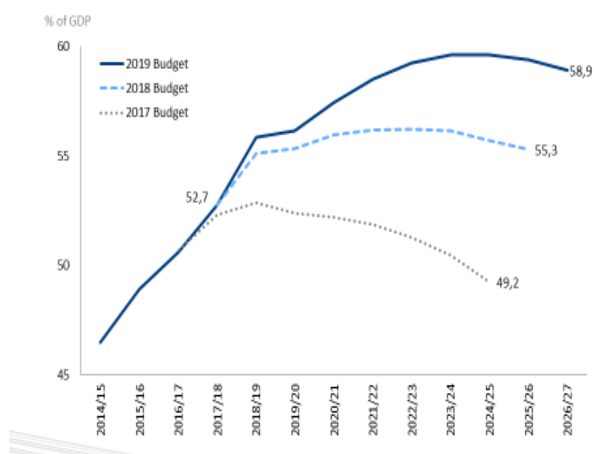
There is considerable complexity in these reforms, and in restoring financial soundness in other state-owned companies. The debate is sometimes couched in simplistic "privatisation" or "developmental state" terms – in practice, there are many ways in which the balance can be shifted between statutory or state-provided services and competitive or market-based arrangements. Systematic and well-sequenced reform paths are needed, with careful attention to both efficiency and fairness considerations. The central challenge is recapitalisation of Eskom and stabilisation of its finances.

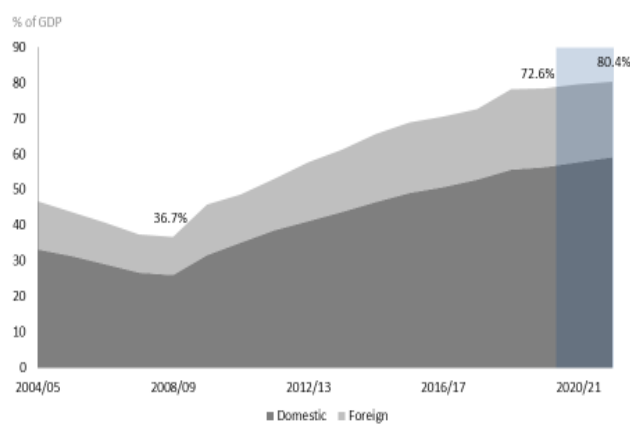
Fiscal policy in support of economic recovery

There is no credible room for conventional "pump-priming" fiscal support for faster economic growth. Heterodox measures are needed which could be broadly deficit-neutral in the medium term, but will contribute to longer term growth and deficit reduction. While debt remains high as a share of GDP, it is important to reduce the country's risk premium, resolve outstanding policy uncertainties, shift spending towards investment and address the balance-sheet weaknesses of Eskom and other state-owned companies.

While a period of fiscal consolidation is needed to stabilise the rising debt-GDP ratio, it is also important to avoid the negative shock of a deep austerity adjustment. Until confidence is restored and households and firms raise investment and increase borrowing again, the fiscus must continue to support a sufficient momentum of demand to maintain economic activity and forestall a self-inflicted recession. An accommodating monetary policy stance is an important complement to this imperative.

Lower inflation in the 1990s led to lower interest rates and contributed to rising investment and stronger growth in the 2000-2008 period. As the budget deficit was reduced, debt declined as a share of GDP, but slowly at first, given the dynamics of interest rate shifts and debt portfolio trends. Lower inflation might also contribute to lower interest rates, growth and an improved debt outlook in the period ahead, but the adjustment will take time and is compounded by the Eskom position, political contestation and governance challenges.





BER, July 2019. Source: National Treasury.

Where investment and growth can be supported through co-financing initiatives and support for private sector-led development, this should be prioritised. Examples include:

- *Housing finance* – whereas government funding has largely gone to wholly state-funded RDP housing programmes over the past twenty years, co-funding arrangements are now needed that blend DFI portfolio funding, credit-linked subsidies, scaled-up property developments and expanded bank funding of densification and urban development initiatives.
- *Small enterprise and venture capital funding* – whereas private sector and DFI initiatives have been largely separate in the past, greater collaboration is needed to scale up support programmes and ensure that risk is appropriately assigned and managed.
- *Municipal services* – substantial backlogs in electricity, water, sanitation and public transport infrastructure investment and maintenance need to be addressed. Better revenue management is a key to progress, as it unlocks municipal borrowing capacity and provides opportunities for private finance to be mobilised more effectively.
- *Industry and agriculture* – focused efforts are needed to distinguish subsidies, support programmes and tax incentives that work from those that don't, together with stronger consultation and collaboration in implementing sectoral programmes, special economic zones and local investment initiatives.
- *Education, training and skills development* – though government funding of student finance has been greatly increased, there are opportunities for complementary private finance for student housing, loans and vocational education. Substantial revenue flows through SETAs and the Higher Education budget, but there are serious delivery failures and quality programmes in both the skills training and further education systems. Greater business sector involvement is needed in coordination, management and quality assurance, organised across regions and in cities rather than through sectors.

In these and other areas of public policy, fiscal constraints have to be seen as the catalyst for doing things better, more cost-effectively and through enduring partnerships between local, regional and national stakeholders. It is also important that the financial environment should be conducive to investment-led growth, recognising that inflation pressures are subdued and there is limited fiscal capacity to finance accelerated development.

Financial deepening, investment, credit extension and inflation

Since opening up to international financial flows in the early 1990s, South Africa has relied on foreign savings to meet a gap of 3-4 per cent of GDP between investment and savings, largely through portfolio investment in JSE-listed securities and government bonds.

Growth in credit extension had in effect been constrained in the 1980s by foreign sanctions and thus the limits imposed by domestic saving. With the opening up of the economy, comparatively rapid restructuring of South Africa's corporate landscape and international financial linkages occurred. Dominant diversified domestic conglomerates have largely been dismantled, inward flows have raised foreign ownership of South African companies and public debt, and South African companies and individuals have invested substantially abroad. The international dimensions of ownership and investment decision-making in the South African economy are far more salient and inter-connected than 25 years ago. The domestic savings constraint has been lifted and until the 2008/09 recession a secular rise in financial intermediation occurred, including comparatively rapid growth in credit extension to both households and businesses. Though results have been mixed, debt financing of BEE transactions has contributed to diversifying ownership of corporate South Africa.

Although credit extension has not predominantly been driven by investment demand, during South Africa's high-growth phase from 2002 to 2008, gross fixed capital formation increased from 16 per cent of GDP to around 24 per cent. The ratio of gross savings to GDP also increased, though considerably more slowly – rising from 16 per cent in 2001 to 18 per cent in 2009-10.

However, investment fell back rapidly after the recession and in recent years has been about 18 per cent of GDP. The savings ratio has fallen to below 15 per cent.

The growth of monetary and credit activity since 1994 has been considerably greater than would have been required if finance were limited to the allocation of savings to meet investment requirements. Lifetime income smoothing by households, transfers of assets across generations, corporate restructuring and international diversification are also important functions of the financial system.

International opening-up has also been associated with an important change in the nexus between monetary management and inflation. Consumer price inflation came down sharply in the early 1990s, in part because of shifts in Reserve Bank policy, but also as a consequence of trade liberalization. This contributed to declines in inflation expectations and substantially lower interest rates, supported by the introduction of an inflation targeting regime. Exchange rate volatility remains an important source of upward or downward movement in price inflation, though the pass-through fades over a one- to two-year period. Domestic interest rate policy, furthermore, is unavoidably linked to interest rate setting in global financial markets, taking into account differences in inflation trends and expectations.

In the period since the recession, the financial environment has been considerably more restrictive. Against the background internationally of continued "quantitative easing" by major central banks,[4] the SARB has allowed money supply and credit extension growth to decline considerably relative to their elevated pre-recession levels, and money market interest rates have trended upwards since 2013. Following a spike in CPI inflation in 2007-08 after the 2006 exchange rate depreciation, consumer price increases have remained moderate, declining to between 4 and 5 per cent over the past two years.

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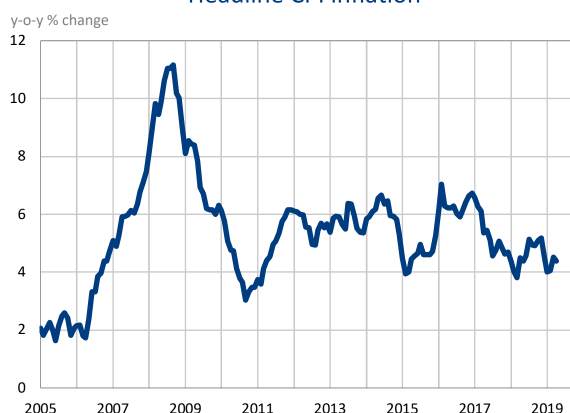
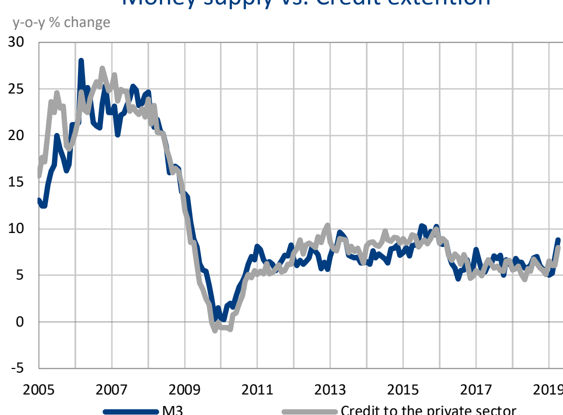
[4] The case for "quantitative easing" in South Africa's present circumstances is briefly considered in the Appendix.





BER, Trends June 2019.

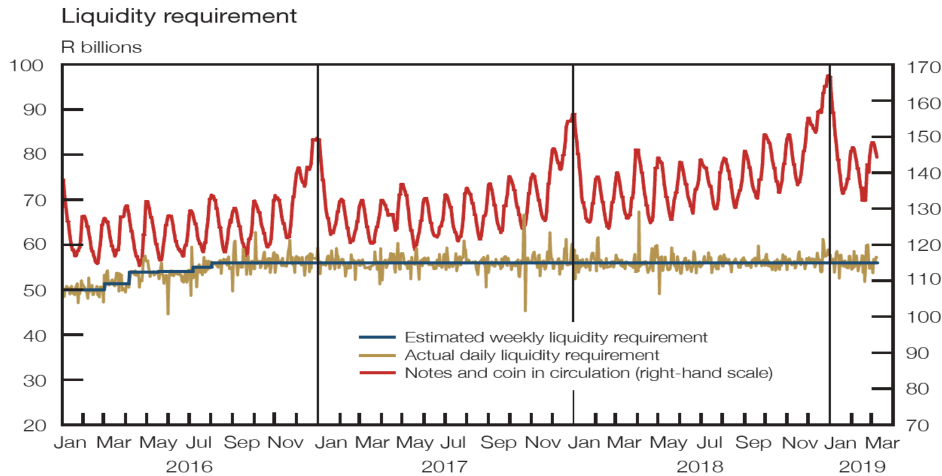
The trends since 2005 in headline CPI, money supply and private sector credit extension, short-term interest rates and the nominal and real effective exchange rates are illustrated above. A sharp depreciation of the rand in 2006 led to a two-year upward trend in inflation and rising interest rates. Following the 2009 recession, inflation, money supply growth and interest rates have settled at lower levels, and the real effective exchange rate remains somewhat weaker than its elevated 2005 level.

The role of monetary and financial policies in strengthening investment and social development are explored below, taking into account financial and price stability considerations.

Monetary Policy

The Money Market Shortage

A centrepiece of South Africa's monetary policy framework is the money market shortage, through which banks are obliged to borrow at the repo rate "discount window" to meet their cash reserve requirements. Since September 2016, the average daily liquidity requirement has been "purposefully" kept at R56 billion, up from around R10 billion a decade ago, through the SARB's liquidity management operations including forex forward swaps and purchases or sales of securities. The liquidity requirement means that the repo rate is transmitted directly through to the money market and to the associated lending rates of banks.



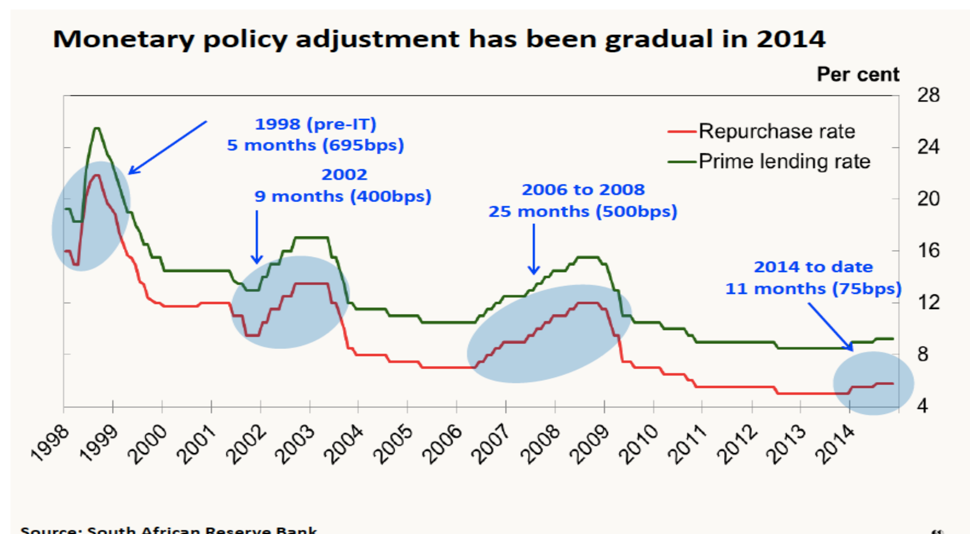
SARB, Quarterly Bulletin, March 2019.

The recent stable nominal market shortage represents a mild easing of liquidity conditions in real terms, though the relevance of this "classical" approach to monetary management in current circumstances is unclear. The signalling influence of repo rate decisions is in itself a transmission instrument, but broader credit market conditions and risk assessments come into consideration in determining the structure of deposit and lending rates applied to different categories of bank clients.

SARB policy rate adjustments

The SARB began to tighten monetary policy in 2014, emphasizing that its adjustment would be gradual and sensitive to prevailing economic conditions. The attached slide (taken from the Monetary Policy review presentation of December 2014) shows that upward adjustments had been considerably sharper in 1998 and 2006-2008, and there was a lengthy period of comparatively low interest rates subsequent to the 2009 recession.

The mild tightening of interest rates in 2014 was followed by several further increases in 2016, in response to a depreciation of the currency and the subsequent upward drift of CPI inflation. As inflation retreated and with growth very low, the repo rate was reduced on two occasions in 2017 and 2018, then increased in late 2018 and reduced by .25 percentage points in mid-2019.



SARB, Monetary Policy Review, December 2014.

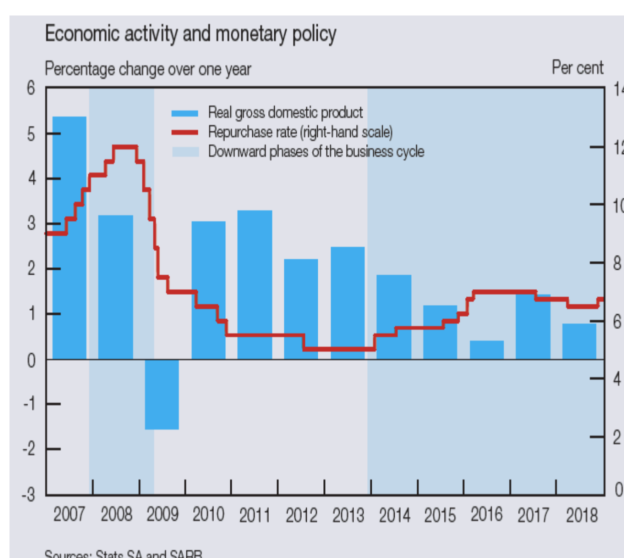
Over this recent period, the stated intention of the SARB has been to bring inflation closer to the midpoint of the target range. Lower inflation expectations, now clustered around 5 per cent, are an indicator of progress towards this goal. If market expectations do settle at the lower inflation level, this should contribute in time to somewhat lower nominal interest rates. However, the adjustment cost to the fiscus has been considerable, raising the real burden of the existing debt stock, contributing to the rising trend in government's debt-GDP ratio and dampening revenue trends. Account also has to be taken of the contribution of "administered prices," including the tariff increases required to meet electricity supply costs and improved municipal services, both to measured inflation and to restricting consumer spending capacity. At least to some degree, administered price increases and taxes are substitutes for interest rate adjustments in moderating consumer demand.

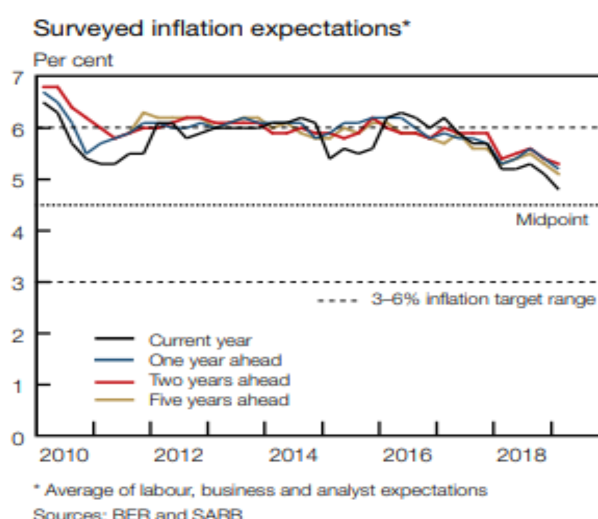
Interest rate setting – the Taylor Rule

Monetary policy in South Africa is guided by the Reserve Bank's quarterly projection model, which includes a "Taylor rule" formula for estimating the policy rate. Although the "rule" is not followed rigidly, there is a close correspondence between the actual repo rate and the formula-based rate.[5]

Named after US macroeconomist John Taylor, the Taylor Rule proposes that the policy rate should be set in relation to a "neutral" rate of interest consistent with stable inflation and the economy operating at full potential. The policy rate is adjusted upwards relative to the neutral rate if inflation is higher than its targeted stable rate, and downwards if the economy is operating below potential.

The formula relies on several "unobserved" variables, which themselves have to be proxied or estimated. The neutral nominal rate of interest requires an estimate of the neutral real rate. Drawing on international practice, the SARB bases its neutral rate assumption on estimates of the international neutral real rate, adjusted upwards for a South African country risk premium and changes in the equilibrium real exchange rate.





SARB, Quarterly Bulletin, March 2019.

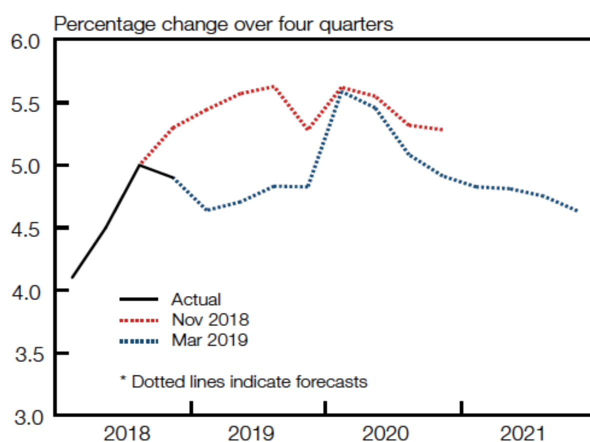
[5] See SARB, *Monetary Policy Review* October 2017, for an exposition of the Taylor rule and its application in the quarterly projection model.

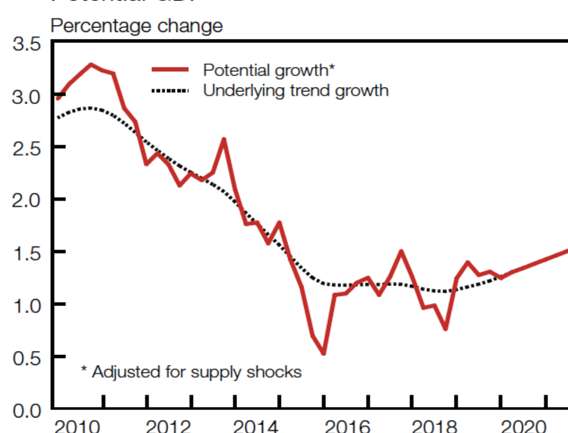
The SARB's Taylor Rule formula has the following structure, consistent with a strong bias towards interest rate stability while leaning against rising inflation. The nominal repo rate is determined by:[6]

- Four-fifths of the previous quarter's repo rate; plus
- One-fifth of the neutral nominal repo rate, adjusted by
    - 150 per cent of the difference between expected inflation and the target inflation rate, plus
    - 50 per cent of the output gap (the difference between actual GDP and potential GDP).

The target inflation rate is given by the midpoint of the target range (ie 4.5 per cent), and expected inflation is derived from survey data for 3, 4 and 5 quarters ahead. The SARB currently expects inflation to rise to about 5.5 per cent in 2020, and to decline thereafter.

Potential output cannot be observed. It is a notional concept, calculated through econometric applications designed to separate trend growth from cyclical disturbances, or to identify underlying production determinants.[7] Internationally, the level of unemployment is commonly regarded as an important indicator of the output gap. With high unemployment regarded as a "structural" feature of the SA economy, other constraints such as investment levels, electricity supply and international trade conditions are assumed to dominate over labour market considerations. Statistical approaches that focus on separating cyclical from trend growth in effect assume that economic output reverts to its potential as the effect of demand or supply shocks fade. The SARB currently estimates potential output growth at just 1.3 per cent, down from around 3 per cent in 2010.





SARB, Monetary Policy Review, April 2019.

[6] The Taylor rule formula in the SARB's quarterly projection model is the following:

$$i_t = 0.79 i_{t-1} + (1 - 0.79)\left\{i_t^* + 1.57\left[\frac{1}{3}(E\pi_{t+3} + E\pi_{t+4} + E\pi_{t+5}) - \pi^*\right] + 0.54(y_t - y_t^*)\right\} + \varepsilon_t$$

where i_t is the nominal repo rate, i_t^* is the neutral nominal repo rate, $\frac{1}{3}(E\pi_{t+3} + E\pi_{t+4} + E\pi_{t+5}) - \pi^*$ is the forward-looking CPI inflation gap and $y_t - y_t^*$ is the output gap.

[7] Nir Klein, *Measuring the Potential Output of South Africa.* Africa Department, International Monetary Fund, 2011.

With 2019 inflation below the mid-point of the target range, nominal GDP growth barely above inflation expectations, unemployment rising and retail market pricing power constrained by such weak demand, it seems clear that the SARB has considerable room to reduce the repo rate without risking an escalation of price increases. In relation to growth and investment, this would assist in accommodating a recovery in private sector credit extension.

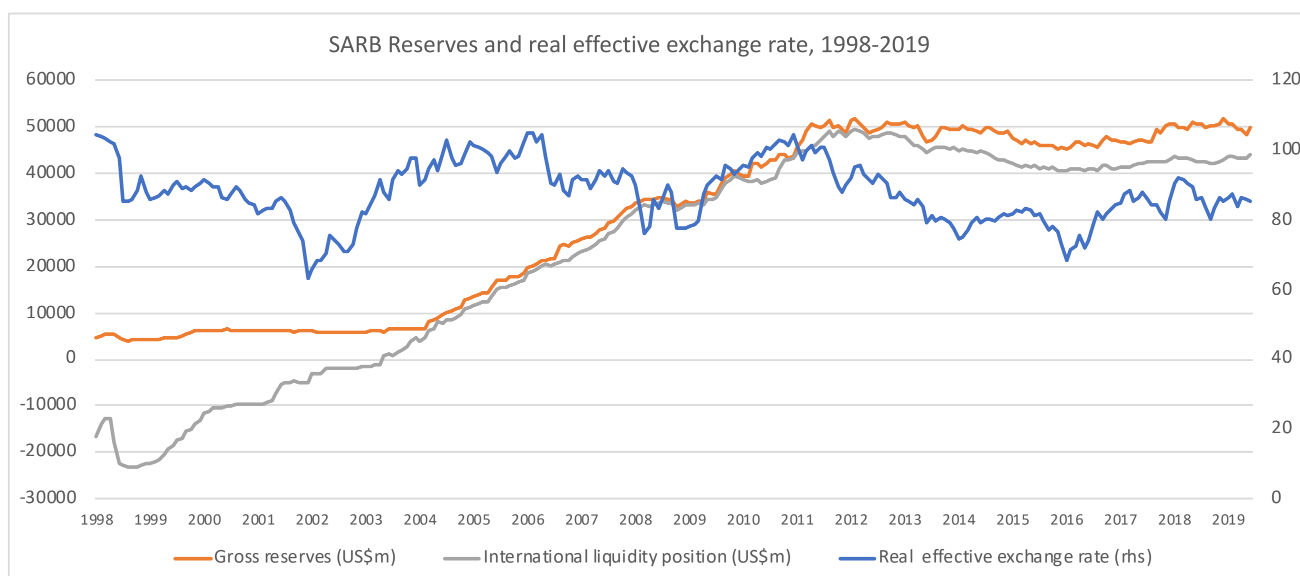
Monetary policy and the exchange rate

Lower interest rates might lead to a somewhat weaker exchange rate, though the transmission dynamics are not straightforward and at least in part dependent on unobserved expectations and investor confidence. Under conditions of uncertainty about the fiscal outlook and rising debt, the SARB's caution about easier monetary policy reflects, in part, concern about the impact of lower interest rates on the exchange rate and the resultant passthrough to inflation.

There is a strong presumption in South African monetary management that the exchange rate cannot be targeted, and that left to determine its own level it contributes to financial stability as a "shock absorber".

The rand is highly traded internationally, and so there is merit in this argument. But there are also good reasons for thinking that South African manufacturing competitiveness and export growth potential are negatively affected by both exchange rate volatility and periods of comparative over-valuation of the rand. This particularly affects more labour-intensive sectors, such as clothing and textiles, furniture and horticulture.

Though a targeted value of the real exchange rate may be impractical, interventions from time to time to lean against over-valuation of the rand are possible. This has contributed, in the past, to an accumulation of reserves and improvement in the SARB's international liquidity position, in turn providing a degree of protection against external shocks.



SARB, Gold and foreign exchange position.

Until about 2011, an understanding between the SARB and the National Treasury allowed the monetary impact of the Reserve Bank's accumulation of foreign reserves to be offset by issues of government bonds for non-funding purposes, although by the end of 2009 the inflation risk had

abated and a more expansionary monetary stance was emerging. The resulting balances, credited to the Treasury, have contributed to the accumulation of profits in the Gold and Foreign Exchange Contingency Reserve Account, estimated as R278 billion at the end of January 2019.

Interventions to accumulate reserves and lean against over-valuation of the rand appear to have been in abeyance since 2011, when the rand began to weaken. The international liquidity position peaked at USD 49.6 billion in February 2012, with the rand at R7.40 to the USD. The international position currently stands at about USD 44 billion, with the rand around R15 to the USD. Arguably, with the benefit of hindsight, both the international reserve position and the competitiveness of South African industry would have gained from stronger interventions to counter the comparative strength of the rand in real terms in 2010-12 and in 2017 and 2018.

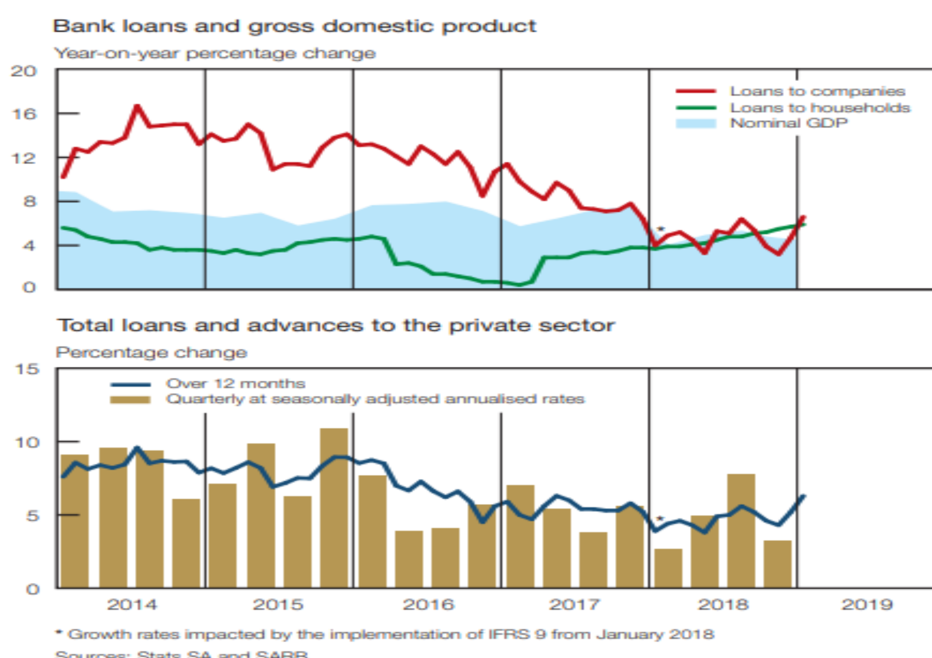
Private sector credit extension

South Africa is now in its longest recorded cyclical downturn of some 5½ years, characterized by rising unemployment, persistent deleveraging by households and sluggish business investment.

Following a marked slowdown in the years following the recession, private sector credit extension has broadly kept pace with nominal GDP over the past five years, but lending has largely been to companies in distress while loans to households have increased considerably more slowly than the overall economy.

Shifting trends in lending to households and enterprises

Household debt has fallen from over 85 per cent of disposable income at its peak in 2008 to just over 70 per cent currently. Debt service costs have moderated to below 10 per cent of disposable income. Many households are nonetheless still under stress, both as a result of the wealth effects of equity losses and because of the higher payment obligations associated with instalment credit and unsecured loans.

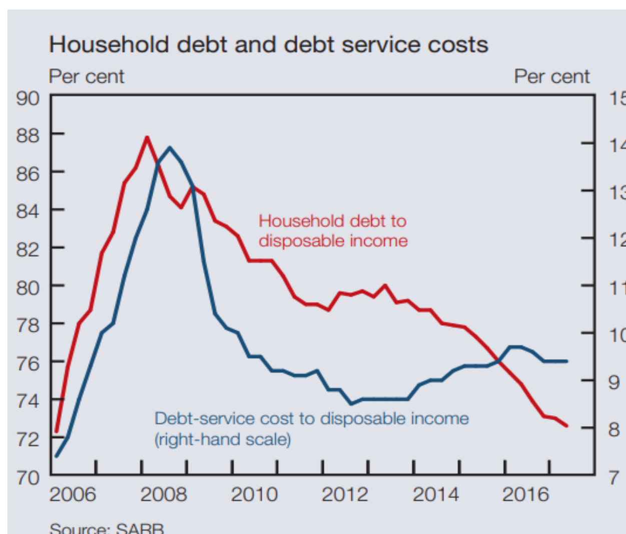


SARB, Quarterly Bulletin, March 2019.

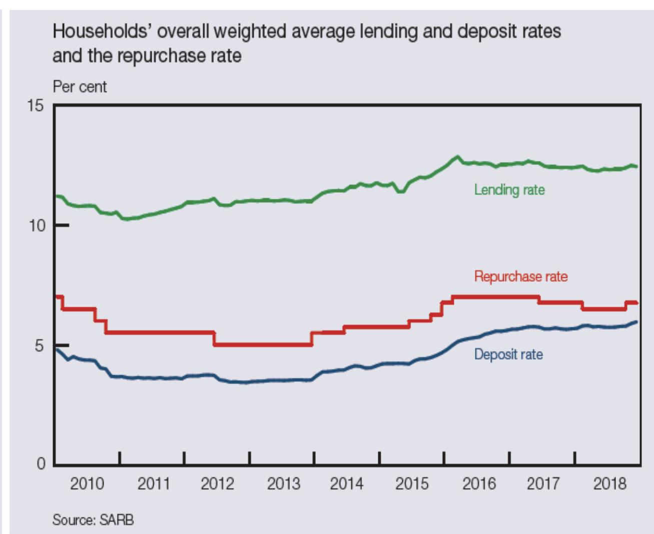
In the period 2008-2013, although the repo rate was rapidly reduced, borrowing costs to households or businesses did not decline as much. Mortgage lending fell relative to unsecured lending and instalment sales, as banks imposed more stringent risk assessment of clients, partly in response to tighter capital adequacy standards. Over the period 2008-2018, mortgage advances increased by 4.7 per cent a year, while "general loans" increased by 11.4 per cent. Total credit extended to the private sector increased by 7 per cent a year, whereas monetary sector credit to government increased by 19 per cent a year.

Slow growth in mortgage lending reflects in part a weakening in the maturity transformation function of banks in the wake of the recession and subsequent regulatory reforms. It also reflects lack of progress in affordable housing delivery and insecurity in household incomes. More broadly, it signals a coordination failure in housing, urban development and the financing system. In the context of South Africa's legacy of spatial fragmentation, under-investment in the built environment and the need for accelerated restructuring of land and property ownership, this transfer facilitation function of the financial system serves a vital transformation purpose.

The relative decline in mortgage lending after 2008 and tightening of credit standards has led to somewhat higher average lending rates to households, now close to 10 per cent in real terms. Deposit rates have also trended upwards as banks' competition for funds has intensified.



SARB, Monetary Policy Review October 2017.



SARB, Quarterly Bulletin, March 2019.

In sum, private sector credit extension has not yet regained momentum since the recession, households and smaller businesses face higher real interest rates than a decade ago and the banks' role in maturity transformation has weakened as longer-term mortgage finance has given way to unsecured and short-term credit facilities. Of particular concern is the continued deterioration in lending for property development and home improvements, as this is so central to social and economic development and improved living standards. Slow growth and volatility in financing of business investment are also inimical to sustained growth and employment creation.

Access to finance and income distribution

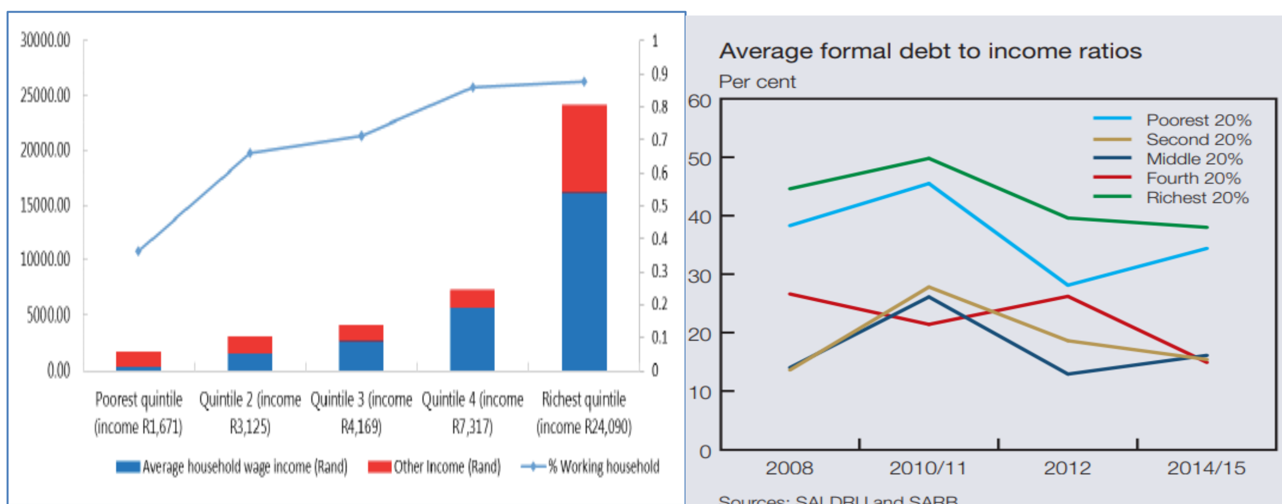
Of special importance in South Africa's circumstances is the pattern of household borrowing relative to income distribution.

Not only is household income higher unequal – the top quintile accounting for over 60 per cent of income – but access to finance is also unbalanced. Survey data illustrated below shows that debt to income ratios are highest for the top quintile and bottom quintile of the income distribution, and lowest for the middle quintiles. Within the top quintile, the debt burden is particularly high for "upper middle-income" households in the ninth and lower tenth decile, rather than the highest income groups.

Comparatively low levels of debt in the middle-income groups of the overall distribution reflects perhaps their employment and earnings vulnerability during periods of slow economic growth. But it also reflects the substantially higher interest and debt service costs faced by lower-income borrowers.

Improved access of middle-income households to lower cost long-term debt would appear to be sustainable without imposing undue burdens on affordability, in a context of rising employment and earnings. This is a central benefit of improved income distribution and household income security – a "virtuous circle" effect – though its contribution to development and improved living standards has to accompany enduring improvements in growth and structural change.

In the context of rising inequality in many countries, and the growth of finance as a share of economic activity and locus of decision-making power, the global recession of 2008-09 has provoked debate about the role of finance, its regulation and its contribution to reinforcing or countering income and wealth inequality.[8] In line with developments internationally, South Africa has undertaken considerable regulatory reform of its financial sector, alongside improved surveillance and more stringent reporting requirements. The separation of prudential from market conduct regulation should assist in enabling distributional and financial access issues to be better understood and more proactively addressed, as part of a broader financial inclusion agenda.



IMF, Country Report No. 17/189, 2017. ***SARB, Monetary Policy Review October 2017.***

Municipal borrowing and infrastructure requirements

Government's infrastructure financing requirements are largely local or municipal, and are mainly concentrated in the nine metros and 19 secondary cities, and associated transport operators, water

[8] A brief discussion of "modern monetary theory" perspectives is provided in the Appendix.

boards and electricity distributors. Metropolitan rail infrastructure and commuter services are housed in a nationally owned entity, PRASA, but are functionally local or regional services.

District municipalities vary in their functions and capabilities, but typically oversee water and sanitation functions on behalf of their constituent local councils. Water boards are national entities, but they are best thought of as service providers to local or district municipalities.

The architecture of the financing of local infrastructure and related services is therefore rather complex. Municipalities receive substantial grants for operating and capital purposes from the National Revenue Fund, in effect benefiting from the national revenue base and its borrowing capacity. But these transfers are strongly biased towards local and district municipalities and for services to low-income communities. They serve an important redistributive purpose, but are not designed to support self-financing urban development or industrial infrastructure requirements.

Faster and sustained economic growth requires a substantial acceleration in investment in municipal infrastructure and services. This is not just about facilities and services that meet households' consumption needs adequately, it is also about investing in the logistical efficiency and capabilities that sustain technological progress, employment creation and enterprise development as urbanization and economic diversification proceed. Without these investments, economic growth will stutter and social progress will die.

Support for municipal investment through capital grants from national government is not enough – there also has to be investment in capacity for future requirements financed through debt and private capital-raising. The proliferation of conditional grants has also arguably distorted investment patterns and tied up project management and engineering capacity, undermining necessary maintenance and long-term investment programmes.

Consolidated municipal cash flows - 2007/08 to 2018/19

R million	2007/08	2016/17	2017/18	2018/19	Average annual growth
Operating activities - cash receipts	**127 508**	**283 016**	**306 287**	**341 134**	9,4%
Of which: Intergovernmental operating transfers	*23 500*	*68 469*	*80 548*	*78 752*	11,6%
Operating activities - payments	114 460	265 888	281 816	326 554	10,0%
Surplus/(deficit) from operations	**13 048**	**17 128**	**24 471**	**14 580**	
Intergovernmental capital transfers	13 469	34 248	32 262	38 347	10,0%
Cash surplus/(deficit) after capital transfers	26 517	51 376	56 733	52 927	
Payments for capital assets	**29 958**	**48 748**	**55 560**	**51 143**	5,0%
Cash surplus/(financing requirement)	(3 441)	2 628	1 173	1 784	
Memo: Outstanding debt (end of year)	**29 667**	**62 043**	**62 512**	**67 286**	7,7%
% of GDP	1,4%	1,4%	1,3%	1,3%	

Source: National Treasury

On a consolidated basis, South African municipalities have low levels of debt – less than 1.5 per cent of GDP and 15 per cent of their revenue.[9] It is mainly owed to the DBSA rather than raised from the capital market. On an inflation-adjusted basis, municipal debt has not increased over the past 25 years, despite rapid urbanisation and rising infrastructure requirements. National Treasury data show that in the 2017/18 and 2018/19 years, municipalities recorded consolidated cash-flow surpluses from their operating and investment activities, paying down their debt or increasing cash holdings. Actual

[9] National Treasury, *Municipal Borrowing Bulletin*, Issue 12, March 2019.

payments for capital assets in 2018/19 were R51.1 billion, 25 per cent below budget and R4.4 billion less than in 2017/18.[10]

These results reflect a potentially catastrophic collapse of construction and maintenance of infrastructure and municipal assets. Although municipal revenue and billing systems need to be strengthened, this is not the problem. Since 2007/08, local government operating receipts have increased from R128 billion to R340 billion, an increase of 9.4 per cent a year. Capital expenditure has increased from R30 billion to R51 billion, or 5.0 per cent a year, representing a substantial decline in real terms.

There is considerable variation in the financial position of municipalities and associated entities. Assessment of the accounts is complicated by comparatively large accruals of both revenue owed and bulk payables. But the overall cash position, which mainly reflects the healthy financial position of the metros and large cities, indicates that substantial operating surpluses are generated and debt is well within prudent limits. However, far greater investment in infrastructure is needed, together with improved revenue management, higher levels of borrowing and appropriately structured private finance.

The problem here is neither monetary policy nor availability of capital. It is in the management of infrastructure assets, municipal planning, budgeting and procurement activities, and weak coordination between municipalities and associated utilities and service providers.

Macroeconomically, the deterioration in municipal infrastructure spending over the past decade represents a direct subtraction from GDP of at least 1 per cent,[11] and substantially more in sustainable growth potential. Looking forward, a boost to construction spending equivalent to 1 per cent of GDP financed through municipal borrowing, taking into account the level of under-utilised capacity in the sector and its comparatively low leakage through imports, would raise GDP by at least this amount and raise government revenue, without undue risk to inflation or financing capacity.

Conclusion

A substantial moderation in both overall inflation and the trend in consumer prices has been realized over the past decade. GDP inflation averaged 8 per cent a year over the 2008-2010 period, and headline CPI inflation averaged 6.7 per cent. Last year, GDP inflation was 3.9 per cent and CPI inflation was 4.7 per cent. This has been achieved in part through somewhat tighter monetary policy since 2014. The decline in inflation also reflects the depressed state of the economy, the absence of firms' pricing power and continued deleveraging by both households and businesses. The unexpected decline in GDP inflation in 2018 accounts in part for the downward revisions in government revenue and worsening of debt-GDP ratios in 2019 and for the period ahead.

It is hard to judge to what extent higher growth and employment might have been achieved if monetary policy had been more accommodating. There are some advantages in lower inflation, though it contributes to a more rapid rise in public debt relative to GDP and puts businesses under

[10] National Treasury, *Local Government Revenue and Expenditure: Fourth Quarter Local Government Section 71 Report (Preliminary Results) for the period 1 July 2018 – 30 June 2019.* Issued 3 September 2019.

[11] Calculated on the assumption of capital spending growing at the same rate as operating income over the past decade.

stress if wages, electricity and other costs continue to rise at higher rates. There is a risk that inflation expectations will rise again, if prices rise in response to tax increases, rand depreciation or wage pressures.

More broadly, monetary management has to be located within the wider context of strengthening capital adequacy within the financial sector, policy uncertainty and deteriorating business confidence over the past decade. Households have chosen to curtail their borrowing and businesses have been cautious about debt sustainability and future income growth. Government investment, and particularly municipal infrastructure spending, have been held back by management challenges and coordination failures.

For the period ahead, household and business balance sheets are in better health and cities are strengthening their capacity to plan and execute infrastructure development programmes. While national government finances remain under stress, investment and growth need to come from increased financing targeted at housing, municipal infrastructure, enterprise development and trade promotion.

South Africa's macroeconomic policy framework cannot be focused only on containing public debt and lowering inflation, it also has to support the structural changes needed to improve growth performance and employment: higher investment, more labour-intensive industry, urban investment and housing, industrial diversification and trade competitiveness.

The changes required, the structural shifts necessary to build momentum in growth, employment and broader economic participation, are unlikely to emerge from separate programmes of fiscal, industrial, monetary, financial, urban and labour market policy adjustments, from supply- or demand-side efforts alone, or from government and business operating on separate tracks. A slow-growth trap is a many-person prisoners' dilemma, in which coordinated action is required and no single player can be expected to take the steps required in the absence of collective assurances and a shared strategy.

Appendix

Balance sheet recession

In the wake of its asset price inflation bubble of the 1980s, largely debt-financed, the Japanese economy experienced a long period of low growth, and low or negative inflation. Domestic demand remained weak despite historically unprecedented low interest rates and persistent fiscal deficits.

In an important study of this period of extended economic stagnation, Richard C Koo argues that its cause was not structural weakness in the Japanese productive economy or inadequate access of households or firms to finance, but a collapse of demand for credit triggered by a “balance sheet recession”.[12]

The collapse of asset prices after the 1980s boom led businesses to pay down debt rather than invest. Despite low interest rates, the private sector demand for credit was negative. For nearly twenty years, nonfinancial corporations sought to reduce their debt levels rather than pursue profit opportunities and expand activity.

Falling asset prices after 1990 led to a loss of wealth equivalent to three years of Japanese GDP. This “balance sheet effect” caused an extended decline in private sector demand. Economic output, incomes and employment were maintained only through a long period of substantial budget deficits and a rising debt-GDP ratio.

Although the circumstances of the US and Europe in 2009 were different in some respects, this “balance sheet” analysis of the Japanese experience was influential in persuading central banks and finance authorities to persist with large-scale purchases of financial assets to keep interest rates low and maintain demand following the recession.

Quantitative Easing

In the wake of the 2009 recession and the collapse of confidence in financial institutions following losses in the US subprime housing market and debt problems in several EU countries, the leading central banks of the world embarked on huge asset purchase programmes, known as “quantitative easing”. Initially targeted at distressed banking and corporate assets that investors were no longer willing to hold, extraordinary central bank holdings now include a wide range of government bonds, and financial and nonfinancial corporate securities.

The effects of quantitative easing have been to relieve financial markets of a substantial overhang of troubled assets, to assist banks and financial institutions to restore the health of their balance sheets and to keep interest rates low. The associated injection of liquidity into financial markets has supported asset values while countering deflationary tendencies, but has not (yet), despite ten years of substantial expansion of central bank balance sheets, led to inflationary pressure through consumer demand.

Following the 2009 recession, the SARB lowered the policy repo rate substantially, but did not embark on unconventional asset purchases. South Africa’s major banks and financial institutions remained sound and the economy initially recovered moderately well to the combination of conventional monetary easing and fiscal stimulus.

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[12] Richard C. Koo, ***The Holy Grail of Macro Economics: Lessons from Japan’s Great Recession.*** John Wiley, 2009.

With the weakening of commodity prices after 2012 and deteriorating investor confidence, the recovery lost momentum. However, the SARB raised the repo rate over the 2013-2015 period, concerned about rising inflation. As this increased real interest rates somewhat, it arguably contributed to an already deteriorating growth trend, though it is hard to judge to what extent.

In the context of government's constrained fiscal and debt position of recent years and Eskom's weakening balance sheet, the possibility of "quantitative easing" adapted to South Africa's circumstances has come under consideration. Superficially, it seems unnecessary that unconventional central bank measures should be adopted while there is still room for interest rate reductions. But monetary policy has always involved a mix, explicit or implicit, of price and quantity instruments – the policy rate, and bank reserve requirements or open market operations that influence monetary quantitative aggregates.

At its most fundamental level, quantitative easing is about the ability of the monetary authority to take a wider systemic view, over a longer time horizon, than any individual market participant. It is an expansion of a collectively held portfolio on behalf of society as a whole in order to reduce risk, limit contagion effects across financial markets and assist in restoring long-term investor confidence.

By keeping interest rates lower, for longer, quantitative easing has assisted in restoring value and liquidity in global capital markets. This does not mean that debt liabilities have been extinguished – rather, it has facilitated debt restructuring and burden-sharing, allowing more time for countries, financial institutions or businesses in difficulties to restore balance sheet sustainability.

A difficulty with the quantitative easing proposal in South Africa's circumstances is that it would not, in itself, reduce either the government's or Eskom's debt. Purchase of Eskom or government securities by the SARB would leave their debt liabilities unchanged. Furthermore, these are not distressed assets ("junk bonds") trading at discounted values, and so there would be no gain to investors, over time, from the restoration of liquidity or solvency. Eskom bonds are mainly guaranteed and so investors have not, as yet, suffered losses.

If Eskom's balance sheet is to be made good without imposing a loss on investors, its debt liability will have to shift to the fiscus and to taxpayers. The central bank can assist in distributing this burden over time, but the guarantee mechanism means that the losses of a utility that cannot be recovered through future tariffs have to be met by the fiscus.

Furthermore, a SARB holding of government debt would not in itself reduce the budget deficit or the trend in the debt-GDP ratio. Central bank holdings of Eskom bonds would not change the incentives or dynamics of its institutional restructuring.

What remains is to consider the possible impact of SARB asset purchases on interest rates and the capital market. Reserve Bank asset accumulation could lead to lower long-term rates and assist in supporting long-term investor confidence. But if SARB intervention in the capital market is seen as signalling a deferral of necessary policy shifts or weakening of financial discipline, its negative impact on investor sentiment would offset any such benefit. The appropriate conclusion appears to be that the SARB could only usefully support the capital market in the context of credible growth, fiscal consolidation and Eskom restructuring strategies.

The same conclusion applies to the monetary impact of Reserve Bank asset purchases. Quantitative easing would enable banks to expand credit or fund managers to diversify into other productive investments. But if businesses and households remain pessimistic about growth and unwilling to borrow, access to liquidity will not be transmitted into capital formation, business expansions or household investment.

ASISA

Modern Monetary Theory

Building on the idea that money is a construct over which the state exercises monopoly control, a broad school of thought has emerged in recent years that argues that government budgets do not face absolute financial constraints.[13] This heterodox approach to modern macroeconomics is associated with a critique of modern economies as excessively "financialised," in ways that reinforce the power of elites and their influence over wealth and income distribution.

Though the theory emphasises that sovereign governments can finance budget deficits through issuing money, it is recognised that there are real productive and resource constraints that limit consumption and investment capacity. The power of money creation has to be exercised with regard to these constraints. In modern economies, money creation is effectively outsourced to banks through the fractional reserve regulatory framework overseen by the monetary authority or central bank. Modern monetary theory argues that this oversight is an instrument of economic management over which states should exercise more control, complemented by the direct monetary mechanism of the budget deficit.

Though governments may run deficits, these represent surpluses of other economic sectors – households, firms or the external sector. External debt is subject to costs or resource constraints that do not apply to domestic debt – in a phrase that echoes earlier Keynesian arguments, if we "owe it to ourselves" then debt should not be construed as a burden on future generations. Quantitative easing, in this approach, is seen as the refinancing of government (and other) debt through the creation of reserve money by the consolidated government-central bank.

Modern monetary theory rejects the idea that the economy should be "steered" by central banks raising or lowering interest rates – the "natural rate of interest in a world of fiat money is zero, and…pegging it higher is a giveaway to the investor class."[14] Economies should, instead, be managed by the fiscal instruments of taxation and spending. Inflation can be controlled through these instruments, together with bond issues that draw savings into the fiscus for productive allocation. Governments, on this view, should not regard the budget deficit as a constraint limiting the pursuit of full employment. Modern monetary theorists argue that "job guarantees" should be central to public policy in modern states.

Mariana Mazzucato, for example, argues that modern economies reward activities that "extract value" rather than create it, particularly through advanced financial services activities that capture rent in unproductive ways, distorting the distribution of income and wealth. She argues that our conventional measures of growth and GDP fail to distinguish appropriately between productive and unproductive activities.[15]

An interesting variation on this perspective was published by Adair Turner, the former head of the UK Financial Services Authority, drawing on his experience in responding as a regulator to the 2008 financial crisis and its aftermath. Turner argues, on the one hand, for much stricter capital adequacy

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[13] Modern monetary theory has antecedents in post-Keynesian and earlier monetary writing, such as Abba Lerner's 1947 article, *Money as a Creature of the State*, and Hyman Minsky's work on financial instability.

[14] Peter Coy, Katja Dmitrieva and Matthew Boesler, *Bloomberg Businessweek, 21 March 2019.*

[15] Mariana Mazzucato, ***The Value of Everything: Making and Taking in the Global Economy***. Penguin, 2019.

and other restrictions on bank lending, and on the other hand, for a greater role of government finance in creating and allocating money and spending power.[16]

Modern monetary theory has come under strident criticism recently, particularly in its potential application in developing countries reliant on foreign savings and at risk of excessive government spending fuelling inflation.[17]

[16] Adair Turner, ***Between Debt and the Devil: Money, Credit, and Fixing the Global Economy.*** Princeton University Press, 2016.

[17] See, for example, articles by Kenneth Rogoff and Sebastián Edwards in *The Big Picture: Modern Monetary Disagreement,* Project Syndicate, 2019.