

Fiscal and Monetary Policy Considerations: Restoring Growth in the South Africa Economy

Macroeconomic Policy Seminar
Bureau for Economic Research
Stellenbosch

4 December 2019

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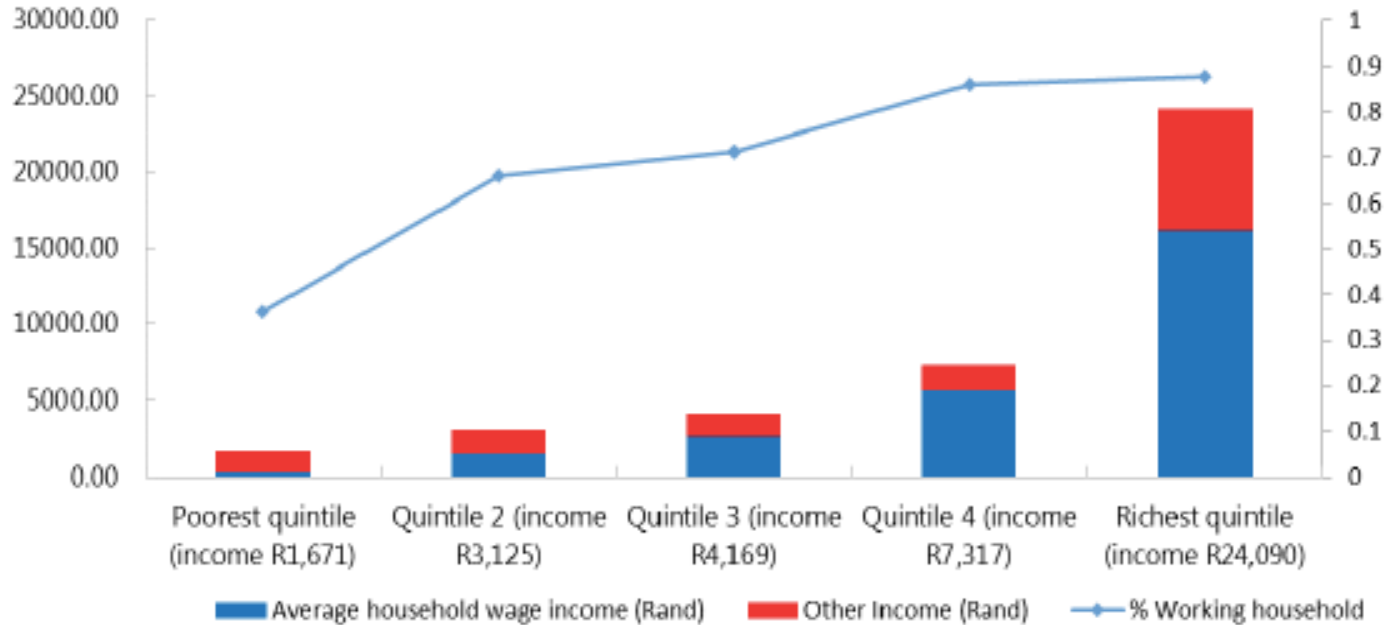
Outline of argument

- Diagnosis –
 - SA's “low growth trap” as an n-person prisoners' dilemma
 - Substantial policy coordination failures hold back confidence & investment
 - Post-recession recovery delayed by balance sheet recession & GDP inflation shock
- Limited fiscal room for manoeuvre
 - Growth stimulus has to come from self-financing investment projects & public-private co-financing programmes
- Monetary accommodation & private sector credit extension
- Municipal investment & housing as foundations of improving living standards

Growth and employment imperative

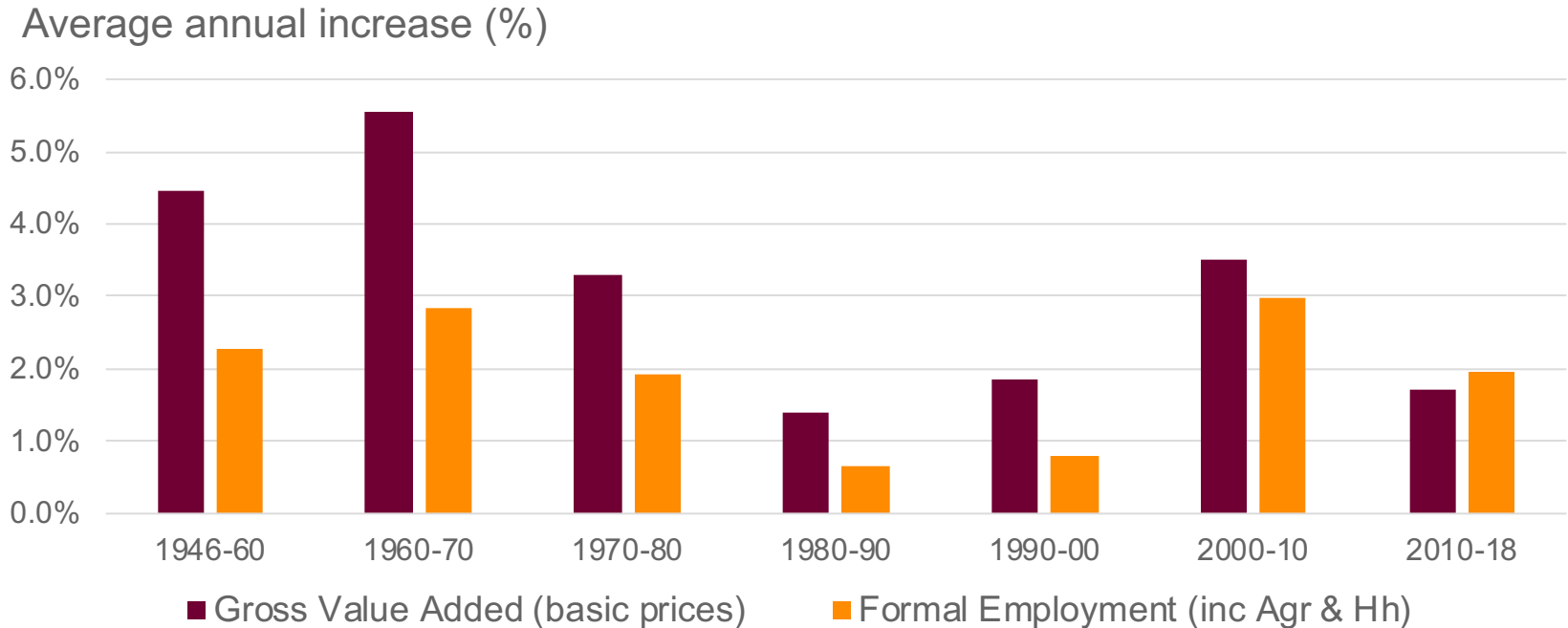
- Employment-intensive growth is central to inclusivity and social sustainability
 - Low levels of labour market earnings < 50th %tile makes SA an outlier
- Macro stabilisation is not enough
 - Slow road to economic collapse if investment stalls and incomes and living standards stagnate
- Raising living standards is not a mystery
 - It derives from technologies, logistical capabilities and investment designs that have been known for a century or more

Household income and the distribution of work opportunities

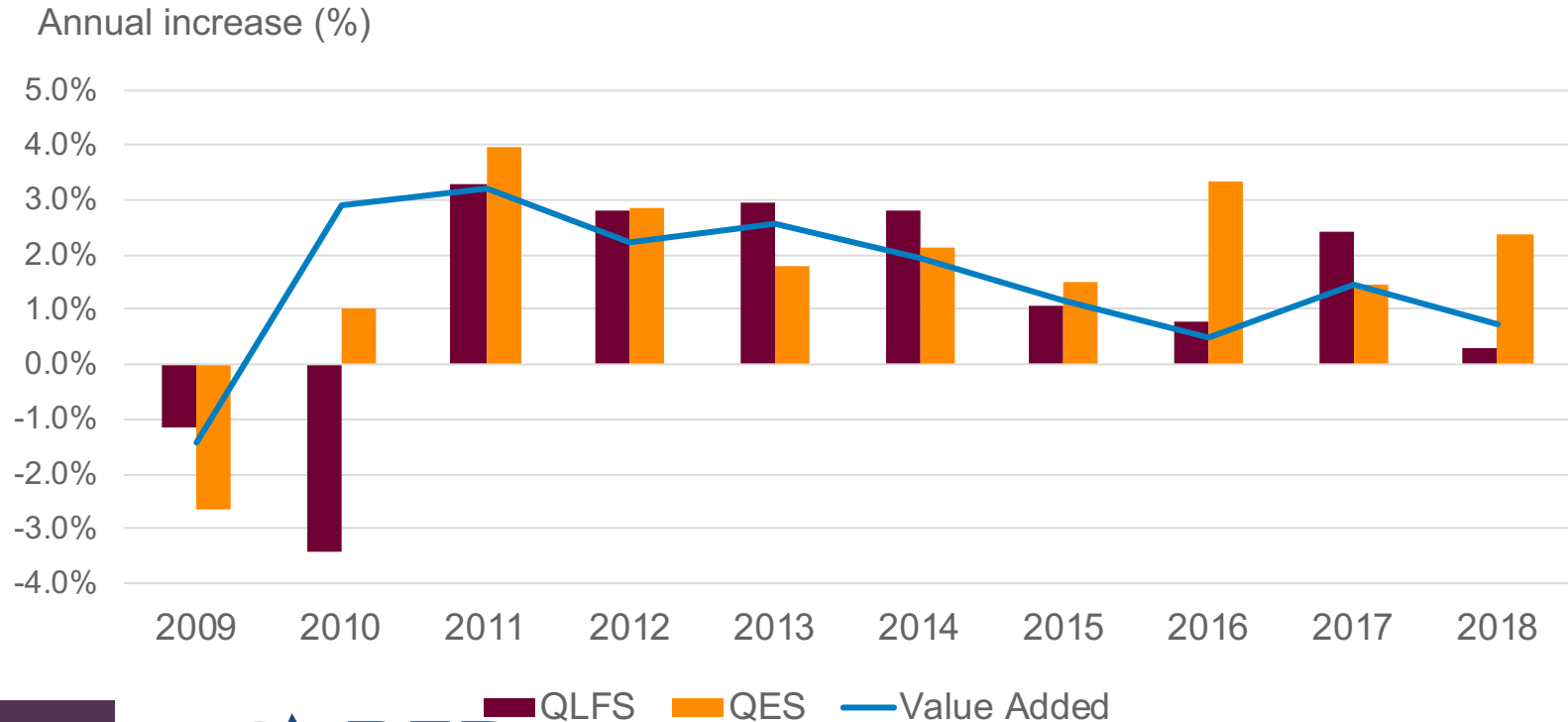


Source: International Monetary Fund, Country Report No. 17/189, 2017

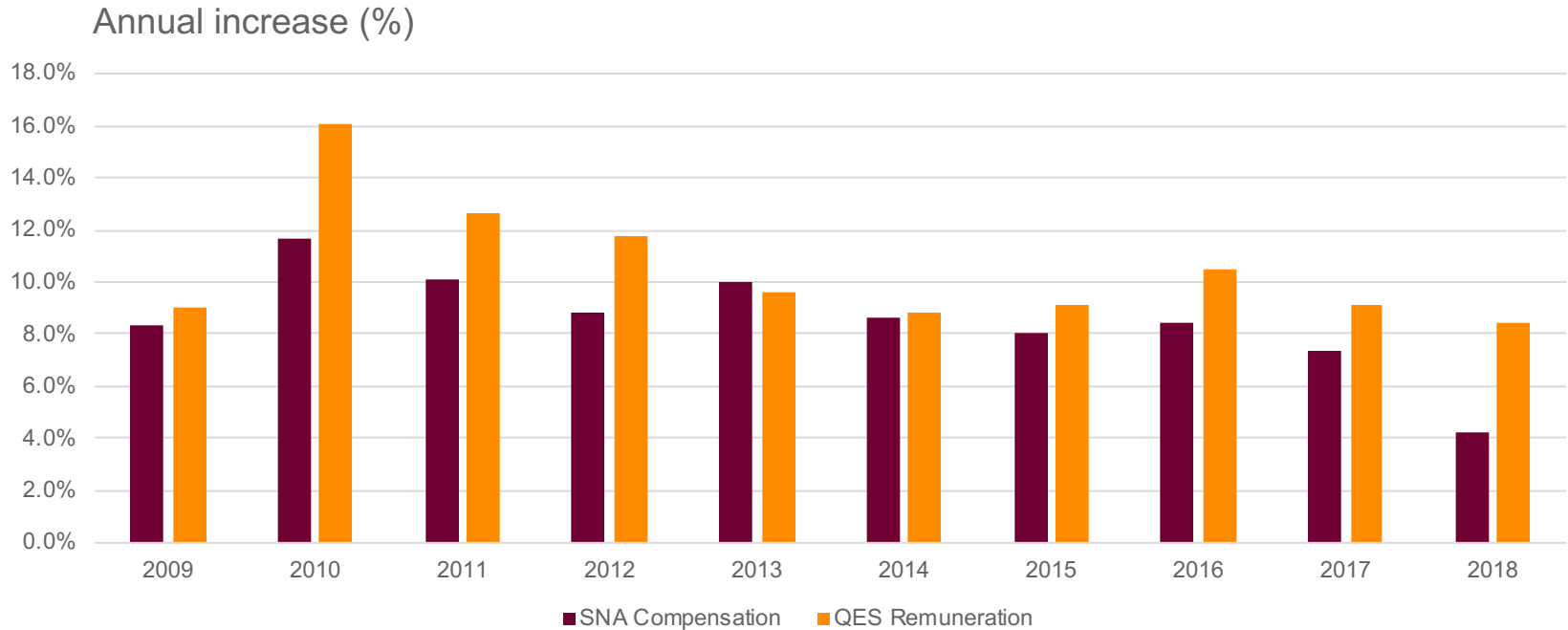
South African economic growth and employment 1946-2018



South African economic growth and employment 2008-2018



Formal sector remuneration – QES vs National accounts



Low growth trap as a sub-optimal Nash equilibrium

- The n-person Prisoners' Dilemma
 - Global climate change and carbon reduction
 - Business investment in a context of future uncertainty
 - Trade union approaches to wage determination in context of high unemployment
 - Balance sheet recession
- The “Stag Game”: cooperation to share proceeds vs lower non-coop payoff
 - Lack of trust between public and private sectors is stag game equilibrium
 - Social engagement and redistribution in a “dual economy” may have stag game features

Growth as a cooperative strategy

- Cooperation is more than policy certainty, it is also a joint investment strategy
- First-order economic principles...
 - Property rights, competition, market-based incentives, sound money
 - ...do not map into standard policy packages and institutional arrangements
- Successful economic reforms are designed for local context and conditions
- “Igniting” growth is simpler than sustaining it
 - Growth episodes often follow limited and unconventional interventions that open opportunities or remove constraints
 - Sustained growth requires deeper institutional reforms to withstand shocks and maintain productive dynamism

Dani Rodrik, “*Growth Strategies*”, prepared for the *Handbook of Economic Growth*, August 2004.

Growth, employment and development – a “virtuous circle”

- Expanding employment is key to reducing poverty and unemployment, and expanding productive frontier
 - Caution: number of reports written on growth and employment policy in SA over the past 25 years is large; impact on policy hard to find
- An enabling environment for higher rates of investment is needed
 - Savings responded to higher growth in the 2000s, though slowly
 - SA investment depends on both domestic and foreign savings
- Urbanisation is a powerful motive for productivity advances
 - Most of the great improvement in living standards of the 20th century derived from innovations of the 1870s
 - Water & sanitation, electricity, refrigeration, TV & telecoms, motorised transport (Robert Gordon)
- *There are both “learning spillovers” and “scale-economy externalities” that account for under-investment and failure to diversify in a decentralised low-growth equilibrium (Rodrik)*

Balance sheet recession and the nominal GDP shock

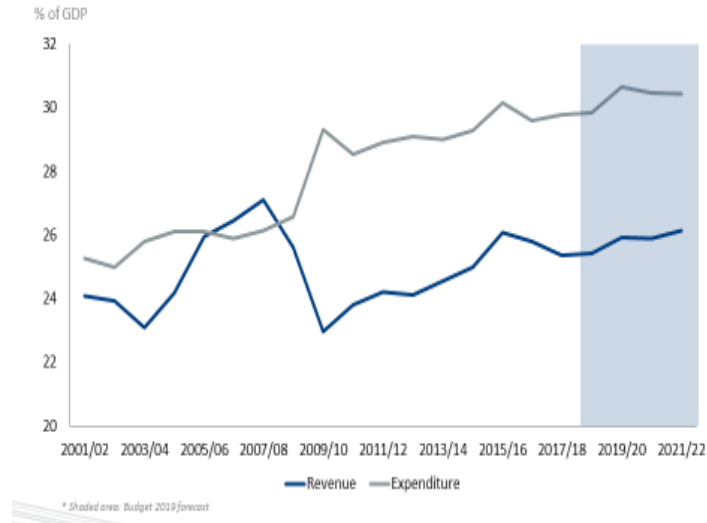
- Public debt has increased substantially since the Recession...
- Private sector debt has moderated
 - Household and corporate deleveraging following negative wealth shock
 - Household debt down from 85% of disposable Y in 2008 to 70% today
- Divergent responses to slower nominal GDP than anticipated
- Both public sector & corporate debt increasingly owed to RoW
- The 2018 nominal GDP shock:
 - 2018 GDP inflation revised down from 6.2% to 3.9% in March 2019 P0441 stats
 - 2019 Budget projections were based on GDP growth of 7.2%; now down to 5%

Fiscal policy considerations - tax

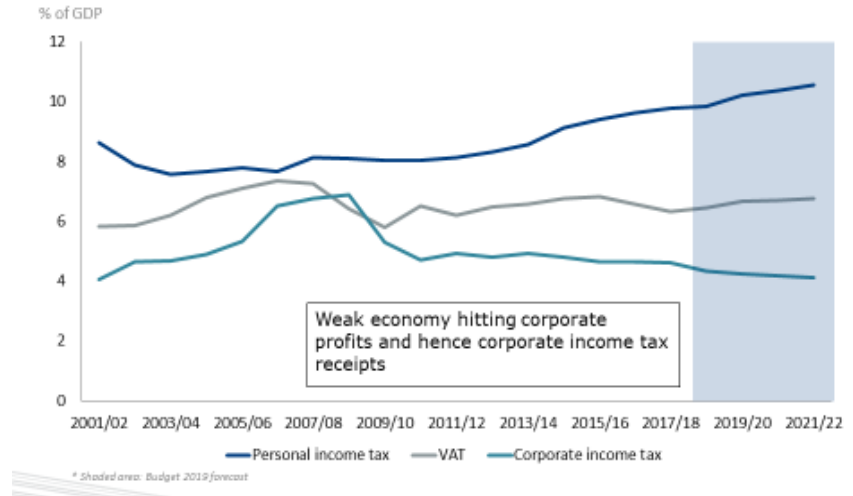
- Overall tax burden has increased over past decade:
 - PIT has not been fully adjusted for inflation over the past five years
 - The maximum marginal PIT rate increased from 41 per cent to 45 per cent in 2017
 - Capital gains inclusion rates were increased in 2012
 - VAT was raised from 14 to 15 per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

Main budget revenue and expenditure

Main budget revenue and expenditure trends



Main sources of revenue (80% of gross tax)



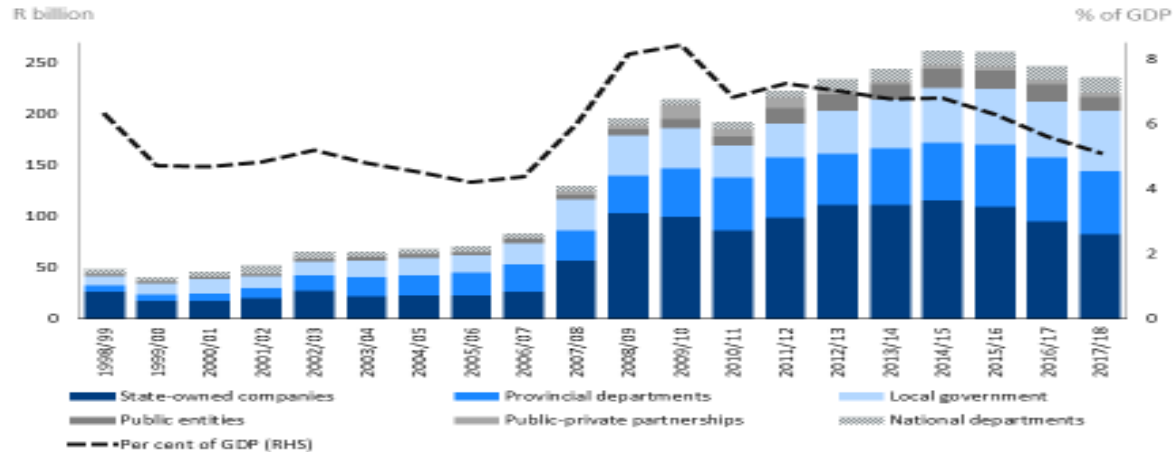
Revenue policy issues

- Tax measures targeted at employment have to be considered:
 - Extension of the youth employment incentive as a basic income subsidy to low-wage workers, complement to minimum wage standard
 - Extension of urban development zone tax incentive
 - Support for export-oriented agriculture and labour-intensive sectors
- Non-tax revenue can be substantially strengthened
 - Municipal services
 - Education (HE financing), Health (UPFS and cost recovery from health insurers)

Expenditure policies

- Can austerity be avoided?

Public infrastructure spend declining in nominal terms and as share of GDP



Consolidated spending – 2006/07 – 2017/18

Consolidated spending

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

Extra-budgetary liabilities

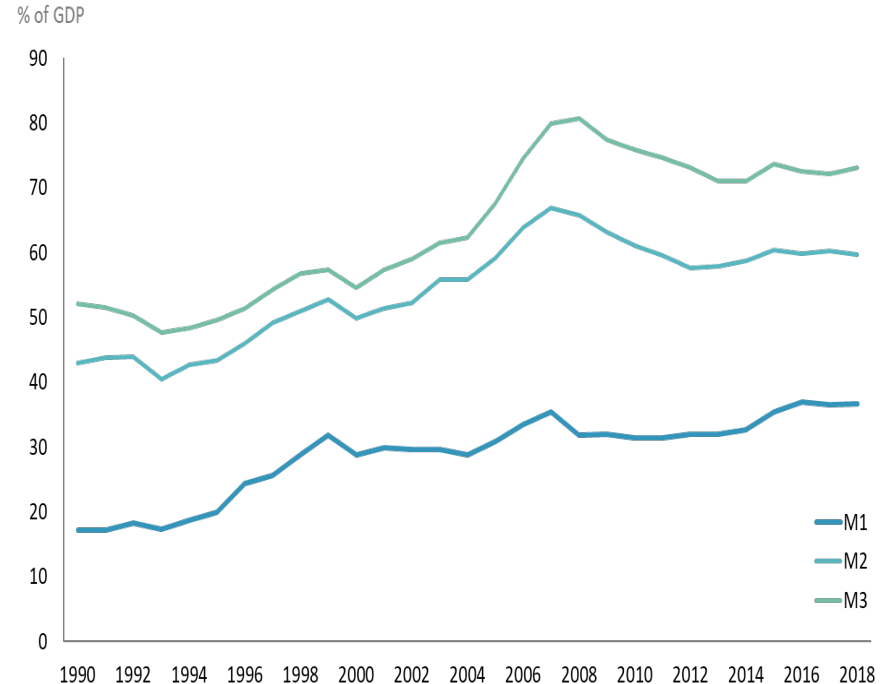
- As much as half of Eskom's debt of R450 billion may need to be taken over by the fiscus, accompanied by restructuring of the industry and recovery of revenue from consumers and municipal distributors.
- The legislative reform of the Road Accident Fund has still to be completed. The unfunded liability of the RAF of about R200 billion will have to be funded alongside the new RABS arrangement.
- A more cost-effective approach to medico-legal liabilities (R90 billion) and other claims against state is needed.
- Where debate is often about "privatisation" or not, there are really many ways in which the balance can be shifted between fiscal and market-based arrangements

Fiscal policy and economic recovery

- Strategic shift towards complementary rather than substitutive strategies:
 - Housing finance and urban development
 - Small enterprise and venture capital
 - Municipal services
 - Industry and agriculture, special economic zones
 - Education, training and skills development
- Can fiscal constraints serve as catalyst for more enduring co-financing partnerships?

Financial deepening and credit extension

- Growth of monetary and credit activity since 1994 substantially greater than requirements of savings-investment intermediation –
 - Also reflects lifetime income smoothing by households, asset transfers across generations, corporate restructuring, BEE transactions and international diversification
- Investment increased from 16 – 24% of GDP between 2002 and 2008
- Both investment & saving fallen back rapidly since 2009 recession

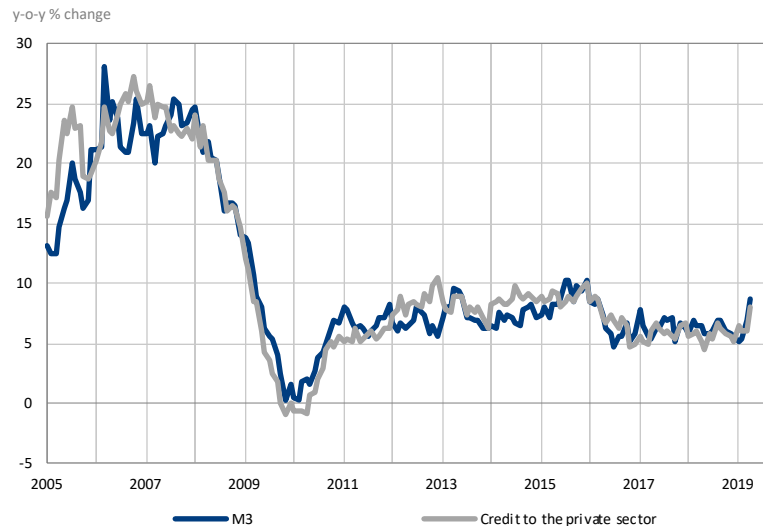


Inflation and money supply

Headline CPI inflation



Money supply vs. Credit extension



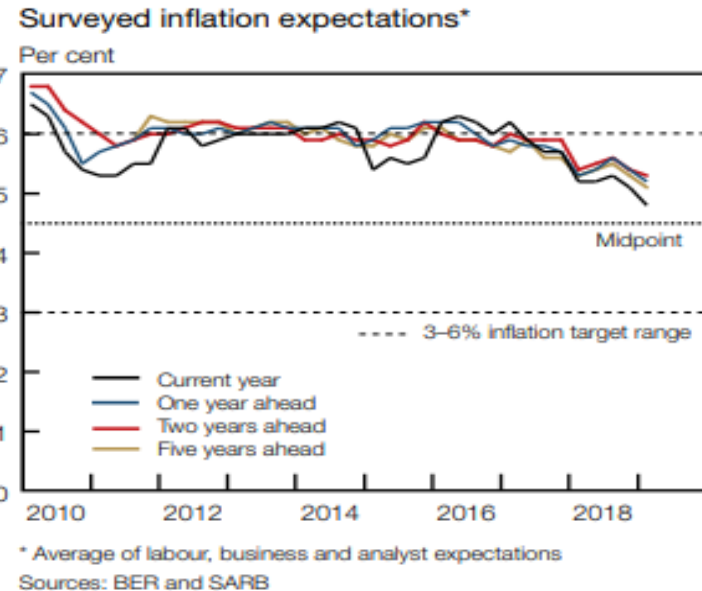
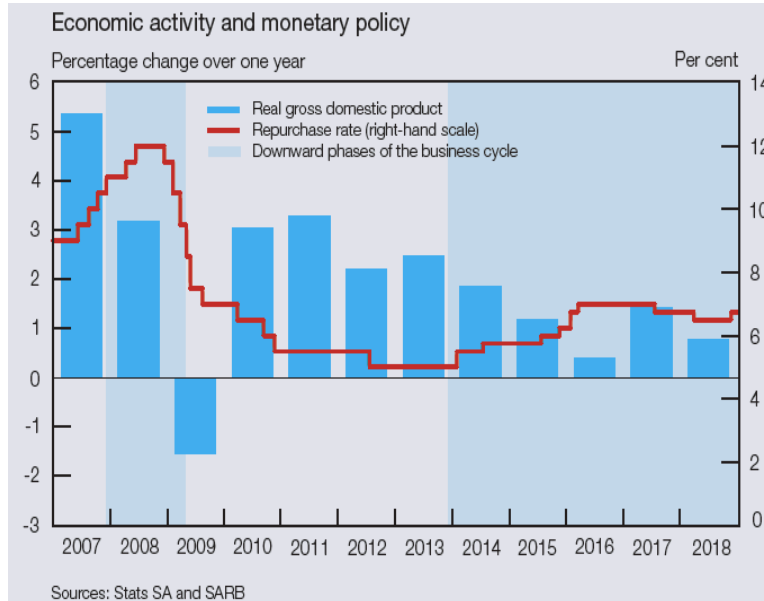
Interest rate setting and the Taylor rule

- The SARB uses a Taylor rule adapted to the SA economy:

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

- The repo rate is (approx.) set at:
 - 4/5ths of the previous quarter's repo rate, plus
 - 1/5th of the neutral rate, adjusted by
 - 150% of the difference between expected and target inflation
 - 50% of the output gap (diff between actual and potential GDP)
 - Potential “trend” GDP growth currently estimated as 1.3% pa.

Economic activity, inflation expectations and the repo rate

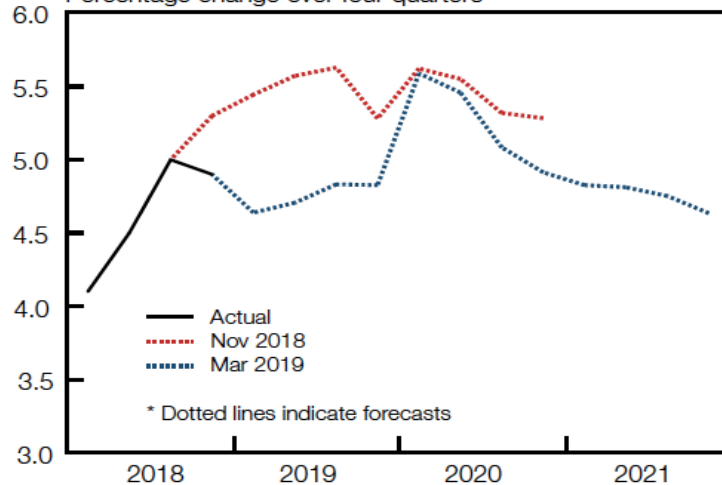


SARB, Quarterly Bulletin, March 2019.

SARB's inflation forecasts and potential GDP

Evolution of the SARB's inflation forecasts*

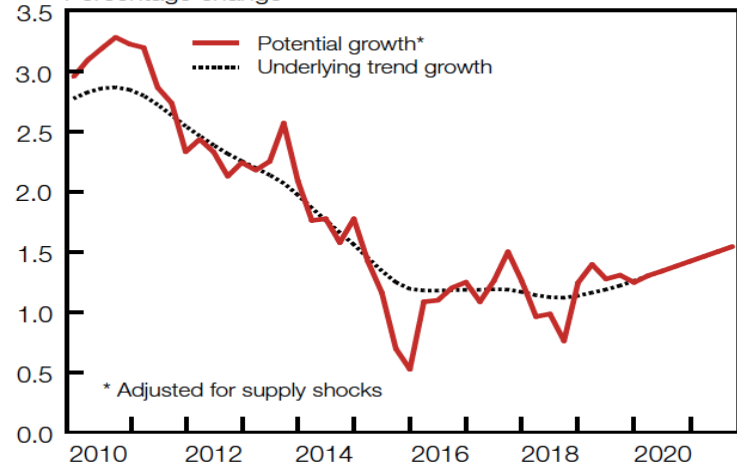
Percentage change over four quarters



Sources: Stats SA and SARB

Potential GDP

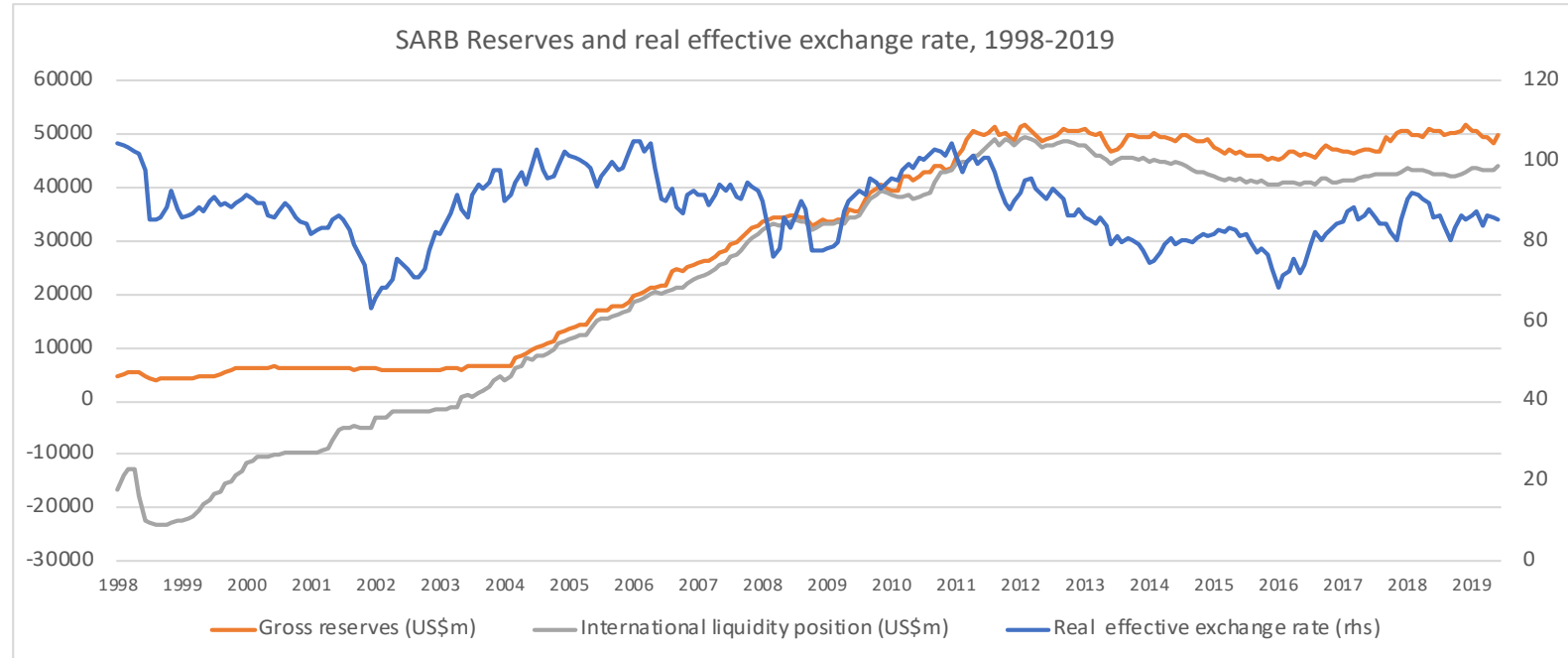
Percentage change



Source: SARB

SARB, Monetary Policy Review, April 2019.

Monetary policy, reserves and the exchange rate



Fiscal and monetary policy coordination

- Fiscal and monetary policy as a stag game – complementary vs substitutive strategies

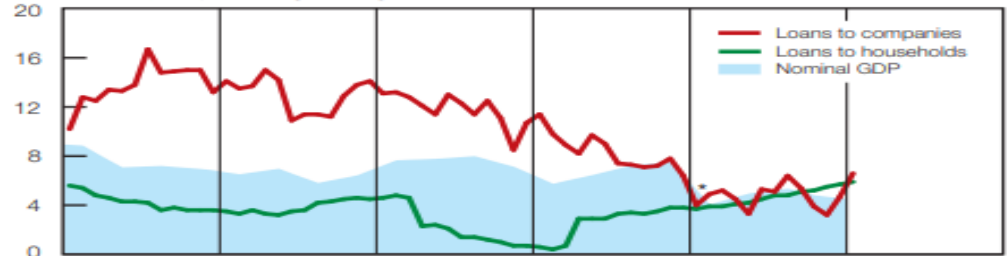
Nearly by definition, when interest rates are low – a especially if the interest rate is lower than the growth rate – debt dynamics are more favourable...So yes, low interest rates increase the room to use fiscal policy.” (Olivier Blanchard)
- Memory of hidden forward cover liabilities informs SA reluctance to entertain quasi-fiscal monetary interventions
- Yet monetary transmission operates partly through quasi-fiscal mechanisms – higher interest costs lead to higher tariffs and taxes
- Interventions to accumulate reserves and lean against over-valuation of the rand have been in abeyance since 2011.
- On “quantitative easing” and SOC debt restructuring: where historic liabilities are held is less important than who pays debt service & retirement

Broadening credit extension

- Financial easing has enabled banks to recapitalise, but has not translated into easier credit conditions for businesses or households
- Slow growth in mortgage lending reflects weakening in the maturity transformation function of banks
- Households and small businesses face higher interest rates than before recession, especially when compared with nominal growth prospects

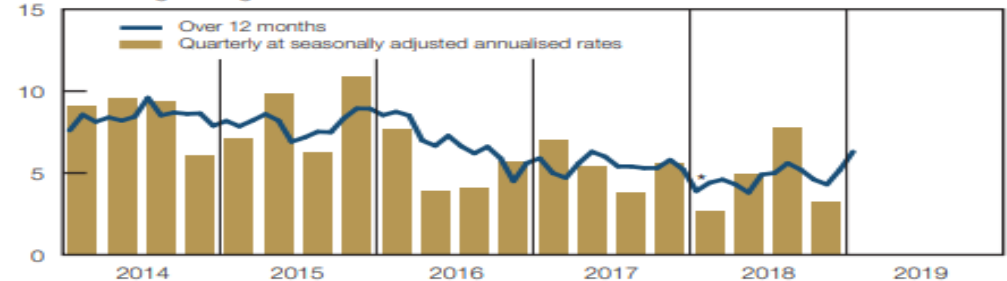
Bank loans and gross domestic product

Year-on-year percentage change



Total loans and advances to the private sector

Percentage change

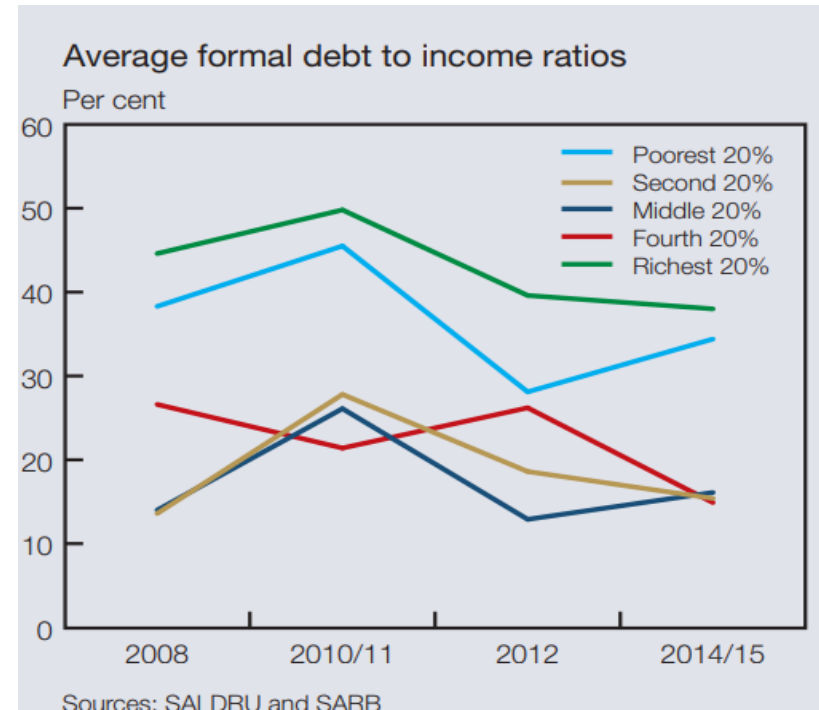
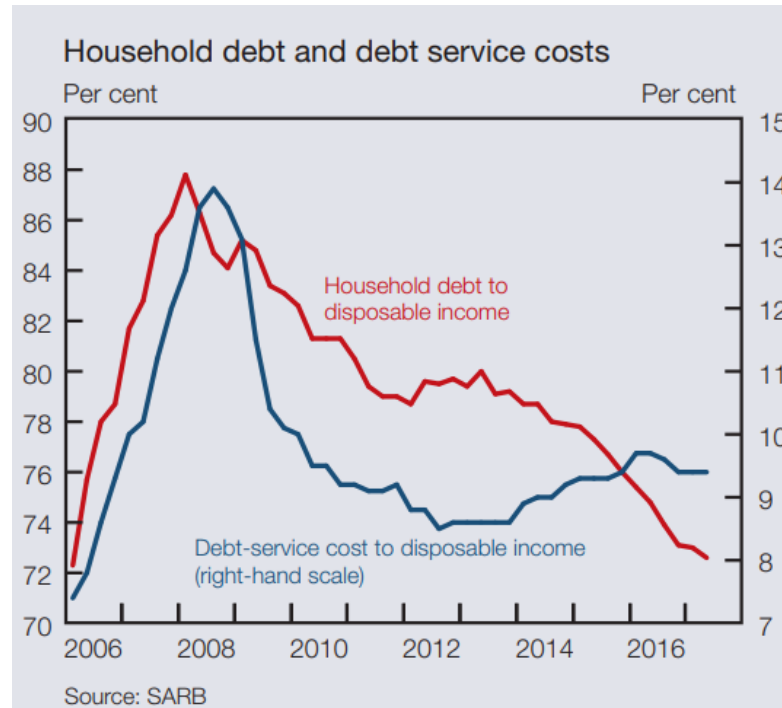


* Growth rates impacted by the implementation of IFRS 9 from January 2018

Sources: Stats SA and SARB

Source: SARB Quarterly Bulletin March 2019

Household debt and income distribution



Urban infrastructure and city development

- Urbanisation and the productivity advances associated with spatial concentration are powerful drivers of growth and rising prosperity...
 - But if cities are not well-planned, with infrastructure to meet water, transport, housing, energy and communication needs they become places of disease and danger
 - Cities are “riddled with market failures” (Spence Commission)
- Fragmented apartheid cities are economically and socially inefficient
 - And so investment in more integrated cities is both growth and equality-enhancing
 - Provided investment is for long-term, and is accompanied by growing enterprise activity
- The metro's and other large cities have comparatively low debt (<R50 bn)
 - But stronger revenue management needs to accompany borrowing for investment

Accelerated investment in housing

- There will be ongoing need for government-sponsored housing schemes and upgrading of informal settlements –
 - Annual delivery has fallen from around 300,000 to 150,000 units a year
 - Backlogs in title-deed provision and weak administration is leading to complexity in informal markets
- Greater impetus has to come from private investment in mixed-use and “affordable” housing stock
 - Held back since the recession by banks’ withdrawal from mortgage market, weaknesses in housing DFIs and limited progress of finance-linked subsidy (FLISP)
- Household income means-tests are incentive-incompatible (and have not been inflation-adjusted):
 - Alternative spatial or unit design targeting would be preferable
- Architecture of accelerated housing investment programme needs to be agreed between MoF, banks, housing depts and cities

Municipal finances – deteriorating in good health?

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

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

Inclusive growth as a cooperative strategy

- Cooperation is more than policy certainty, it is also a joint investment strategy
- Complementarities define cooperative solutions to n-person PDs
 - Public and private investment plans
 - Fiscal and monetary/credit policies
 - National, provincial, local development
 - Sectoral investment and BEE strategies
 - Municipal finance and development & local business strategies
 - Especially further education & training
- *The structural shifts necessary to build momentum in growth... are unlikely to emerge from separate programmes of fiscal, industrial, monetary, financial, urban and labour market policy adjustments, from supply- or demand-side efforts alone, or from government and business operating on separate tracks...*