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SA Future Economy

Policy Briefing:

Monetary and fiscal policy challenges posed by South Africa's deepening economic crisis and the COVID-19 pandemic

By Nombulelo Gumata

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Key recommendations

1. The deficit financed spending approach that was accompanied by a highly accommodative monetary policy stance post-2009 have performed poorly as policy interventions to increase output growth and potential output. As such, there is a case to explore a wider range of potent policy tools and interventions that will propagate and amplify the effects of the current policy mix.

2. Nominal demand management policies such as increased government spending or expansionary monetary policy have a bigger effect on real output in a low inflation regime. Thus, a low and stable inflation regime is necessary for the co-ordination of monetary and fiscal policy to enhance the effectiveness of the transmission of nominal demand management policy shocks.

3. There is a need to drastically change the composition, quality and efficiency of government spending shocks as it matters for productivity gains and the government bond yields. These changes, have to be accompanied by fiscal credibility and sustainability.

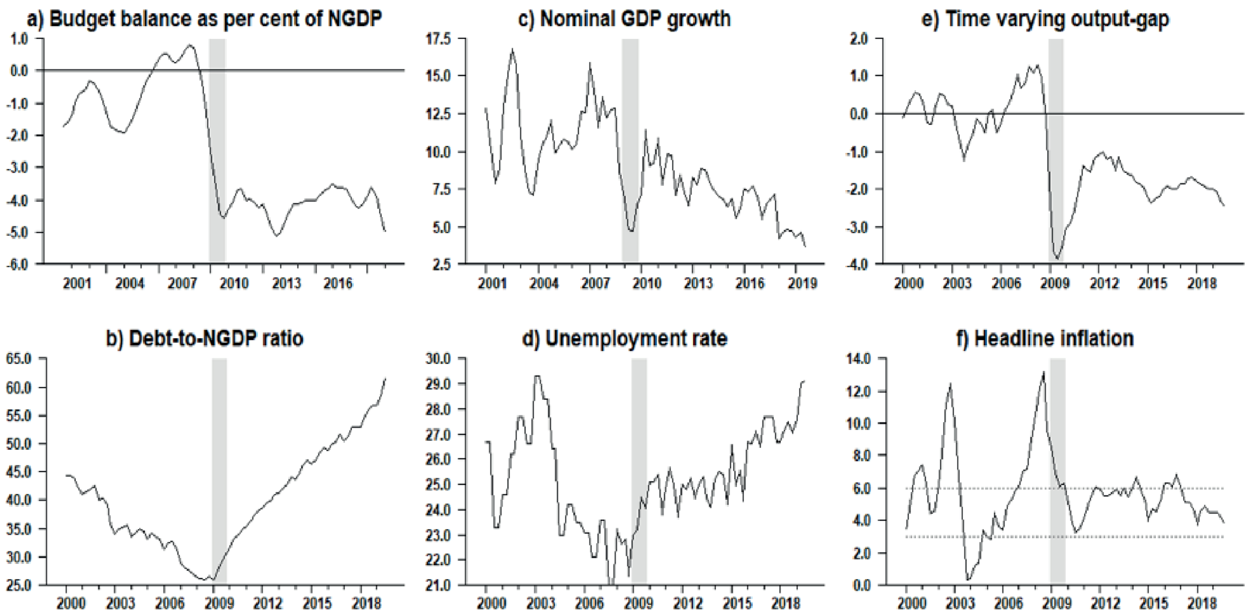
4. Accelerated land reform, redistribution and an increase in hectares planted are necessary broader policy interventions to deal with the problem of poverty, inequality, changing the ownership patterns in the economy, increasing participation in the economy, labour absorption and inclusion. This, has to be accompanied by investment in the value chains, development of new export markets and strategies that cushion the economy against severe cyclical shocks.

5. Policymakers must place urgency on efforts to identify the exchange policy and a strategy of dealing with the adverse effects of severe deprecations on investment and economic growth. Structural reforms should rebalance the economy from high dependency on imports, stabilise electricity price inflation below 6 per cent and increase labour productivity growth.

1. Introduction

What are the monetary and fiscal policy challenges posed by South Africa's deepening economic crisis and the current COVID-19 pandemic? This policy brief contributes to the ongoing discussion debates about what needs to be done and how it should be done. Figs. 1 and 2 put into perspective the nature and severity of the monetary and fiscal policy challenges posed by South Africa's deepening economic crisis and the current COVID-19 pandemic.

Figure 1:
Trends in selected macro-economic indicators

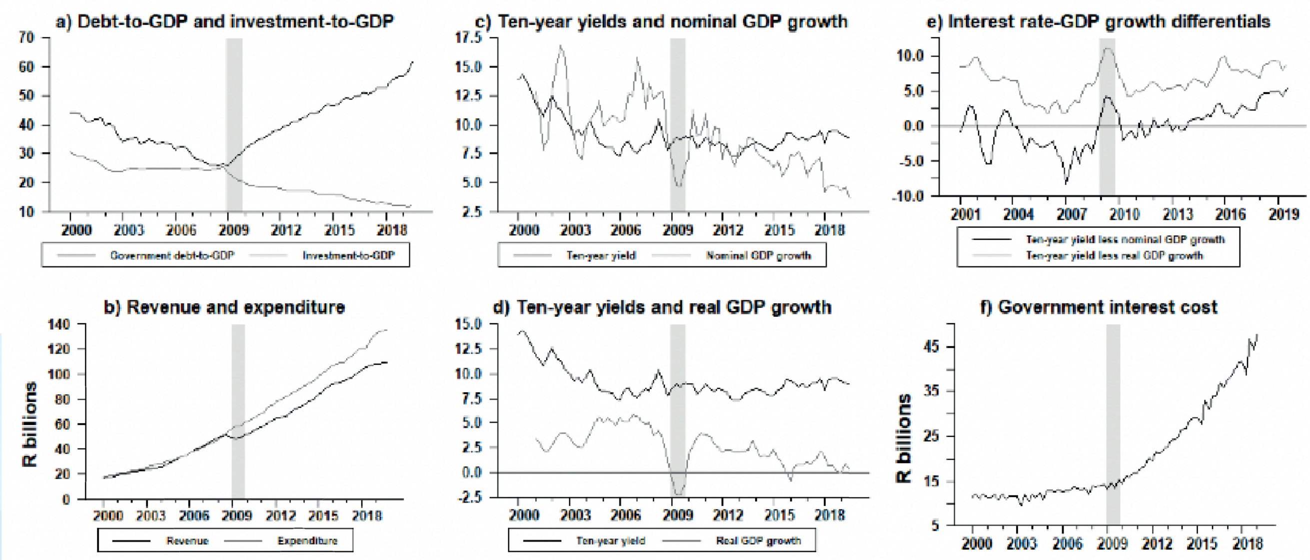


Source: South African Reserve Bank and authors' calculations.

Note: the grey shaded area denotes the recession in 2009. The budget balance as per cent of nominal GDP in (a) was smoothed using the 4-quarter moving average.

Fig. 1(a) shows that post-2009, the budget balance as a ratio of nominal GDP (NGDP) widened and this was accompanied by the increase in the debt-to-GDP ratio in Fig. 1(b). NGDP growth which is the denominator for the fiscal variables continued to trend downwards in Fig. 1(c), the output-gap[1] remained persistently negative and widened in Fig. 1(e), whereas the unemployment rate continued to rise in Fig. 1(d). The trends in Fig. 1 present diverging challenges facing monetary and fiscal policy. The price stability mandate as captured by headline inflation poses no immediate threat and is largely achieved. On the other hand, fiscal sustainability and macro-economic stability as captured by output growth, employment growth and a decline in the unemployment rate has been elusive post-2009 despite the persistently widening budget deficit and an increase in the government debt-to-GDP ratio. There has also been a divergence in the unemployment rate and inflation in Fig. 1(d and f).

Figure 2:
Selected macro-economic indicators



Source: South African Reserve Bank and authors' calculations.

Note: the grey shaded area denotes the recession in 2009.

[1] See Ozbek and Ozlale (2005).

Furthermore, the key variables underlying measures of fiscal sustainability, R which is captured by the ten-year yield on government bonds, has persistently increased above G, which is captured by nominal and real GDP growth in Fig. 2(c, d and e). Last, the debt service costs have continued to increase in Fig.2(f). Thus, what other policy tools are available to decrease R and increase G to help achieve fiscal sustainability? What have we missed or gotten wrong in the policy mix post-2009?

2. Has the accommodative fiscal policy stance been a potent tool?

The Supplementary Budget Review 2020 showed that under the active scenario, the debt-to-GDP ratio peaks at 87.4 per cent in 2023/24 and the budget deficit widens to 15.7 per cent in 2020/21. The SARB at its July 2020 Monetary Policy Committee meeting forecast that the negative output-gap will widen to -7 per cent in 2020 and remain negative at -2.8 per cent in 2022. This means that an increasing debt-to-GDP ratio, a widening budget deficit and the output-gap are going to be with us for a while. What do these trends imply about fiscal multipliers? There has been heightened debate about the size and sign of the fiscal multipliers in South Africa. Without getting into a detailed discussion about the various techniques to estimate the fiscal multipliers and the implications of the estimated sizes of such multipliers, the fact that the budget balance as a ratio of nominal GDP has persistently widened alongside a negative and widening output-gap post-2009 and the increasing unemployment rate, casts doubt on assertions that fiscal multipliers are large. The deficit financed spending approach that has been adopted post-2009 does not seem to a potent and efficient channel through which fiscal policy meaningfully increases economic activity, investment growth and lowers the unemployment rate.

Furthermore, the highly accommodative fiscal stance post-2009 that was accompanied by accommodative monetary policy have performed poorly as policy interventions to increase output growth and potential output. A successful countercyclical and accommodative fiscal policy stance is supposed to dampen the economic slump during recessions and quickly pull the economy out of a slump. This means that these policy interventions have not been as potent as initially thought. They have not been successful in closing the output-gap, stimulating investment growth, and reducing the unemployment rate. There is therefore a case to explore a wider range of potent policy tools and interventions that will propagate (amplify) the effects of the current policies.

3. The co-ordination of fiscal and monetary policy

One of the discussions and debates that has persistent been about the co-ordination of fiscal and monetary policy to ensure that the objectives of price, financial and macroeconomic stability are achieved. Thus, under which conditions does the co-ordination of fiscal and monetary policy[2] produce the best economic outcomes? The Phillips curve characterises the trade-off faced by monetary policy when making decisions about the appropriate monetary policy stance. Estimates of the Philips curve show it has flattened considerably post-2009.[3] A flat Philips curve allows policymakers to support the full employment mandate more aggressively during economic downturns as a sustained inflation breakout is less likely to occur when the Phillips curve is flatter. This means that the SARB can put more weight on the output-gap in its decisions, thus supporting employment growth and a decline in the unemployment rate. Monetary policy can support the full employment mandate without exerting unnecessary undue pressure on the price stability mandate. Long-run inflation expectations must remain anchored at levels consistent with low and stable inflation because they are important for minimising disinflation costs or sacrifice ratios.

4. Implications of low and stable inflation for the co-ordination of monetary and fiscal policy

Fiscal and monetary policy shocks are nominal demand management policies. So, what does empirical evidence say about the effectiveness of nominal demand management policies and the role of low inflation regimes? Gumata and Ndou (2019) show that a positive nominal demand management policy shock, such as increased government spending or expansionary monetary policy, will have a bigger effect on real output in a low inflation regime than in a high inflation regime. Hence, demand policy interventions are less effective in high inflation regimes. Thus, low inflation regimes (inflation below 4.5 per cent) enhance the effectiveness of the transmission of nominal demand management policy shocks.

5. The exchange rate pass-through, demand and supply side shocks

The forecast of the widening negative output-gap until 2022, indicates that demand side pressures are highly unlikely to become an immediate threat to the inflation outlook and outcomes. However, inflationary pressures and shocks do not only emanate from the demand side, often, they arise due to supply side shocks and tend to exert prolonged adverse effects on the inflation outlook and outcomes. However, with respect to the supply side shocks, an important “structural change” has occurred over the years in the form of a substantial decline in the exchange rate pass-through. This means that the ability of the exchange rate to explain movements in consumer price inflation has weakened over time. Ndou et al (2019) show that the decline in exchange rate pass-through is also on account of improved credibility in the conduct of monetary policy conduct. In addition, structural reforms assist in mitigating the adverse effects of a variety of supply side shocks. The

2 The repo rate was decreased by a cumulative 700 basis points from 12 per cent in November 2011 to 5 per cent in December 2012.

3 See Gumata and Ndou (2019)

exchange rate policy is necessary to reinforce the current observed structural change in the exchange rate pass-through.

6. The effects of fiscal credibility, quality, and the composition of spending on fiscal sustainability

The Supplementary Budget Review 2020 showed that under the active scenario, the debt-to-GDP ratio peaks at 87.4 per cent in 2023/24. What are the implications of this debt-to-GDP ratio trajectory for fiscal credibility and fiscal sustainability? Ndou et al (2019) show that when the debt-to-GDP ratio exceeds 60 per cent, this means an increased probability of fiscal imbalances occurring and the fiscal credibility is low. As the debt-to-GDP ratio increases and stays above 60 per cent, fiscal credibility is highly weakened and fiscal sustainability risks become more heightened. Empirical evidence shows in cases where composition, quality and efficiency of government spending shocks is seen as unproductive and low, the yield spreads increase.[4] Attaining fiscal credibility and sustainability imply that there is a need to adopt a path that lowers the debt-to-GDP and change in the composition of government spending.

7. Childcare and unemployment income grants as demand side policy tools

In April 2020, government announced that it will introduce a temporary unemployment income grant of R350 to all unemployed people and pay an additional R500 child income grant per care giver for six months. On the effectiveness of these policy interventions, evidence[5] shows that social income grants, help in decreasing income inequality and improve the spending capacity of the affected population groups. However, fiscal spending via social income grants does not have an impact on employment growth or output growth or investment growth. As such, an increase in social income grants has more persistent positive effects when accompanied by an increase in the binding minimum wage. Thus, a desirable policy intervention is that which complements an increase in social income grants with employment opportunities that pay the minimum wage and above. Nonetheless, with the current state of the economy and labour markets, there is a case to extend these social income grants to the affected beneficiaries beyond the initial stipulated six as the economy adjusts to the COVID-19 shock and output and employment growth start to meaningfully pick up.

[4] *See Gumata and Ndou (2017)*

[5] *See Gumata and Ndou (2019)*

8. Conventional monetary policy and financial regulation interventions

Since January 2020, the repo rate was decreased by a cumulative 300 basis points from 6.50 per cent in December 2019 to 3.50 in July 2020. In addition, the SARB also introduced several changes to financial regulatory tools. Collectively these interventions eased the monetary stance resulting in accommodative monetary and financial conditions. However, evidence shows that for these measures to be effective and potent, they need to be accompanied by accommodative lending criteria and credit conditions in the form of for example, high loan-to-value ratios and low repayment-to-income ratios.[6] The impact of excess liquidity in the banking sector on excessive risk taking and reckless lending behaviour by banks will be addressed by the National Credit Act (NCA) as a financial regulatory tool.

7.3 South African Reserve Bank balance sheet tools

The SARB has also embarked on government bond purchases to ease strains in the bond market since March 2020. The motivations of conducting such large-scale asset purchases (LSAPs) have differed across countries. Evidence on LSAPs shows that they reinforce the effectiveness of loose policy rates and tend to be more potent and have incremental effects when conducted over time. The effectiveness of LSAPs does not depend on them being deployed during a period of market turbulence. It matters how a given stock of asset purchases is built up over time and how this interacts with the monetary policy stance. The size, duration, and composition matter. Evidence shows that LSAPs decrease income inequality, mostly by reducing the unemployment rate for poorer households and by increasing the wages of the employed. There is therefore a case for the SARB to conduct LSAPs beyond the stated objective of dealing with market dislocations due to the COVID-19 pandemic.

There are other SARB balance sheet tools that can be used to complement and reinforce the effects of LSAPs and assist in the achievement of the fiscal sustainability, price, financial and macro-economic stability mandates. For instance, the SARB can embark on a reserves accumulation policy which is integral to the exchange rate policy, fiscal sustainability, price, financial and macroeconomic stability. Evidence shows that the accumulation of foreign exchange reserves plays a role in appreciating the exchange rate, lowering bond yields, lowering permanent and overall R/US$ exchange rate volatility. Combined, these factors lower inflation and lessen the burden of adjustment on the repo rate whilst supporting the price stability mandate. The SARB must adopt a broad approach to forex reserves adequacy that complements sound macroeconomic and prudential policy frameworks and limits vulnerability to multiple shocks. The reserves accumulation policy must also

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[6] *See Gumata and Ndou (2017)*

be pursued to provide a stream of investment income to help finance part of the fiscus, intergenerational savings and an endowment fund

The lengthening of the repurchase agreements can also be effectively used to complement the loan guarantee scheme. Central banks have relied on central bank funding in the form of targeted long-term refinancing operations funding to influence the private banks' balance sheets developments, funding conditions and risk-bearing capacity. The risk sharing between the National Treasury and banks neutralises the impact of risk assessment and pricing on the interest rate charged and non-performing loans on lending to SMMEs. The interest rate pass-through, lending-repo rate margins, the loan intermediation mark-ups and lending criteria are important factors in the bank lending value chain. The interest rate charged on loans under the scheme is fixed at the repo rate plus 3.5 per cent and this renders the prime rate as the interest rate ceiling or cap. Also, the interest rate charged will vary one-to-one with changes in the repo rate partly addresses the fact that banks adopt an asymmetric approach to passing through the repo rate changes lending rates.[7]

9. How do we raise output growth close the revenue and expenditure divergence?

We conclude the policy brief by discussing the sectoral "structural reform" policies that can raise nominal and real GDP growth (*G*).

9.1 The role land reform in increasing potential and actual output

There is a need to embark on accelerated land reform, redistribution and an increase in hectares planted which are broader policy interventions aimed at dealing with the problem of poverty and inequality at a much broader level. These are supply side policy interventions aimed at unleashing potential GDP and increasing output growth, changing the ownership patterns in the economy, increasing participation in the economy, labour absorption, and inclusion. At the same time, the policy of accelerated land reform and an increase in hectares planted because they are aimed at creating a class of self-employed people through the formation of co-operatives, small and medium enterprises, they also present a channel through which employment can be created. Youth employment also benefits from positive shocks to the agricultural sector output-growth and exports growth. Furthermore, bringing underutilised land in the former homelands and communal areas will a make a significant and meaningful difference in the agricultural sector contribution to the agricultural sector output growth, employment, and labour productivity. Land reform must be accelerated, and this must be accompanied by heightened investment growth, value add and the support of the agricultural sector to venture into new export markets.

[7] *See Ndou et al (2019)*

9.2 The role of the mining sector

For the mining and specific commodity sectors, empirical evidence confirms the validity of the dominance of the "exports-led GDP growth" hypothesis. However, exports growth in the mining sector is intensively associated with mining commodity employment growth and less so with mining commodity gross value added. But these positive effects are not persistent and do not result in intensive employment growth. Hence, the export-led strategy seems to be quite disappointing and is an insufficient condition for job creation in the mining sector. The mining sector is an export driven sector with extremely limited value add. This implies that there is a strong case for mineral beneficiation. Thus, strategies aimed at investing in the value chains for the mining commodity sectors, development of new export markets and cushioning the sector against the cyclicality and severe slumps in global demand and commodity prices will support the mining sector.

9.3 The manufacturing sector as a driver of output and employment growth

The manufacturing sector explains 71 per cent of the variation in GDP growth and 41 per cent of the variation in private sector employment growth.[8] This means that the manufacturing sector will play an important role in increasing output and employment. In addition, evidence shows that the (i) construction sector followed by (ii) finance, insurance, real estate and business services sector; (iii) transport, storage and communication sector and (iv) wholesale and retail trade, catering and accommodation sector are more responsive to positive GDP growth shocks. Alternatively, these sectors have a high output-employment growth intensity. Thus, policies aimed at supporting these sectors will raise nominal and real GDP growth, employment growth and lower the unemployment rate.

10. The role of the exchange rate policy, exports growth channel and investment growth

The exchange rate policy and investment growth are also important aspects of the policy mix that needs to be adopted. The period post-2009 was characterised by a massive and persistent depreciation in the exchange rate that was not accompanied exports growth. This is because evidence shows that the contractionary effects of large real exchange rate depreciations via the balance sheet and investment channels have detrimental effects on investment and output growth and neutralise the beneficial effects of exports growth. The contractionary effects of large exchange rate effects tend to be a drag on investment growth and far outweigh those of competitiveness and exports growth. This means that we cannot depreciate our way to output growth via the exports growth channel alone. The

[8] This is on a bilateral basis

exchange rate depreciation plays an extremely limited role in stimulating domestic growth via the exports growth channel. Thus, policymakers must place urgency and more weight on efforts to identify the exchange policy and a strategy of dealing with the adverse effects of severe deprecations on investment and economic growth. Structural reforms and policy interventions to rebalance the economy from high dependency on imports, should consider the effects of the high import content, interventions that stabilise electricity price inflation below 6 per cent, increase in labour productivity growth, effectively use competition policy and merger remedies to preserve a competitive environment that supports SMMEs and reduce income inequality.

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