

ERSA Research Brief

May 2016

Shaping macroeconomic outcomes

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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

Which way to go?

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

¹ 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. WP/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 Courne de, 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.

this misses two crucial points 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.

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.⁴ 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.⁵ 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.⁶ Weak global demand, especially for commodities, may have suppressed exports even as exchange rates depreciated, while supplier responses may also be more muted than normal. 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.⁷

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.⁸ 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 preventing more benign

⁴ 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.

⁵ 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.

⁶ 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.

⁷ 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).

⁸ 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.

economic adjustment. 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.

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.⁹

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.

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.¹⁰

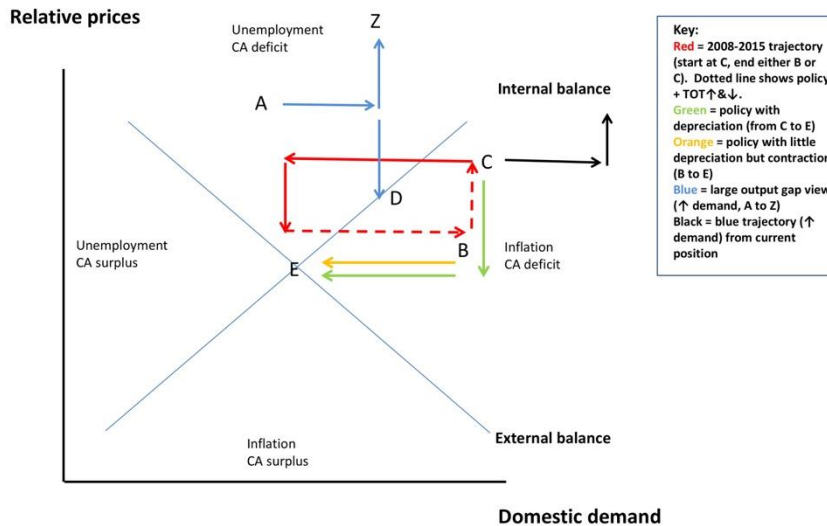
Figure 1 provides a view of the transition of the economy since 2007 in a Swan diagram.¹¹ A movement up along the vertical axis is a real appreciation. The Swan diagram relates relative prices (real exchange rate levels) to domestic demand or absorption for small open economies. I try to show the impact in the diagram of four substantively different policy trajectories (and starting points).

⁹ 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/>.

¹⁰ Production shifts from non-tradables to tradables, while consumption shifts from tradables to non-tradables. Wages rise in terms of what they can buy in non-tradables compared to tradables.

¹¹ 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.

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).

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).

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).¹² 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.¹³ 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 complement to this strengthening of the monetary policy framework. If enacted they would do most of the work to lower inflation.¹⁴

Coordinating policy to get better outcomes

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).¹⁵ A key positive shock would come 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.¹⁶

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

¹²Including tighter access to finance, regulations, higher tariffs, etc.

¹³ 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.

¹⁴ 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.

¹⁵ See the growth effects of reforms in D Faulkner, C Loewald and K Makrelov, 'Achieving higher growth and employment: Policy options for South Africa', ERS Working Paper Series No. 334, March 2013.

¹⁶ Perhaps by ensuring that management of SOEs is guided by longer-term considerations than short-term financial risks.

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).

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 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.