

# South African Macroeconomics and Growth

*By early 2016, the growth trajectories of many emerging markets had become unsustainable, with high current account deficits and falling growth rates. Since then, most of these economies have adjusted, some gradually and some abruptly forced by recession. South Africa's adjustment has been much slower, with some decline in the trade and current account deficits, but few clear steps to shift growth higher or to a more sustainable, investment and export-intensive composition. Exports barely responded to higher prices and the global recovery in demand.*

These partial adjustments and weak economic growth outcomes are endogenous to a policy stance that has relied on supportive global financing conditions, high commodity prices and a doubling of the public debt. Fiscal and monetary space has shrunk as the potential growth rate has declined to about 1.5% and long term inflation expectations remained sticky, ranging between 5 and 6%.<sup>1</sup>

What has gone wrong? If the intention of macroeconomic policy was simply to offset the Global Financial Crisis (GFC) shocks, then the settings to do that have long ago done whatever good could have been achieved. Economic growth did, in fact, rise to about 3% in 2010 and 2011.

But if policy intended to re-achieve a much stronger long term growth rate, then the settings were not appropriate to the task. Prolonged monetary and fiscal action to raise demand, reducing saving and pushing up inflation, have worked against the need to increase competitiveness. In addition to microeconomic reforms, competitiveness requires rigorously counter-cyclical fiscal settings to raise saving, monetary policy set to achieve permanently low inflation rate, and asymmetric exchange rate policy. These will lower long-run capital costs and reduce price-level appreciation. While I focus on macroeconomic policy effects on stronger potential growth in this article, it remains the case that microeconomic factors remain the primary impediments. Aligning microeconomic policies, the focus should be on price determination that is tied to productivity growth rates and of course much stronger investment. The last should be achieved by more fiscal emphasis on investment and efficiency, demopolising network sectors and increasing competition in the private sector.<sup>2</sup>

## An unsustainable fiscal response to the GFC

The global financial crisis generated four, more or less simultaneous, shocks: a steep decline in commodity prices, in trade demand, in currency values, and in domestic demand. Most countries responded with fiscal policy and interest rate cuts, the two immediately available policy tools. South Africa did the same. A high rate of growth in government spending was maintained, even as the tax to GDP ratio fell sharply. As the economy recovered in 2010 and 2011, the fiscal deficit should have been reduced, not least because the output gap had largely disappeared. It wasn't, however,



**Chris Loewald** is the Head of Policy Development and Research of the South African Reserve Bank. He was formerly Deputy Director-General of the Economic Policy Division of the South African National Treasury (2006 to 2011); Acting Deputy Director General for the Budget Office and the Chief Director for Fiscal Policy. He holds both an MA and a PHD in International Economics and European Studies from John's Hopkins University

and with subsequent annual deficits, the public debt level rose by 80% in seven years, from 27.1 to 49.4% of GDP. The largest increases in debt occurred between 2009 and 2012, persisting through the rebound in the economy. Government spending as a proportion of GDP<sup>3</sup> rose from 27% to 33%. As economic growth weakened from 2011 onward, the fiscal position became increasingly constrained. Efforts to spend more were confronted by an already high debt level and the risk of much higher funding costs and credit-rating downgrades.

Had growth been sustained beyond 2011, the fiscal position would have been more sustainable. But the deteriorating growth outcome has been endogenous to fiscal settings as growth in capital budgets slowed relative to exceptionally strong growth in the state wage bill (which rose from 12 to 16% of GDP).<sup>4</sup> Although head-count growth has been contained more recently (it grew by more than 15% across national

and provincial levels alone over 5 years), wage increases for existing employees continue to grow in real terms.

<sup>5</sup> The new budget, released on 21 February, moderates growth in the public sector wage bill but does not reduce its overall size. It grows by 7.3% per year and stays stable at 35% of consolidated expenditure, based on inflation of 5.4% a year. This growth in jobs has severely constrained fiscal consolidation and will permanently limit counter-cyclical fiscal space in future, unless the economy grows strongly.

*Despite being weak, the global economy recovered as did the exports of other emerging market economies. This should have happened in South Africa also, but didn't.*

Space for public investment spending was also crowded out by rapid growth in debt service costs, a function of the near doubling of the debt level and sticky inflation. Debt service costs 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. It 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 roughly tripled from 2009, reaching 3.3% of GDP in 2016/17 and rising to 3.7% of GDP by 2019/20. Contingent liabilities to state-owned enterprise have doubled since the global financial crisis, as a proportion of output, and now amount to about 18% of GDP.<sup>6</sup> This implies that government debt levels could, under adverse circumstances, quickly approach 70% of GDP, well above most posited sustainability thresholds.

The rise in public debt is both a consequence and cause of economic stagnation. 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%. This has contributed to continuous upward revisions of expected debt-to-GDP ratios. More importantly, rescuing the situation would require a significant reversal in the fiscal trajectory. With the nominal yield higher than the nominal GDP growth rate, government needs to run significant primary surpluses to keep the debt level stable.<sup>8</sup>

While we can plausibly argue that fiscal policy was appropriately counter-cyclical in the immediate crisis period, substituting for falling external demand, it is much harder to make the case for continuing such large deficits after 2011. Despite being weak, the global economy recovered as did the exports of other emerging market economies. This should have happened in South Africa also, but didn't. The lack of export response and sustained leakage of the stimulus into imports implied that the fiscal deficit was the main driver of the current account deficit and could do nothing

to reverse the fall in external demand. Instead, by keeping inflation and interest rates higher than they would otherwise have been without the sustained stimulus, fiscal policy alone appreciated the exchange rate and weakened the response of exports to global growth.

As a result, the current account deficit remains substantial, at about 3% of GDP, and will grow larger with stronger economic growth. The trade balance turned to surplus late in 2016 and into 2017, but this was caused by rising export commodity prices, weak oil imports and declining capital goods imports.<sup>9</sup> To get a stronger non-commodity export response will require more real depreciation (relative to equilibrium) than before, a task made more difficult by the persistent gap between South Africa's inflation rate and the low inflation environment globally.<sup>10</sup>

*Is expanding credit and consumption, public or private, the only way to achieve more economic growth? Some commentators certainly appear to think so.*

The rise in debt and poor net export outcomes occurred without a crisis, largely because of the policy framework put in place in the late 1990s and early 2000s. The floating currency allowed the exchange rate to adjust to the serial negative shocks. The floating rate has also warned 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.<sup>11</sup> On the fiscal side, the low level of public debt achieved up to 2008 enabled the post-crisis counter-cyclical response at an historically low short term financial cost. Without that, fiscal policy would have been constrained to consolidate years earlier.

## Going in the right direction

The policy mix described above has been sustained in part by sustained high commodity prices and primarily because the global environment provided cheap financing of public and private debt. Is expanding credit and consumption, public or private, the only way to achieve more economic growth? Some commentators certainly appear to think so.<sup>12</sup> But that growth model depends on debt when productivity slows, and cannot be repeated unless a permanently higher growth rate is achieved. Worse, if benign global conditions dissipate and financing conditions deteriorate, a negative debt dynamic will make it more likely that policy has to tighten to maintain solvency, and potentially quickly.

The GFC was a severe economic shock that primarily reduced external demand. 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? The adjustment to that shock should have relied on relative price adjustments – lower real industrial and input prices to maintain export and production volumes – and a temporary fiscal response. This is often thought about in microeconomic terms. But fiscal and monetary policy also have long-term effects on the composition of growth and shares of tradables and non-tradables because of their effects on the balance of saving and investment and relative import and export prices. With real depreciation and less absorption (domestic demand), the basic adjustment path is for production shifting to tradables and relatively more expenditure switching to consumption of non-tradables.

The main obstacle to greater real depreciation is domestic – the propensity for prices to rise and reverse the relative price change initially caused by currency depreciation. These serial cost-raising shocks to supply feed through into a stubbornly high

inflation rate via largely adaptive expectations and import parity pricing, and is made possible by 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).<sup>13</sup>

Getting different outcomes requires a more robust policy framework that increases credibility and lowers inflation expectations. Improving the policy framework with a lower and clearer policy target is the least cost option.<sup>14</sup> Fiscal policy would also

*Allowing private firms to enter these sectors and provide competition to the public firms would lead to better economic outcomes – improved governance and long term efficiency gains in state enterprises, and also fewer demands placed on the fiscus.*

benefit from a more rules-based approach to make effective budget guidelines that have been already adopted – counter-cyclicality, debt sustainability and inter-generational equity. Easing micro constraints would further create macroeconomic policy space and reduce potential adjustment costs. Product market reforms that increase competition and weaken pricing power and indexation are a needed complement to this strengthening of the monetary policy framework. If enacted they would do most of the work to lower inflation and improve competitiveness.

For periods of currency appreciation, reserves policy 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, provide more public investment, and perhaps use temporary tax credits for tradeables sectors. In these conditions, fiscal policy should seek to contribute to competitiveness by aiming for fiscal surpluses or smaller deficits. More fiscal consolidation would allow a slightly more relaxed monetary stance, which could then be supplemented if needed with an asymmetric forex reserves accumulation policy.

### Coordinating policy to get better outcomes

Getting more growth and a lower current account deficit suggests more investment, with more of that provided by private sector exporters and import-competing firms. The macroeconomic policy suggested here will support them, but at some cost of lower returns to importers and domestic non-tradeables producers. But the biggest short term economic gains are not going to be found in greater investment and production in existing industries where imports can satisfy demand (clothes, cars, food, etc.). Instead, near term growth can be induced in over-regulated network sectors where supply is costly and restricted and below demand (telecommunications, energy, transport).<sup>15</sup> Allowing private firms to enter these sectors and provide competition to the public firms would lead to better economic outcomes – improved governance and long term efficiency gains in state enterprises, and also fewer demands placed on the fiscus. Eventually, lower costs in these latter sectors will help to increase growth in the tradeables sectors, including import-competing businesses, and broader economic growth. These policy innovations would encourage private investment moving across both tradeables and non-tradeables sectors.

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, in particular 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).

Tax credits that create rent-seeking is another area for better use of fiscal resources. Fiscal savings could be reallocated to temporary assistance for firms and individuals that bear the costs of reforms, thus enabling faster shifting of capital and labour into more rapidly growing sectors.

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. Most importantly, steps to increase sustainable economic growth will generate an expansion in fiscal resources that the country needs.

## 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, less debt and consumption-dependent, balance of production. The second initiative sets out the 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. 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.

*The views expressed in this article are solely those of Chris Loewald and do not reflect the views of any other institution.*

---

### NOTES

1. See Johannes Fedderke and Daniel Mengisteab, Estimating South Africa's output gap and potential growth rate, SARB Working Paper, WP/16/02, March 2016 and Vafa Anvari, Nelene Ehlers and Rudi Steinbach, A semi-structural approach to estimating South Africa's potential output, SARB Working Paper, WP/14/08, November 2014.
2. See Boris Cournède, Antoine Goujard and Álvaro Pina, How to achieve growth- and equity-friendly fiscal consolidation? A proposed methodology for instrument choice with an illustrative application to OECD countries, OECD WP1088, 2013.
3. Carmen M. Reinhart and Kenneth S. Rogoff, Growth in a time of debt, NBER Working Paper Series, Working Paper 15639 <http://www.nber.org/papers/w15639>.
4. 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. For more read International Monetary Fund, (2016), South Africa: 2016 Article IV Consultation, cr16217.pdf. Relative to emerging market peers, South Africa's wage bill is now among the highest. World Bank, 2016, Size of the Public Sector: Government Wage Bill and Employment, public sector data set.v
5. Government reined in employment growth from above 3% in 2008-2013 to 1.2% since the fiscal consolidation program, which started in late 2013.
6. These institutions are crucial to private-sector performance as they determine important input costs for businesses. On state control in product market rigidities, SA scores much higher than OECD average, and above Brazil, Chile and Mexico (OECD 2013 PMR indicators).
7. Paul et al., 2016, Budget Review, SARB Economic Note, March 2016. A debt to GDP ratio for general government of 50% sets a limit beyond which additional debt lowers economic growth rates. See Prudent Debt Targets and Fiscal Frameworks, OECD Economic Policy Paper No 15, July 2015, page 20.
8. 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.
9. Up to 2017, a decline in South Africa's terms of trade had offset some volume improvement on the trade and current account balance. See JF Ruhashyankinko et al, External rebalancing: Commodity prices flatter Turkey but sully South Africa, Goldman Sachs Economic Research, 26 April 2016.
10. 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). See also Anand, Rahul, Roberto Perrelli, and Boyang Zhang (2016), South Africa's Exports Performance: Any Role for Structural Factors? IMF Working Paper WP/16/24. They also find that structural constraints impede export responses. See Berman, N., Martin, P., & Mayer, T. (2012). How do different exporters react to exchange rate changes? The Quarterly Journal of Economics, 127(1), 437-492.
11. Although this effect may have weakened in recent years as financial corporate borrowing increased.
12. See for instance Brian Kantor, Unleashing the household sector, Business Day Op-ed, 30 July 2015.
13. Including tighter access to finance, regulations, higher tariffs, etc.
14. The gains to this approach go beyond the lower inflation rate. Matching real income growth to productivity growth would help with external competitiveness, while greater product and labour market competition, and more skilled immigration would eventually expand demand for less-skilled workers.
15. See the growth effects of reforms in David Faulkner, Christopher Loewald and Konstantin Makrelov, Achieving higher growth and employment: policy options for South Africa, ERS Working paper 334, March, 2013

## BIBLIOGRAPHY

- Anand, Rahul, Roberto Perrelli, and Boyang Zhang (2016), South Africa's Exports Performance: Any Role for Structural Factors? IMF Working Paper WP/16/24.
- Vafa Anvari, Nelene Ehlers and Rudi Steinbach, A semi-structural approach to estimating South Africa's potential output, SARB Working Paper, WP/14/08, November 2014.
- Bernanke, Ben, (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., & Mayer, T. (2012). How do different exporters react to exchange rate changes? *The Quarterly Journal of Economics*, 127(1), 437-492.
- Central Bank of Chile; 2015 'Monetary Policy Report', September 2015.
- Carlson et al. (2008), Distress in the Financial Sector and Economic Activity, Finance and Economics Discussion Series, Federal Reserve Board, Washington, D.C.
- Claassen, Emil-Maria, *Global Monetary Economics*, OUP, 1996.
- Corden, Max, *Economic Policy, Exchange Rates and the International System*, OUP 1994.
- Coumède, Boris, Goujard, Antoine and Pina, Alvaro, How to achieve growth- and equity-friendly fiscal consolidation? A proposed methodology for instrument choice with an illustrative application to OECD countries, OECD WP1088, 2013.
- Faulkner, David, Loewald, Christopher and Makrelou, Konstantin, Achieving higher growth and employment: policy options for South Africa, ERSA Working paper 334, March, 2013.
- Fedderke, JW and Mengisteab, D, Estimating South Africa's output gap and potential growth rate, to be published as SARB WP, January 2016.
- Fedderke, Obikili and Viegi, Markups and concentration in South African manufacturing sectors: an analysis with administrative data, forthcoming.
- Hlatshwayo, Sandle and Magnus Saxegaard (2016), The Consequence of Policy Uncertainty: Disconnects and Dilutions in the South African Real Effective Exchange Rate-Export Relationship, IMF Working Paper WP/16/113.
- Fowkes and Walter, Current account rebalancing: an exploration of the trade data, SARB Economic Note, 2016-19, 24 June 2016.
- International Monetary Fund, (2016), South Africa: 2016 Article IV Consultation.
- Kantor, Brian, Unleashing the household sector, *Business Day Op-ed*, 30 July 2015.
- Lubin, David, EM Economics View: Can EM survive "Trumponomics"? *Global Economic Outlook and Strategy: Prospects for Economies and Financial Markets in 2017 and Beyond*, December 2016.
- Mishkin, Frederick (1991), Asymmetric Information and Financial Crises: A Historical Perspective, in *Financial Markets and Financial Crises*, ed. by R. G. Hubbard, pp. 69–108, Chicago: University of Chicago Press.
- National Treasury, 2016, Medium Term Budget Policy Statement 2016.
- OECD 2013 PMR indicators
- Paul et al., 2016, Budget Review, SARB Economic Note, March 2016.
- Reinhart, Carmen M., Rogoff, Kenneth S., Growth in a time of debt, NBER Working Paper Series, Working Paper 15639.
- Ruhashyankinko, Jean-Francois, et al, External rebalancing: Commodity prices flatter Turkey but sully South Africa, Goldman Sachs Economic Research, 26 April 2016.
- Sharma, Ruchir (2012). Breakout Nations: In Pursuit of the Next Economic Miracles pp. 183 – 184.
- Statistics South Africa, Statistical release P3043, Manufacturing: Utilisation of production capacity by large enterprises, August 2015.
- Visser, Erik and Theo Janse Van Rensburg, South African exports – two inconvenient truths, SARB Economic Note, 7/7/2016.
- World Bank, 2016, Size of the Public Sector: Government Wage Bill and Employment.