



Shaping macroeconomic outcomes

Chris Loewald

ERSA Policy Paper 23

July 2017

Shaping macroeconomic outcomes

Chris Loewald¹

May 2017

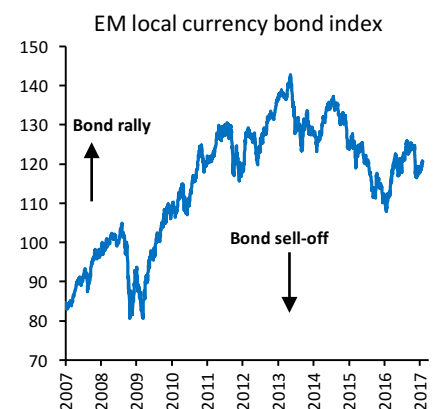
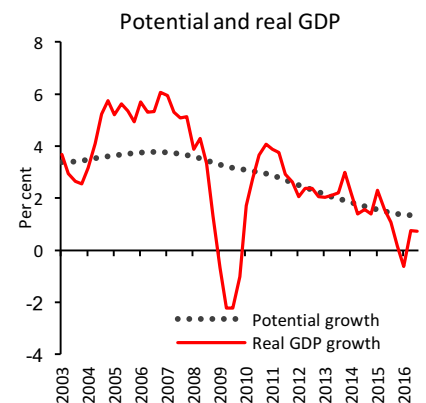
Introduction

By early 2016, financial market participants had become increasingly critical of unsustainable current account deficits and low, unbalanced growth in many emerging economies. In response, adjustments have occurred (or are in process) in a wide range of countries – including Russia, Brazil, Mexico, Colombia, Ghana – gradually guided by policy in some instances and much more abruptly forced by recession in others. South Africa's trajectory lies somewhere between – with some decline in the current account deficit in late 2016 and into 2017, but few clear steps to shift the composition of economic growth to something more sustainable. The recent current account moderation has fallen on the private sector, resulting in very weak investment and economic growth.

This ambiguous condition and poor growth outcomes reflect the approach taken in the immediate wake of the global financial crisis to be supportive of aggregate demand while waiting for a recovery in global growth to lift the economy. This policy has lasted for nearly a decade because of supportive global financing conditions, initially low debt levels and robust terms of trade. While sustainable for a long period of time, and an important expression of counter-cyclical policy, it has become progressively less effective and ultimately endogenous to the poor growth performance, persistent inflation and external vulnerability besetting the economy. Public borrowing is not generating economic growth. The potential growth rate of the economy, as well as it can be measured, has fallen to around/below 1% today.²

A new approach to policy would move beyond the usual recommendations – either that macroeconomic policy can be more expansionary or that it is helpless without electricity supply and structural reform. The economic problem has deepened – addressing rising external and internal financing costs and falling export revenues with either of these approaches is inadequate. Policy should seek to reverse the decline in potential growth of the economy and boost job creation and exports in ways that reduce external imbalances.

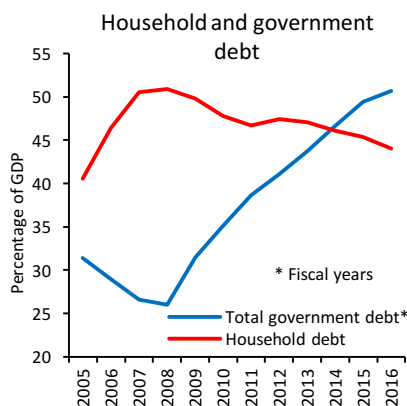
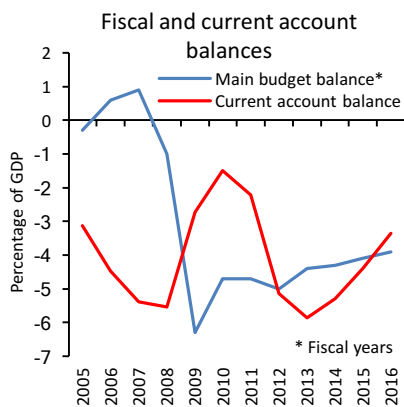
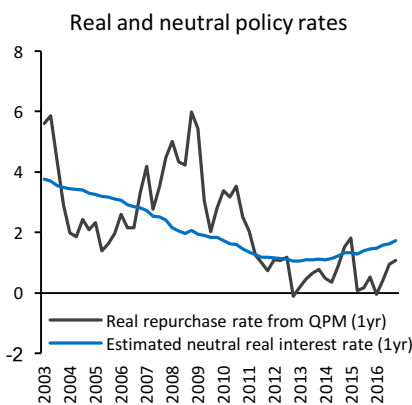
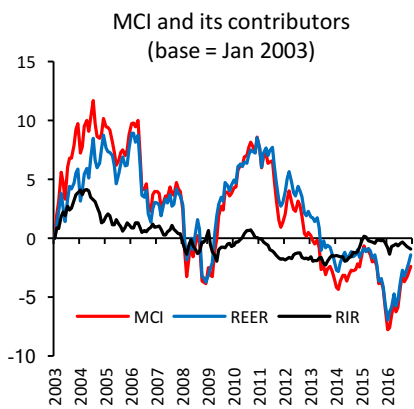
That can be achieved with a more investment and growth-oriented fiscal policy and a tweaked monetary policy framework that better supports it via a lower long term cost of capital.³ With structural reforms and consistently lower inflation rate, a more persistently competitive real exchange rate could also be achieved. Less expansive macroeconomic policies will strike some as counter-productive when factor use is low, but this misses two crucial points



¹ The author is grateful to David Fowkes, Andreas Woergoetter, Erik Visser and Konstantin Makrelov for their comments and assistance. The views in this article are the author's own.

² J Fedderke and D Mengisteab, 'Estimating South Africa's output gap and potential growth rate', *South African Reserve Bank Working Paper Series No. WPP/16/02*, March 2016 and V Anvari, N Ehlers and R Steinbach, 'A semi-structural approach to estimating South Africa's potential output', *South African Reserve Bank Working Paper Series No. WP/14/08*, November 2014.

³ B Cournède, A Goujard and A Pina, 'How to achieve growth- and equity-friendly fiscal consolidation? A proposed methodology for instrument choice with an illustrative application to OECD countries', *OECD Economics Department Working Paper Series No. WP1088*, October 2013.



about the economy – supply does not respond to higher inflation and the real exchange rate is important for sustainable growth. Rather, higher inflation simply entrenches the existing structure of the economy, the bias against exports and import-competing activities, and works against sustainably higher employment levels in tradeables sectors, especially for less skilled workers. Moreover, the economy is insufficiently flexible to quickly price recently unemployed labour and capital back into production (and least of all into tradeables sectors), resulting in an output gap that disappears over time and a higher rate of unemployment. This implies that macroeconomic policy cannot be managed according to purely cyclical considerations. In a small open economy cyclical indicators of economic growth matter less than in a large closed economy. This does not mean that short-term cyclical conditions should be ignored, but that rather that they need to be analysed in a longer-term framework that places a premium on the sustainability of near-term outcomes.

In this short paper I try to outline a revised macro approach for South Africa. First I discuss the response to the crisis and why it resulted in less of a recovery than expected. Second I look at the current account deficit and what keeps it large. The remainder of the note then unpacks the adjustment that the economy needs and the monetary and fiscal frameworks that could generate better economic outcomes.

Macroeconomic responses expand vulnerability

Six years after the worst of the global financial crisis, South Africa’s weak economic growth and external imbalances remain, despite a robust counter-cyclical macroeconomic policy response. The real policy rate has been persistently negative and fiscal deficits have been large, keeping up spending by both the private and public sectors and sustaining a significant current account deficit.

Public spending and debt sustainability

In the wake of the global financial crisis, fiscal policy supported the domestic economy with aggressive spending over and above automatic tax stabilisers.⁴ This resulted in rapid public debt growth of a cumulative 80% in merely seven years, from 27.1 to 49.4% of GDP. The largest increases in debt occurred between 2009 and 2012. The debt level rose to be roughly in line with emerging market norms, but because this rise outpaced that of other economies it reduced the relative and comparative advantage South Africa had in risk premiums and affected the economy’s financing costs. I return to this later.

In terms of economic growth, the rise in debt, despite the seemingly moderate overall level, hides two constraints.⁵ One is the proportion of overall spending that is relatively less productive than it could be. The post-crisis fiscal stimulus was dominated by strong growth in the state wage bill (which rose from 12 to 16% of GDP), driven initially by higher public wages and later by rising public sector employment.⁶ Relative to emerging market peers,

⁴ The tax-GDP ratio would have fallen 2 percentage points, which in itself was significant stimulus.
⁵ For a discussion of debt and economic growth, see C M Reinhart and K S. Rogoff, ‘Growth in a time of debt’, *NBER Working Paper Series No. 15639*, January 2010.
⁶ In real terms, public sector wages per worker increased post-crisis by 1.62 percentage points per year before the start of the fiscal consolidation program, which started in late 2013. See International Monetary Fund, *South Africa: 2016 Article IV Consultation*, 2016.

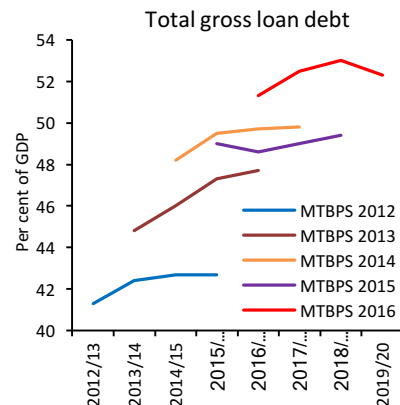
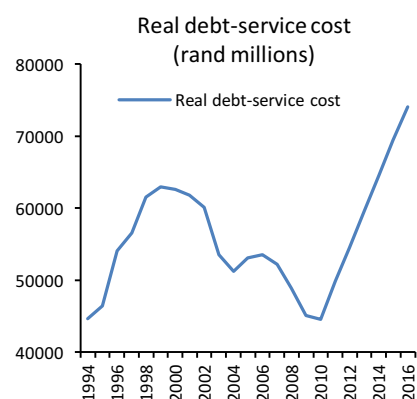
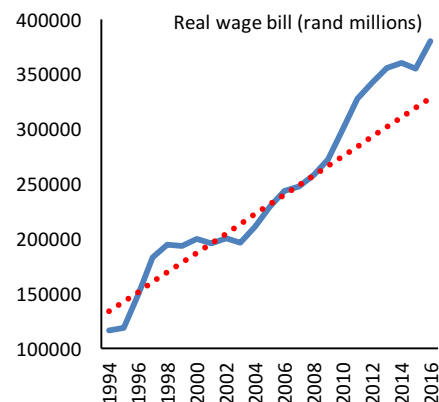
SA's wage bill is now among the highest.⁷ Although head-count growth has been contained more recently, wage increases for existing employees continue to grow in real terms.⁸ Public salaries are still rising at above 2%, in real terms, with the current wage agreement only ending in 2017/18.⁹

The second constraint is that the higher level of borrowing is now generating high debt service costs. These grew at an annual average of 13.5% over the past three years, a rate of increase expected to moderate only marginally to 10.1% out to 2019/20. Debt service remains the fastest growing expenditure item, outpacing even post-school education and training (increasing by an average annual rate of 9.2% till 2019/20). Debt-service costs have increased to 3.3% of GDP in 2016/17.¹⁰

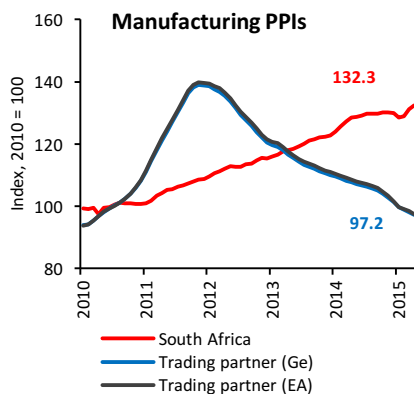
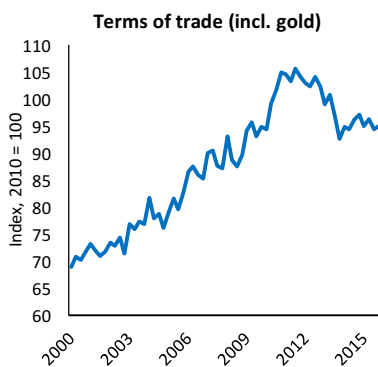
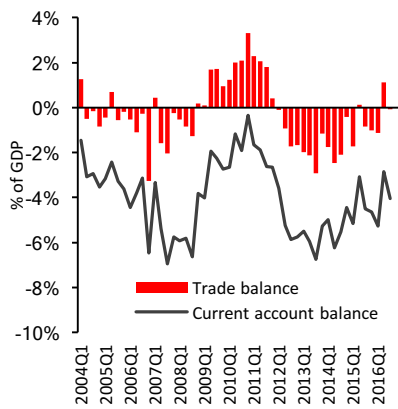
The slower pace of economic growth also heightens financial risks associated with other public sector entities, especially the rise in debt guarantees and other contingent liabilities to state-owned enterprise (SOE). The SOEs, large monopolies strategically placed in network sectors such as communications, electricity and transport, have been well placed to extract debt guarantees from the state while resisting reform. Contingent liabilities have doubled since the global financial crisis, as a proportion of output, and now amount to about 18% of GDP. This implies that government debt levels could, under adverse circumstances, quickly approach 70% of GDP, well above most posited sustainability thresholds.¹¹

The rise in public debt is both a consequence and cause of weak economic performance. Large, downward revisions in GDP growth have become standard: 2015/16, 2016/17 and 2017/18 growth projections have all been revised down from above 3% to around 1% from the first to the most recent MTBPS forecast. This has contributed to continuous upward revisions of expected debt-to-GDP ratios. The debt trajectory shows that the longer term fiscal outlook has deteriorated from a clearly sustainable position to a potentially unsustainable one. With the nominal yield higher than the nominal GDP growth rate, significant primary surpluses need to be run to keep the debt level stable.¹² At higher debt levels generally, fiscal space is limited and policy constrained to be pro-cyclical.

Stronger economic growth, driven by rising productivity, is required to reverse fiscal deterioration, and fiscal policy could contribute more to that by focusing on how spending effects potential growth. The economic impact of State Owned Enterprises (SOEs) should be one area for improvement, largely by reducing their drag (high cost) on the economy.¹³ Without a major effort to boost potential growth, fiscal consolidation may need to become broader



⁷ World Bank, *Size of the Public Sector: Government Wage Bill and Employment*, 2016 (public sector data set).
⁸ Government reined in employment growth from above 3% in 2008–2013 to 1.2% since the fiscal consolidation program, which started in late 2013.
⁹ South Africa. National Treasury, 'Medium Term Budget Policy Statement 2016', 26 October 2016, p 54.
¹⁰ South Africa. National Treasury. 2017. Budget review 2017, p 81.
¹¹ M Paul, S Redford and L Soobyah. 'Budget review'. *South African Reserve Bank Economic Note Series No. EN/16/09*, March 2016. The OECD has suggested that a debt to GDP ratio for general government of 50% sets a limit beyond which additional debt lowers economic growth rates. See F Fall, D Bloch, J-M Fournier and P Hoeller, 'Prudent debt targets and fiscal frameworks', *OECD Economic Policy Paper No. 15*, July 2015, p 20.
¹² A simple calculation of the long run sustainable public debt ratio at current nominal growth rates, interest rates and primary deficit is about 65%. Higher nominal interest rates (one percentage point) lowers this to 50%. The primary surplus needed to keep the debt level stable, with a nominal interest rate of 10%, an inflation rate of 6% and a real growth rate of 1% is 1.9% of GDP.
¹³ These institutions are crucial to private-sector performance as they determine important input costs for businesses. On state control product market rigidities, SA scores much higher than OECD average, and above Brazil, Chile and Mexico (OECD 2013 PMR indicators).



and deeper, with a particular focus on the government wage bill. I return to these issues in the conclusion. In the meantime, the fiscal position contributes to a persistent current account deficit.

A current account adjustment?

Alongside declining trend growth, the sustained current account deficit is a reasonable sign of on-going macroeconomic disequilibrium. The current account deficit fell when global trade and import demand temporarily collapsed in 2008 and in 2016, but otherwise has been a continuous source of financing risk. The trade deficit averaged -1.9% over last three years until the latter half of 2016, while the incomes and payments deficit averaged -2.5% over last three years.

The sustained deficit on the income and transfers account is caused by high spending levels, both relative to income and as a share of GDP, and has been encouraged by low interest rates. Over the longer term, a softening terms of trade should filter through to incomes and tax revenue, pulling down this deficit (at a stable debt level). The adjustment is likely to be gradual, however, and negative for short-term growth, even as the risk premium on rand assets remain high.¹⁴

The trade balance has improved in recent quarters as household consumption, investment and government spending has moderated, but the propensity to deficits has a mix of structural and cyclical causes.¹⁵ The structural component might be thought of as price inelastic demand for capital goods (SOE investment, manufacturing sector machinery), intermediate goods (oil products), and consumption goods. Because of this inelasticity the import bill constrains the production- and expenditure-shifting by producers and consumers that should occur when the currency depreciates.¹⁶ If this structural aspect of the trade deficit is dominant, then there can be no J-curve effect and no rebalancing from currency depreciation. If, on the other hand, currency depreciation incentivises exports and compresses imports in sufficient quantities, the trade balance should narrow. This process was visible from mid-2014 into mid-2015 and again late in 2016, although in large part due to favourable swings in oil and commodity prices, and despite little export response.

On the net factor payments account of the current account, there appears to be some softening of the net outflows to GDP ratio. This is partly a response to rising South African investment abroad, pulling in greater receipts. It should also reflect softer non-resident demand for rand assets. Despite this recent moderation, however, the quality of the available financing seems to be deteriorating. Some of the funding shifted towards unrecorded transactions and ‘other’ investments (the latter primarily driven by the banking sector). FDI flows have also declined sharply and portfolio flows have moderated, and will be negatively affected (in quantity and quality) by the credit rating downgrades. This compositional shift poses risks, particularly through the banking sector.

¹⁴ See for instance, D Lubin, ‘EM Economics View: Can EM survive “Trumponomics”?’ *Global Economic Outlook and Strategy: Prospects for Economies and Financial Markets in 2017 and Beyond*, December 2016.

¹⁵ A contributing factor to household consumption has been the rise in the public sector wage bill and the resulting high growth in unit labour costs. These increased especially rapidly in 2009 and 2010. Public sector wages alone grew by about 4 percentage points of GDP after 2009 from 12 to 16% of GDP.

¹⁶ Conceptually this is similar to depreciation where there are foreign currency liabilities, the forced repayment of which redirects spending.

The biggest change involves ‘other’ investment, which has become an important source of deficit funding. These are mostly banking sector-related, and consist of flows such as loans and deposits of banks.¹⁷ These flows are lumpy and appear relatively short-term: just 12% of banking sector liabilities are long-term loans. And much of the sectors’ borrowing is in foreign currency – over a quarter of all foreign currency-denominated debt is held by the banking sector, with 75% of this debt maturing in less than a year. Generally these short-term liabilities are rolled over or replaced, but new loans may not be available under adverse circumstances.¹⁸

The role of FDI in funding has also been weak, and on average inflows have worsened post-crisis.¹⁹ Net FDI outflows have been recorded for the last two years. The post-crisis decline in net FDI has been driven primarily by domestic firms seeking exposure overseas by purchasing foreign assets. These FDI outflows have been large and persistent since 2012. Although this could be interpreted as a sign of strength as local firms expand internationally, it could also reflect weakness, in particular consistently stronger productivity growth in services compared to manufacturing.²⁰

There is also a large and long-term opportunity cost to lower FDI inflows, which are typically considered the most stable source of financing and also the most beneficial for growth, in that they bring technology transfers.²¹ In growth terms, a more far-reaching improvement to current account sustainability might occur if the same level of foreign saving financed private rather than public investment – the net factor deficit would be generating a higher economic growth rate. This is discussed more below.

Although it has proven possible to finance a large current account deficit for an extended period of time, despite slowing growth and rising domestic risks, continued financing should not be taken for granted. Indeed, with greater reliance on banking sector flows and high debt levels, large deficits will continue to create market volatility, pushing up risk premia and financing costs.

Global financing of imbalances

This combination of higher debt levels and external imbalances has been supported, roughly from 2010, by the various quantitative easing programmes of developed economy central banks and excess global saving. These have generally helped to contain the cost of financing the rapid expansion in debt.²² The ‘taper tantrum’ of 2013 was a first indication that benign financing costs

¹⁷ Other investment is a residual category that includes third-party transactions such as trade credits, loans, deposits & other accounts receivable/payable. In essence, it captures investment other than the conventional capital flows of FDI, portfolio and derivatives.

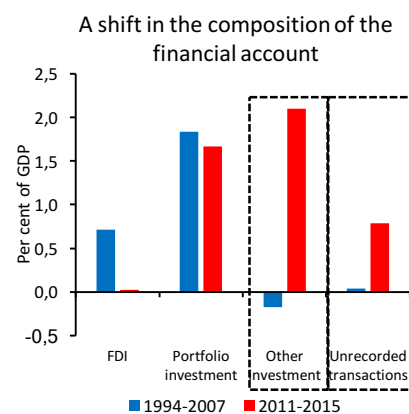
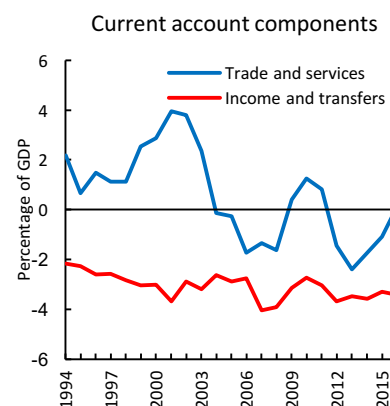
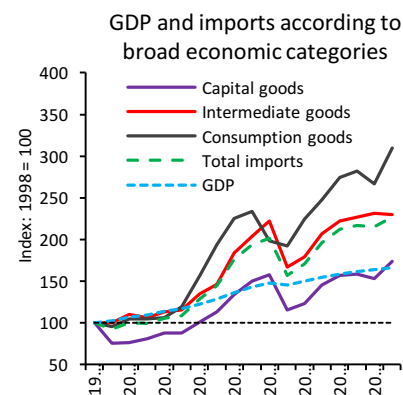
¹⁸ Europe accounts for over 70% of South African foreign loans, mostly via the UK (accounting for 87%) and Germany (9%). A shock to the European banking sector, or a decision to divest from South Africa, could therefore quickly shut down this source of funds and cause contraction in the real economy. F Mishkin, ‘Asymmetric information and financial crises: A historical perspective’, in *financial markets and financial crises*, edited by R G Hubbard, 1991, pp 69–108; B Bernanke, ‘Nonmonetary effects of the financial crisis in the propagation of the great depression’, *American Economic Review* 73(3), 1983, pp 257–276 and M Carlson, T King and K Lewis, ‘Distress in the financial sector and economic activity’, *Finance and Economics Discussion Series No 2008/43*, October 2008.

¹⁹ FDI flows have formed a majority of financing in only three out of the last 22 years. Unrecorded transactions have also grown rapidly, from near-zero in the pre-crisis period to being much larger than FDI flows and worth around half as much as portfolio flows.

²⁰ R Sharma, ‘Breakout nations: In pursuit of the next economic miracles’, 2012, pp 183–184.

²¹ This cost may be very high. Michael Spence’s Growth Commission argued that the importation of knowledge and technology via foreign direct investment accounted for much of the catch-up of fast-growing economies to advanced economy income levels.

²² Public debt costs have been however the fastest growing area of spending, growing by about 10% per year.



might not last forever, and as the US economy has slowly recovered it has become clearer that emerging markets will face higher costs in future. The December 2016 rise in the Fed Funds rate caused a 4% decline in the rand-dollar exchange rate. And yet, normalisation has been modest, with an incremental strengthening of the US recovery, and the same gradualism likely in Europe.

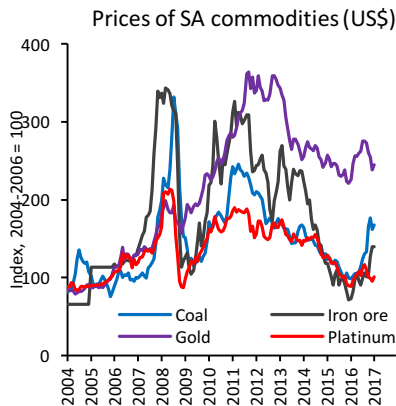
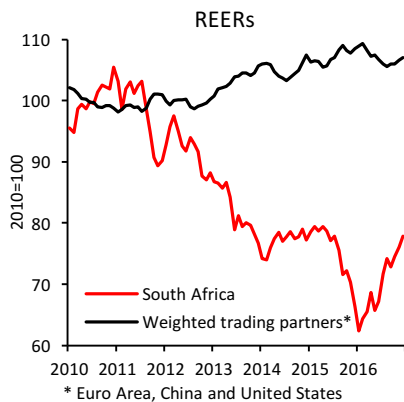
Another risk to easy deficit financing is the unwinding of the commodity super cycle that peaked around May 2011. South Africa's real commodity terms of trade have fallen by about 42% since then.²³ As part of this moderation in prices, oil prices fell from the middle of 2014 through 2015, with significant fits and starts, helping to put a floor under the decline in the terms of trade.²⁴ Through 2016, commodity prices rose again albeit less consistently across commodities, with oil prices first rising and then softening.

Assuming a continued incremental slowing in China's growth rate it seems reasonable to expect South Africa's terms of trade to moderate over the next couple of years.²⁵ The negative demand shock implied by this may be prolonged. But the overall impact from this slide on the economy depends also on the size of the fall in volume of commodity exports, shifts in risk premiums, and what the real rand does in response, with greater real depreciation moderating the overall (rand) effect.

Which way to go?

Recent macroeconomic settings have done little to resolve high debt levels or to shift the pattern of production and consumption in ways that rebuild policy space or reduce vulnerabilities. Household debt levels have remained at historic highs of between 77 and 82% of disposable income since 2010, although 2016 saw a more substantial decline to 74%. And import demand has stayed high while growth in export supply has been modest.²⁶ As a result, the current account deficit is still substantial, at about 3–4% of GDP. Considerable improvements to the trade balance occurred late in 2016 and into 2017, but it is not clear that these are permanent or driven by a sustainable pick up in the production of tradable goods – despite significant real exchange rate depreciation.²⁷ Rising commodity prices and declining capital goods imports have been the main drivers of the improvement, and most of those prices (coal, manganese, ferrochrome, iron ore) have softened.

A range of studies show that the responsiveness of exports to real exchange rate changes has fallen since the great financial crisis.²⁸ Weak global demand, especially for commodities, may have suppressed exports even as exchange rates depreciated, while supplier responses may also be more muted than



²³ On Citibank's measure.

²⁴ By about 45% in real terms (USD) for the SA commodity index, compared to a decline of about 25% in the global commodity index. In rand terms, because of currency depreciation, the fall from 2011 turns into a small gain, although from early 2014 there is a drop of about 16% for the global index. For South Africa's commodity index the decline in nominal rand terms is 23% from January 2011.

²⁵ SARB forecasts for the terms of trade however have not reflected such a view, and are determined by a relationship between global growth and demand for commodities that has apparently broken down. Forecasts for 2013, 2014, 2015 have been far too high.

²⁶ D Fowkes and R Walter, 'Current account rebalancing: An exploration of the trade data', *South African Reserve Bank Economic Note Series No. EN/16/19*, June 2016.

²⁷ The decline in South Africa's terms of trade has offset some volume improvement on the trade and current account balance. See J F Ruhashyankinko, et al, 'External rebalancing: Commodity prices flatter Turkey but sully South Africa', *Goldman Sachs Economic Research*, 26 April 2016.

²⁸ R Anand, R Perrelli and B Zhang, 'South Africa's exports performance: Any role for structural factors?' *IMF Working Paper Series No. WP/16/24*, February 2016.

normal (see table below).²⁹ Growth in trading partners has been slightly weaker than global growth, but rapid growth in Sub-Saharan Africa until recently offset the otherwise less favourable compositional impact of weak trading links to parts of Asia. In South Africa, most large exporters are also large importers, obscuring the effects of depreciation. Other studies, such as by Hlatshwayo & Saxegaard find large structural effects plus uncertainty impeding exports.³⁰ Policy uncertainty weakens REER-export responsiveness by decreasing production and making firms less sensitive to price changes.

The low responsiveness of exports may also be because the real equilibrium exchange rate has also fallen, in line with a narrower real interest rate gap, a decrease in the terms of trade, higher debt and lower potential growth. To get a permanent shift in the trade balance and a greater contribution of exports to growth may require more real depreciation (relative to equilibrium) than before, a task made more difficult by the global low inflation environment.³¹

The existing policy framework and its weaknesses

The policy framework put in place in the late 1990s and early 2000s has played a key role in preventing the rise in debt and poor net export outcomes from causing a crisis. On the fiscal side, the low level of public debt achieved up to 2008 enabled the post-crisis counter-cyclical response at a relatively low short term financial cost. The floating currency allows the exchange rate to adjust to fiscal deterioration and higher input costs, while the bias against intervention avoids tempting the authorities into costly efforts to try to stem depreciation. It has also tended to warn the private sector away from creating foreign currency liabilities, a central problem in the Asian crisis of 1997/98 and for East European economies more recently.³² Transparency was in part increased with the inflation targeting framework to reduce the pass-through from currency movements to inflation.

As beneficial as it is, the floating currency on its own should not be expected to fully offset negative shocks. Ideally, negative demand and supply shocks should result in relative price adjustments as specific industrial prices and input prices adjust quickly to maintain volumes. However, at best they adjust slowly, and therefore effectively reverse the *real* depreciation needed to shift the composition of growth (to tradeables) and consumption (to non-tradeables). Prices and wages move largely asymmetrically, magnifying the economic costs of shocks (mostly via unemployment and income loss) and

²⁹ Anand et al. (2016) finds external demand statistically significant for South African exports, with a greater impact on the mining sector, closely followed by manufacturing. They also find that structural constraints impede export responses. Alternatively, high-performance firms may increase their mark-up more than their export volumes under depreciation. See N Berman, P Martin and T Mayer, 'How do different exporters react to exchange rate changes?', *The Quarterly Journal of Economics*, 127(1), 2012, pp 437–492.

³⁰ S Hlatshwayo and M Saxegaard, 'The consequence of policy uncertainty: Disconnects and dilutions in the South African real effective exchange rate-export relationship', *International Monetary Fund Working Paper No. WWP/16/113*, June 2016.

³¹ With lower global inflation, any rise in domestic inflation worsens competitiveness, as per the equation: real exchange rate = nominal exchange rate (foreign prices/domestic prices).

³² Although this effect may have weakened in recent years. Private sector foreign currency denominated debt has increased from 1.8% to 2.8% between 2008 and 2016. SA banks have increased foreign currency liabilities sharply in recent quarters, probably through a range of loan arrangements, either syndicated or from global head offices. These may be a response to the need to meet Net Stable Funding Ratios. Non-financial corporates also borrow from foreign parent companies to provide USD and Euro-backed domestic financing, for instance for automobiles.

preventing more benign economic adjustment.³³ It has only been a sustained economic downturn that has *somewhat* moderated input cost growth.

Due to these rigidities the downward phase of the commodity cycle resulted in South Africa facing a permanently lower economic growth rate with a higher inflation rate. This asymmetric pricing behaviour is central to poor macroeconomic outcomes and induces a soft form of inflation accommodation that allows real appreciation and achieves neither good employment creation outcomes nor greater competitiveness. The root of the problem is microeconomic, but macroeconomic policy guidance can and should play a much stronger role in shaping better micro outcomes.

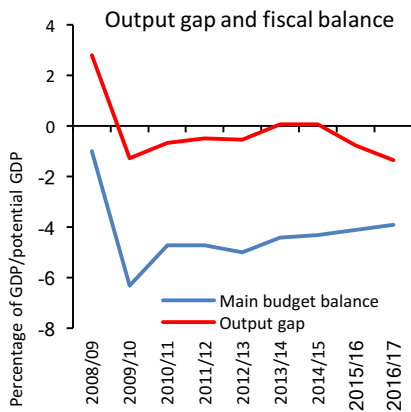
Finding a better direction

With negative commodity shocks and effective indexation of production costs to inflation, monetary and fiscal settings could be set to move the economy on to a more robust growth path with more sustainable macroeconomic balances. Without stronger balance sheets in households and the public sector, price rigidity helps to preserve the high debt and high cost, consumption-driven economy. This consumption model, dependent on relatively high skill job creation and income growth, but also on debt when the other two slow, cannot be repeated. Private and public debt levels become too high and are not sustainable in a global environment of higher real interest rates. Greater consumption, moreover, is not likely to ever equate to full employment, because it is less efficient in creating jobs in tradeables sectors. Nonetheless, these conditions give rise to public pressure to further expand credit and fiscal deficits to achieve economic growth.³⁴

This implies that the conventional counter-cyclical response to weak growth, however, will not suffice. There is simply no policy space left and the efficiency of stimulus spending is fading – requiring ever more spending to get at a diminishing growth return and incapable of reversing falling potential growth rates. This implies that achieving internal balance will remain elusive.

Much stronger net export growth would help to resolve these macroeconomic difficulties. We could imagine that much stronger world growth will push up demand for commodity exports, generating a positive spiral of outcomes in the economy. With more global growth in the outer year of our forecasts, fewer hard choices need to be made about how to keep the fiscal and current account positions sustainable. This hopefulness has been our macroeconomic policy since 2008. But even as global growth has picked up, non-commodity exports have not.

The policy mix has been sustained, not because global growth has materialised, but because the global environment allowed large fiscal and current account deficits and public and private debt to be cheaply financed. As these conditions dissipate, upward pressure on yields will raise costs and force a squeeze on spending to satisfy the higher cost of debt. With worsening financing conditions, weak economic growth and the high debt level exacerbate the negative debt dynamic non-linearly, making it more likely that policy has to tighten to maintain solvency, and potentially quickly.



³³ This may be due to product and labour market structure and adaptive price expectations. See J Fedderke, N Obikili and N Viegé, 'Markups and concentration in South African manufacturing sectors: An analysis with administrative data', *Wider Working Paper Series No 2016/40*, April 2016.

³⁴ See for instance B Kantor, 'Unleashing the household sector', *ZAeconomist.com* blog, 30 July 2015, available at <http://www.zaeconomist.com/sa-economy/unleashing-the-household-sector/>.

Avoiding this implies that, in the absence of stronger economic growth, some reduction in financing needs is required. Spending moderation in turn entails in the short-term slower growth in gross domestic product. And gives rise to the usual criticism that with the growth rate low, a negative output gap has opened up and policy should seek to reverse it. However, there are some reasons to be sceptical about the utility for policy of that gap.

The sustained fiscal deficit and other public spending should have reduced the output gap, so too the post-2009 rise in commodity prices. Some sectors, like wholesale and retail trade and financial services, have increased in size beyond 2008 levels, suggesting at sector level gaps have closed. A substantial negative gap may have opened up in the export sector as iron ore demand from China has weakened, but it is not clear what this means for the output gap as a policy variable. Is the basic iron and steel sector (about 30% of the capacity utilisation index and largely accounting for movements in it) responsive to interest rates, either in terms of output or shifting factors to other uses?³⁵

It also seems useful to recognize that output across the economy in 2007 and 2008 was too high due to financial, asset price and terms of trade bubbles, making historical analyses of potential growth and the gap less useful. The potential growth rate was much lower than we have tended to believe. This implies that estimates of the output gap need to be treated with caution and that better sectoral estimates would be helpful.³⁶ In particular, like controlling for financial cycles, adopting natural resource and non-resource estimates that reflect commodity cycles might be more useful.³⁷

A stronger case can be made for lower interest rates to support interest-sensitive sectors, although these are more obviously constrained by existing high household debt levels. Growth in these sectors would be more sustainably supported by permanently lower inflation, which would lower the yield curve and potentially lower long run borrowing costs, favouring longer-term investment planning.

If short-term growth can no longer be supported with demand management policies, then how might economic adjustment and a sustainable composition of growth be encouraged? This is often thought about in microeconomic terms. And this is obviously much of the story, but it risks suggesting that macroeconomic policy has no role. Fiscal and monetary policy have an effect on the composition of growth and shares of tradeables and non-tradeables because of their effects on the balance of saving and investment and relative import and export prices. They need to work together – less fiscal demand on capital markets is critical to achieving lower financing costs, as is a lower inflation rate, and both support real depreciation. With real depreciation and less absorption (domestic demand), the basic adjustment path is for production shifting to tradeables and relatively more expenditure switching to consumption of non-tradeables.³⁸

³⁵ The output gap is a neat way of assessing inflationary pressures but the gap does not necessarily coincide with current account deficits and their sustainability. The output gap may also be more useful analytically when capital and labour (factors of production) can move from one sector to another.

³⁶ J Fedderke and D Mengisteab, 'Estimating South Africa's output gap and potential growth rate', *South African Reserve Bank Working Paper Series No. WP/16/02*, March 2016.

³⁷ Central Bank of Chile, 'Monetary policy report 2015', September 2015 and the subject of current research work.

³⁸ Production shifts from non-tradeables to tradeables, while consumption shifts from tradeables to non-tradeables. Wages rise in terms of what they can buy in non-tradeables compared to tradeables.

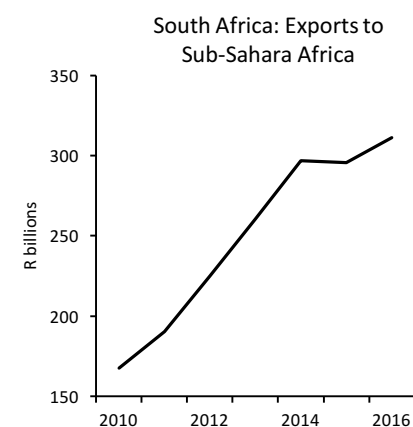
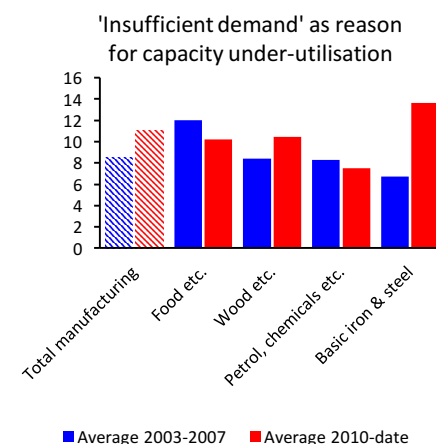
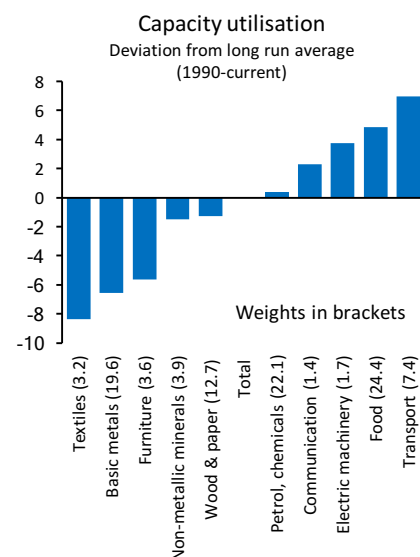
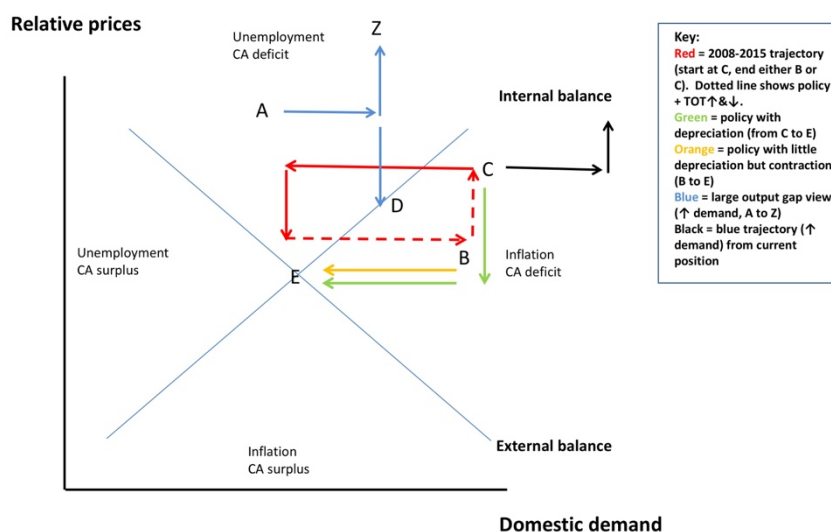


Figure 1 provides a view of the transition of the economy since 2007 in a Swan diagram.³⁹ A movement up along the vertical axis is a real appreciation. The Swan diagram relates relative prices (real exchange rate levels) to domestic demand or absorption for small open economies. I try to show the impact in the diagram of four substantively different policy trajectories (and starting points).

Figure 1: Macro position in a Swan diagram



In this space, South Africa started in 2007 at about point C, in a position of rising inflation and with a large current account deficit. The global financial crisis resulted in a lurch leftwards into unemployment and a smaller deficit (red line left), with considerable depreciation (red line down), roughly into 2009 and 2010. As potential growth slowed and macroeconomic policy became much more expansionary, the economy shifted back again along the dotted red line, to somewhere around point B or C. The difference between points B and C concerns the level of the real exchange rate. If one thinks that the real exchange rate has depreciated and is in something like equilibrium now, then one might think the economy currently rests at point B. If one thinks that further real depreciation is required to move towards external balance, then one might choose point C.

The *first* policy trajectory is a move to the right (black lines) from point C caused by an increase in expansionary policy. Larger fiscal deficits and lower rates would shift South Africa to the right (increased demand) and up (real exchange rate appreciation), further from equilibrium.

An alternative *second* hypothesis is that we currently sit at point A, a combination of cyclical unemployment, falling inflation, and a current account deficit (too high real exchange rate). If we accept this view, then the blue lines suggest what happens if fiscal or monetary becomes more expansionary – inflation increases and the real exchange rate appreciates, resulting in a larger current account deficit while employment in tradables falls (to point Z).

³⁹ The Swan diagram relates relative prices (real exchange rate levels) to domestic demand or absorption for small open economies, originally the Australian, but is also commonly applied to small European and Scandinavian economies. See E-M Claassen, *Global monetary economics*, 1996 or M Corden, *Economic policy, exchange rates and the international system*, 1994.

A *third* trajectory might be from point A to point D, in which demand is further expanded (movement to the right). A shift towards internal and external balance might occur in this scheme if the exchange rate depreciates continuously faster than domestic prices rise, or if nominal depreciation occurs alongside effective control of prices and real appreciation is prevented (downward arrow towards D).

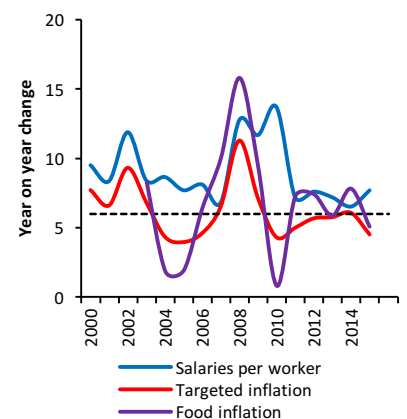
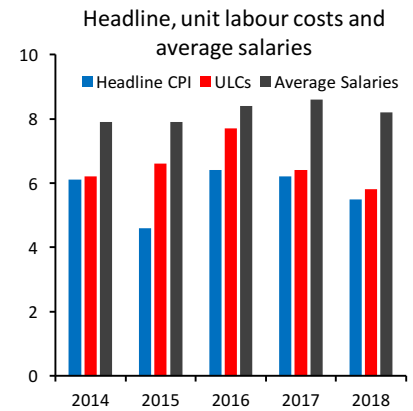
Whether one chooses A or C as the policy starting point matters greatly. Choosing point A implies that there is an output gap that can be narrowed with expansionary macroeconomic policy. Choosing the *third* policy trajectory further implies that the demand expansion that results in currency depreciation is *not* unwound by inflation. These seem unlikely outcomes given historical pricing behaviour and structural constraints to greater price flexibility. Price and wage rigidities are strong in the economy, as discussed further below, and contribute to the economy resting at somewhere around point C. They ensure that any expansionary shock results in mostly inflation and a rising import bill, rather than domestic output growth and job creation, foreclosing the possibility of moving from A to D (and making it difficult to move from C to E). A *fourth* policy trajectory is of moving from point C to point E. In this move, the real exchange rate needs to depreciate (orange or green downward arrows) and demand gradually moderate (orange or green leftward movement to E).

Strengthening the macro framework

Central to the perspective in the Swan above is deciding how to maintain a real depreciation to get more of a net export response. Achieving depreciation accounts for the distinction between points B and C in the diagram.

The main obstacle to real depreciation is domestic – the propensity for prices to rise and reverse the relative price change initially caused by the currency. In addition to serial cost-raising shocks to supply, currency weakness feeds through into a stubbornly high inflation rate via largely adaptive expectations and import parity pricing. The underlying cause for this is a combination of a restricted supply of skilled labour (increasing wage inequality), weakly competitive product markets and various barriers to entry for new firms (which reduce price competition and labour demand).⁴⁰ Worse, it works for positive demand and supply shocks also, as seen in the rise in commodity prices from 2003, which induced non-commodity sector price and wage increases.

Getting different outcomes requires a more robust policy framework that enhances the impact of the policy stance on price and wage setting in the economy. Increasing credibility of the policy framework and/or monetary policy tightening would reduce the inflation rate expected by price and wage setters. Improving the policy framework is the least-cost option here, with a clearer policy target and improved communications to critical groups.⁴¹ Easing those micro constraints alone creates macroeconomic policy space and reduces potential costs. Product market reforms that increase competition (and thereby weaken pricing power and rigidities) are a needed

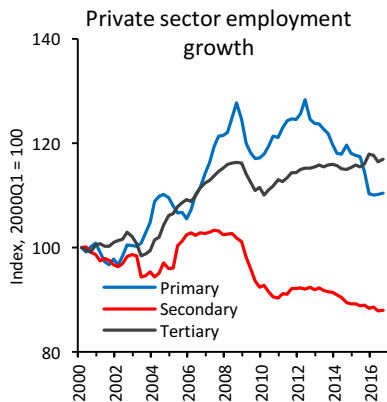


⁴⁰ Including tighter access to finance, regulations, higher tariffs, etc.

⁴¹ The gains to this approach go beyond the lower inflation rate. Shifting real wage growth to slower rates would help with external competitiveness, while greater product and labour market competition, and more skilled immigration would eventually expand demand for less-skilled workers.

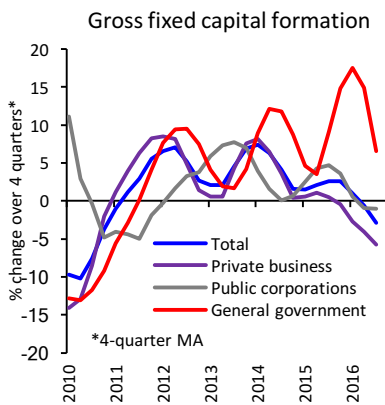
complement to this strengthening of the monetary policy framework. If enacted they would do most of the work to lower inflation.⁴²

For periods of currency appreciation, reserves policy needs to play a stronger role to reduce loss of tradeables production. This can lean against appreciation, but it cannot stop it. For that reason, more flexible use of fiscal measures would be required to shift excess returns away from commodity, finance and real estate and towards raising the productivity of factors of production, public investment, and perhaps temporary tax credits for tradeables sectors. In these conditions, more broadly, fiscal policy should seek to contribute real depreciation by aiming for fiscal surpluses or smaller deficits. In a similar way, but much smaller in degree, tighter policy in the short term could attract some capital inflow on the back of carry trades, putting some upward pressure on the exchange rate.⁴³ More fiscal consolidation would allow a slightly more relaxed monetary stance, which could then be supplemented if needed with an asymmetric FX reserves policy in which the Bank borrows rand to buy foreign exchange.⁴⁴



Coordinating policy to get better outcomes

The preceding discussion is not an argument to ignore aggregate demand. It is an argument to conceptually separate it out from the inflation problem and do something about the composition of demand with tools that might work. Unfortunately, given our sustained fiscal deficits, these tools are not clear cut. Certainly, without fiscal consolidation, the private sector will bear the full cost of any burden of adjustment in the current account, implying much lower private sector growth. Fiscal consolidation, therefore, seems essential to achieving better macroeconomic outcomes, especially rebalancing economic growth away from the public sector and to the private sector. But it also needs to make political economy sense. The measure of this of course cannot be that there are no net economic costs to any economic agent. The macroeconomic policy suggested here will support tradeables producers and consumers of non-tradeables at the expense of excess returns to importers and domestic non-tradeables producers. Gains can be further broadened and enhanced by redirecting public spending to public sector capex, supported by deregulation to induce higher investment. Reducing growth in public sector wages would help moderate nominal demand and weaken price and wage indexation and rigidity more broadly.



A real innovation would be to get private investment moving. The biggest economic gains however are not going to be found in the near term by greater investment and production in existing industries where imports can satisfy demand (clothes, cars, food, etc.). Instead, growth can be induced in over-regulated *network* sectors where supply is costly and below demand (telecommunications, energy, transport).⁴⁵ A key positive shock would come

⁴² Perhaps the most important of these would be to reduce the skilled labour premium that does so much to limit growth and contribute to large income inequalities, by encouraging skilled immigration. An OECD product market regulation target should be set to guide policy adjustments and reforms.

⁴³ In the medium term, lower commodity prices and US normalisation will probably weigh on currency expectations. Higher South African yields might induce offsetting carry trade activity, but are unlikely to reverse the major nominal depreciation the rand has undergone as commodity prices have fallen. In the short term, some reversal in nominal weakness would quite likely be good for confidence and economic growth.

⁴⁴ On its own balance sheet and sterilized with debenture sales. To start addressing currency volatility as a constraint to SMME exports, randomized control trials should test a small subsidy programme to provide free hedging for exporters below an appropriate size threshold.

⁴⁵ See the growth effects of reforms in D Faulkner, C Loewald and K Makrellov, 'Achieving higher growth and employment: Policy options for South Africa', *ERSA Working Paper Series No. 334*, March

from allowing private firms to enter these sectors and provide competition to the public firms. This would lead to better economic outcomes – improved governance and long term efficiency gains in state enterprises, and also fewer demands placed on the fiscus.⁴⁶ Eventually, lower costs in these latter sectors will help to increase growth in the tradables sectors, breaking out of indirect regulatory obstacles to broader economic growth.

Well-targeted and managed public infrastructure programmes would also crowd-in private investment. Too much of the public infrastructure programme has occurred in areas (energy, transport, telecommunications) in which a state owned enterprise could be and should be challenged by private participants. This is a major opportunity cost to the economy, leading to too low a level of investment at too high a cost to both current and future economic growth. A further cost is imposed by pulling scarce resources from other areas of public investment where a natural monopoly of provision by the public sector is appropriate (local infrastructure, free public health and education, security and other public goods).

There seems to be little room to provide tax credits or increase spending, unless they can be shown to endogenously generate strongly positive and sustainable productivity shocks or greater exports. And with existing product markets such tools mostly create new rent-seekers. Fiscal allocations could be adjusted to shift some part of spending and tax credits away in the short and medium term from current fiscal beneficiaries to temporary assistance for firms and individuals that bear the costs of reforms. This would offset temporary income loss as capital and labour gets redirected elsewhere in the economy, reducing economic (and political) adjustment costs and facilitating economic growth.

The size of South Africa's public sector is probably not far from optimal, given the need for expansion of public services. But the spending that does occur needs to be efficient and the services effective, and this requires significantly greater focus by public sector management.

Inflation remains a difficult challenge for the economy. It reduces the real purchasing power primarily of poorer residents, pushes up interest rates, and works against the creation of jobs in tradeables sectors. In the framework suggested here, a permanently lower inflation rate would in the long-term support investment and ultimately job creation. Adjustments to the monetary policy framework, particularly by focusing inflation expectations on the mid-point of the target band, would also help to reduce sovereign risk and term premiums. This would help to lower the neutral real interest rate required in the economy, provide support to the exchange rate, and allow greater monetary policy space especially when economic growth is weak.

Conclusion

In this note, I have argued for three policy initiatives. The first is to identify a general adjustment of macroeconomic policy to move the economy towards lower external imbalances and a more sustainable internal balance of production. The second initiative sets out credibility-enhancing shifts in monetary and fiscal policy that would support moving towards those

2013.

⁴⁶ Perhaps by ensuring that management of SOEs is guided by longer-term considerations than short-term financial risks.

balances. The third initiative is for monetary and fiscal policy to be more closely coordinated and backed up by growth-enhancing reforms. Most of the measures discussed will reduce the size of the trade and current account deficits, in part by continuing to moderate consumption. The cost of this to the economy should be relatively small, since the growth foregone is currently low and import leakage is high, and because the shifts will also pull down inflation and the cost of borrowing over the long term. In effect, some measure of near term growth, mostly from household consumption and largely spent on imports, is traded for stronger longer term growth and future consumption.

Alongside lower long term borrowing costs, an adjustment to the quality of public expenditure and a more competitive real exchange rate will help to boost investment. Eventually exports will also improve, but this will depend on the structure of the investment response. The more product market reforms are enacted, especially targeting the network sectors, the faster the adjustment in the economy and the fairer that adjustment will be.

Bibliography

Anand, R, Perrelli, R and Zhang, B. 2016, 'South Africa's exports performance: Any role for structural factors'. *IMF Working Paper Series No. WWP/16/24*, February. Washington: International Monetary Fund.

Anvari, V, Ehlers, N and Steinbach, R. 2014. 'A semi-structural approach to estimating South Africa's potential output'. *South African Reserve Bank Working Paper Series No. WWP/14/08*, November. Pretoria: South African Reserve Bank.

Bernanke, B. 1983. 'Nonmonetary effects of the financial crisis in the propagation of the great depression'. *American Economic Review* 73(3): 257–276.

Berman, N, Martin, P and Mayer, T. 2012. 'How do different exporters react to exchange rate changes?' *The Quarterly Journal of Economics* 127(1): 437–492.

Carlson, M, King, T and Lewis, K. 2008. 'Distress in the financial sector and economic activity'. *Finance and Economics Discussion Series No. 2008/43*, October. Washington, D.C: Board of Governors of the Federal Reserve.

Central Bank of Chile. 2015. *Monetary policy report 2015*. Santiago: Central Bank of Chile.

Claassen, E-M. 1996. *Global monetary economics*. New York: Oxford University Press.

Corden, M. 1994. *Economic policy, exchange rates and the international system*. New York: Oxford University Press.

Cournède, B, Goujard, A and Pina, A. 2013. 'How to achieve growth- and equity-friendly fiscal consolidation?: A proposed methodology for instrument choice with an illustrative application to OECD countries'. *OECD Economics Department Working Paper Series No. 1088*. October. Paris: OECD Publishing.

Fall, F, Bloch, D, Fournier, J-M and Hoeller, P. 2015. 'Prudent debt targets and fiscal frameworks', *OECD Economic Policy Paper No. 15*, July. Paris: OECD Publishing.

Faulkner, D, Loewald, C and Makrelov, K. 2013. 'Achieving higher growth and employment: Policy options for South Africa'. *ERSA Working Paper Series No. 334*, March. Cape Town: Economic Research Southern Africa.

- Fedderke, J and Mengisteab, D. 2016. 'Estimating South Africa's output gap and potential growth rate'. *South African Reserve Bank Working Paper Series No. WP/16/02*, March. Pretoria: South African Reserve Bank.
- Fedderke, J, Obikili, N and Viegi, N. 2016. 'Markups and concentration in South African manufacturing sectors: An analysis with administrative data'. *Wider Working Paper Series No 2016/40*, April. Helsinki: UNU-WIDER.
- Fowkes, D and Walter, R. 2016. 'Current account rebalancing: An exploration of the trade data'. *South African Reserve Bank Economic Note No. EN/16/19*, June. Pretoria: South African Reserve Bank.
- Hlatshwayo, S and Saxegaard, M. 2016, 'The consequence of policy uncertainty: Disconnects and dilutions in the South African real effective exchange rate-export relationship'. *International Monetary Fund Working Paper No. WP/16/113*, June. Washington: International Monetary Fund.
- International Monetary Fund. 2016. *South Africa: 2016 Article IV Consultation*. Washington: International Monetary Fund.
- Kantor, B. 2015. 'Unleashing the household sector'. ZAEconomist.com blog. 30 July. <http://www.zaeconomist.com/sa-economy/unleashing-the-household-sector/>
- Lubin, D. 2016. 'EM Economics View: Can EM survive "Trumponomics"?'. *Global Economic Outlook and Strategy: Prospects for Economies and Financial Markets in 2017 and Beyond*. December.
- Mishkin, F. 1991. 'Asymmetric information and financial crises: A historical perspective'. In *Financial Markets and Financial Crises*, edited by R G Hubbard. Chicago: University of Chicago Press: 69–108.
- OECD. 2013. PMR indicators.
- Paul, M, Redford, S and Soobyah, L. 2016. 'Budget review'. *South African Reserve Bank Economic Note Series No. EN/16/09*, March. Pretoria: South African Reserve Bank.
- Reinhart, C M and Rogoff, K S. 2010. 'Growth in a time of debt'. *NBER Working Paper Series No 15639*. January. Cambridge: National Bureau of Economic Research.
- Ruhashyankinko, J-F, et al. 2016. 'External rebalancing: Commodity prices flatter Turkey but sully South Africa'. *Goldman Sachs Economic Research*, April.
- Sharma, R. 2012. *Breakout nations: In pursuit of the next economic miracles*. New York: W.W. Norton & Company.
- South Africa. National Treasury. 2016. *Medium term budget policy statement 2016*. Pretoria: National Treasury.
- South Africa. National Treasury. 2017. *Budget review 2017*. Pretoria: National Treasury.
- South Africa. Statistics South Africa. 2015. *Manufacturing: Utilisation of production capacity by large enterprises (August 2015)*. Statistical Release P3043, 5 November. Pretoria: Statistics South Africa.
- Visser, E and Janse Van Rensburg, T. 2016. South African exports – Two inconvenient truths, *South African Reserve Bank Economic Note Series No. EN/16/21*, July. Pretoria: South African Reserve Bank.
- World Bank. 2016. *Size of the public sector: Government wage bill and employment*. Washington: World Bank.