NWU School of Business and Governance

Policy Uncertainty Index (PUI)

3Q2017

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NWU-SBG POLICY UNCERTAINTY INDEX (PUI) RISES FROM 53.1 IN 2Q2017 TO 53.6 IN 3Q2017 (BASELINE 50)

NWU-SBG POLICY UNCERTAINTY INDEX (PUI)

1. INTRODUCTION

As outlined when the PUI was launched last year, the role of policy uncertainty has loomed large in much of the recent economic debate in SA. It is seen to have important implications for business confidence and the investment climate in the country. Hardly any recent economic assessment or media release from international or local financial institutions, business lobbies, economic analysts, financial journalists or credit rating agencies appears without the inclusion of the words 'policy uncertainty' occurring in them. *The design of a policy uncertainty index for SA has nonetheless been spurred not only by economic circumstances in the country, but also by the increasing academic and policy interest globally around the cause, effect, measurement and definition of policy uncertainty.*

There have been many manifestations of policy uncertainty in SA over the years. The institutional setting and policy making environment clearly influence the extent to which negative shocks and developments lead to bad outcomes and tough policy challenges. It seemed that the time had arrived to craft a more accurate measurement of this recurrent factor in SA's economic outlook. *A deeper understanding of how uncertainty 'shocks' affect the SA economy helps policy makers to assess how future shocks will impact markets and business.* The outcome of this research will now be made regularly available on a quarterly basis to hopefully fill a gap in our monitoring of the economic environment.

Interesting correlations have been found of the policy uncertainty index with economic outcomes. *Empirically it shows that when economic policy uncertainty is strongly present in the environment, it indeed lowers investment, employment and output.* High levels of such policy uncertainty inhibit meaningful investment and consumption. Elevated policy uncertainty in many countries contributes to sluggish growth. Economic policy uncertainty then has actual consequences for the economy.

Research suggests that uncertainty is very different across economies. Developing countries seem to have about one-third more macro-economic uncertainty than developed countries. However, this is now changing with events such as Brexit, the controversial policies of US president Donald Trump as well as other geo-political tensions. *The IMF also now compiles a regular Global Economic Policy Uncertainty Index.*

The PUI is published in January, April, July and October of each year. An increase beyond 50 reflects heightened policy uncertainty; a decline in the PUI means reduced uncertainty. *The value of the PUI as a proxy for policy uncertainty will lie in tracking changes in policy uncertainty over time, and as the index settles down in the period ahead and builds a track record.*

2. PUI RESULTS FOR 3Q2017 - WHAT DOES IT SAY?

The aggregate PUI for the quarterly period July to September 2017 is the average of:

- news-based uncertainty
- economists' views on uncertainty
- BER manufacturers' views on political/policy constraints

July – Sept 2015	(Base 50) 50.0
Oct – Dec 2015	55.4
Jan – Mar 2016	53.6
Apr – June 2016	52.5
July – Sept 2016	46.5
Oct – Dec 2016	38.8
Jan – Mar 2017	51.0
Apr – June 2017	53.1
July – Sept 2017	53.6

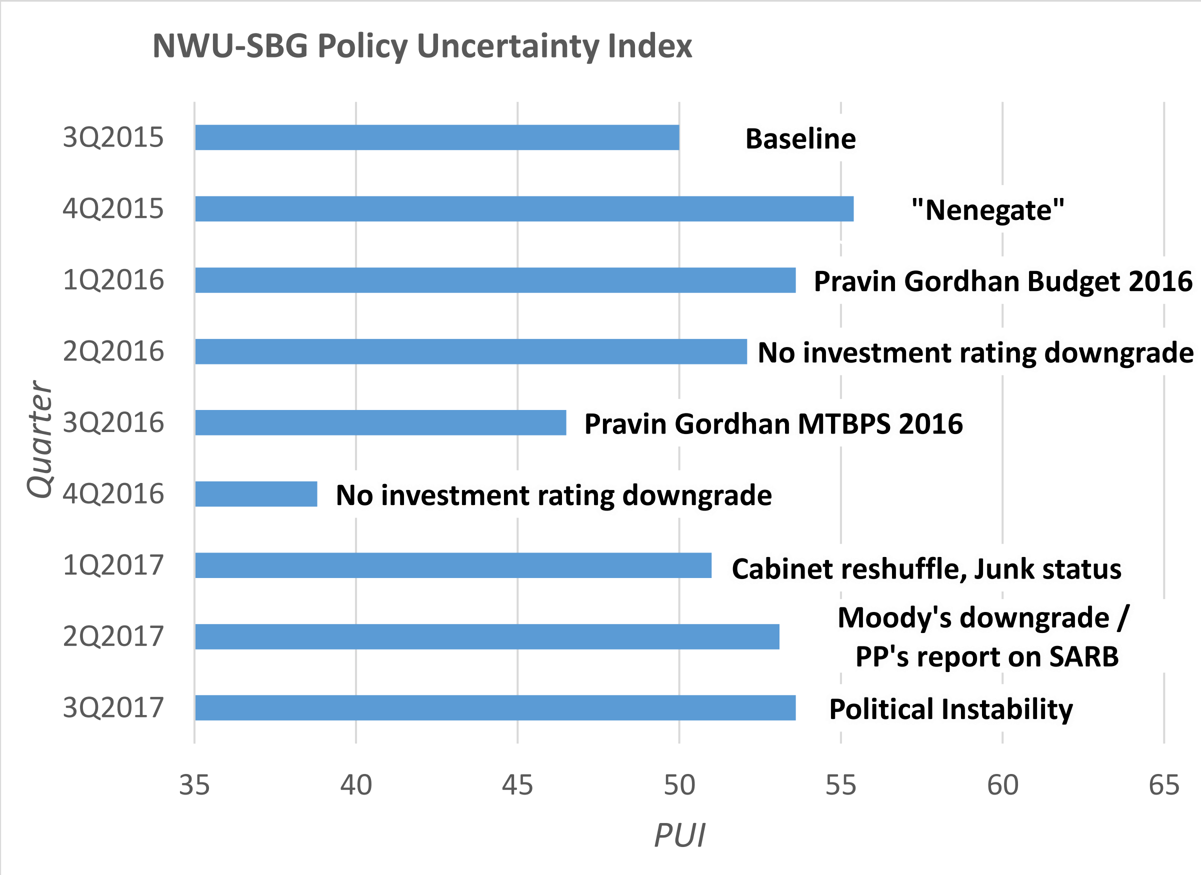
The PUI is the *net* outcome of positive and negative factors influencing the perceptions of policy uncertainty over the relevant period. *The results for 3Q2017 show an average index* *score of 53.6, reflecting a further rise over the PUI of 53.1 in 2Q2017. Hence the PUI has edged further into negative territory.*

Unpacking the three elements of the index shows the following:

2.1. In the media data there was an increase in reporting about ‘policy uncertainty’

2.2. The survey of the economists has reinforced perceptions about high levels of ‘uncertainty’

2.3. The Bureau of Economic Research at the University of Stellenbosch’s latest number on the proportion of manufacturers who indicate that politics is a constraint on doing business in SA is still at a high level of 86, compared with 87 in the previous quarter



3. NARRATIVE ON SOME FACTORS INFLUENCING POLICY UNCERTAINTY

3.1. Global Economic Outlook

Global economic activity continues on its recovery path, according to most international analysis. A number of global agencies, including the IMF, report that world economic growth is still gaining momentum *and appears to be even more synchronised than before*. World growth is now expected to rise from 3.2% in 2016 to 3.6% in 2017 and to 3.7% in 2018. Stronger activity and expectations have helped commodity prices to generally recover from their lows in early 2016. The general view remains that, provided there are no serious geopolitical 'shocks', short term global growth could still surprise on the upside in the months ahead. *Global economic factors still appear to outweigh any political uncertainties or risks, especially in the most advanced economies.* But geo-political tensions, such as over North Korea, are rising.

On the other hand, economic performance across emerging markets and developing economies remains mixed, yet with the Chinese economy still resilient. Among these economies, especially those that rely on energy and metal exports, the adjustment to lower commodity prices remain a key influence on their outlook. The main forces shaping the outlook therefore differ, to some extent, between advanced economies and emerging economies.

But overall most of the pickup in global growth, says the IMF, is expected to be driven by stronger activity in emerging and developing economies. In 2017 the anticipated growth in advanced economies is therefore expected to be about 2.2%, and in developing economies about 4.6%. Sub-Saharan economic growth is now expected to be 4.6% in 2017 and 4.9% in 2018.

Of particular global interest to several emerging economies in the period ahead, including South Africa, is the pace at which interest rates rise in the US and its implications for international capital flows. US monetary policy could be a game changer from this point of view. However, the Monetary Policy Committee (MPC) of the SARB recently expressed its confidence as follows:

'The US Federal Open Market Committee yesterday confirmed the gradual pace of reduction of its balance sheet and the normalization of its policy rate. Along with continued accommodative polices by the ECB this is expected to contribute to the continuation of favourable prospects for capital flows to emerging markets' (MPC 21/9/2017).

Another international survey of relevance both globally and domestically was the recent release of the World Economic Forum's 2017 Global Competitiveness Index for 137 economies, providing insight into the drivers of productivity and prosperity. SA (61st) is still one of the most competitive economies in sub-Saharan Africa (after Mauritius and Rwanda) but it dropped 14 positions in the overall rankings this year. *This is the biggest single annual decline experienced by SA since it originally participated in the WEF survey several decades ago.* We will return to this matter later in the narrative.

As a whole, however, the current outlook for the world economy remains broadly supportive of the SA economy and of the global markets in which SA has economic interests.

3.2. Economic Outlook and Policy Uncertainty

At the time of the release of the 2Q PUI the preoccupation in SA's economic debate was the aftermath of the 'technical recession' experienced as a result of two successive quarters of negative growth i.e. 4Q 2016 (-0.3%) and 1Q 2017 (-0.7%). In the 2Q 2017 GDP growth fortunately bounced back by 2.5% but this has been treated with great caution by most analysts, including the SARB. We need to draw a distinction between a *limited* business cycle recovery and the *structural reforms* needed for *sustained growth*.

It seems likely that economic growth in SA in 2017 as a whole will still be only about 0.6%, rising to about 1,2% next year. This is in line with the latest SARB forecasts as well as its recent leading business cycle economic indicators. Other high frequency data show a mixed picture for economic trends in 3Q 2017, with some more positive numbers to be seen in new motor vehicle sales and building plans passed. But per capita income is likely to continue to decline, as the country as a whole becomes poorer.

The SARB has warned that economic setbacks may worsen if political turbulence - and especially the policy vacuum in mining and agriculture - are not successfully addressed. 'We have to get rid of policy uncertainty’, says SARB Governor Lesetja Kganyago. 'The uncertainty is impacting on the confidence of investors. Unless you restore that confidence, you are going to have a problem', he said in Cape Town in August. The SARB Governor in particular highlighted the examples in the mining and agricultural sectors, which he said required long term assurances of a stable policy environment going beyond any change in government or Minister, if investment was to be encouraged (*Bloomberg*, 2/8/2017).

A major general contributor to policy uncertainty *is* the high level of turnover in Cabinet Ministers and Directors-General in recent years. New research shows that 216 Director-Generals were dismissed, shifted or suspended over the past five years. Most relationships between Directors-General and Cabinet Ministers last less than one year. *This is not only a serious generator of policy uncertainty but also highlights a key factor in weak policy implementation and poor service delivery.* Now there is speculation of yet another Cabinet reshuffle in the near future. The instability at senior levels of the public sector and in the Cabinet has come at a high cost to the economy.

Four typical examples of the economic consequences of persistent policy and political uncertainty as an important factor can be tangibly illustrated in the following selected situations:

3.2.1 The latest research by both Rhodes University economist Professor Gavin Keeton and research unit Intellidex have put the notion that SA companies are simply just hoarding excessive amounts of cash that should be used for investment into proper economic perspective. There is no evidence of an 'investment strike'. *But clearly uncertainty plays an important role in whether business decides to invest or not in an economy, failing which cash reserves may rise.* While business is not monolithic in its approach to such decisions, many companies struggle to see good investment opportunities in a weak and uncertain economic growth outlook, *allied to a high level of anti-business sentiment.*

3.2.2 Thus SARB figures show that private sector investment spending declined by 7% in real terms in 2Q 2017 and has been negative in more quarters lately than it has been positive. *High levels of private and public investment are needed to drive growth and job creation.* The current ratio of 60% for private sector investment is the lowest since 1994. This sub-optimal performance in private fixed investment is not offset by rises in government investment spending. While the private sector has not ceased investing in the economy, the level of investment is not sufficient to enable SA to break out of its present 'low growth trap', or to achieve the longer run goals of the National Development Plan. 'SA is experiencing an investment recession', says Standard Bank Chief Economist Kevin Lings (*Moneyweb*, 17/7/2017)

3.2.3 Then the rate at which economy is shedding jobs is likely to accelerate in present economic circumstances, with overall unemployment now officially at 27.7%. *This continues to reflect not only weak economic growth but also the extent to which policy uncertainty is inhibiting job retention and job creation.* International research suggests that the lower the level of policy uncertainty, the lower the level of unemployment. Statistics SA's employment survey for 2Q 2017 declined by 34,000 jobs, mainly in manufacturing, transport, trade, finance and business services. Employment is a lagging indicator. Hence the retrenchment notices issued by mining houses in recent months are expected to reflected in the figures for 3Q 2017, when new data are released.

3.2.4 A corrosive uncertainty also arises from the *on-going problems of finance, management and governance of ESKOM*. The management and governance failures at a key public utility like ESKOM have serious implications for the private sector, if the situation is not remedied soon. Without management stability and the capacity to contain costs, there is the real prospect of highly damaging rises in electricity tariffs in the years ahead.

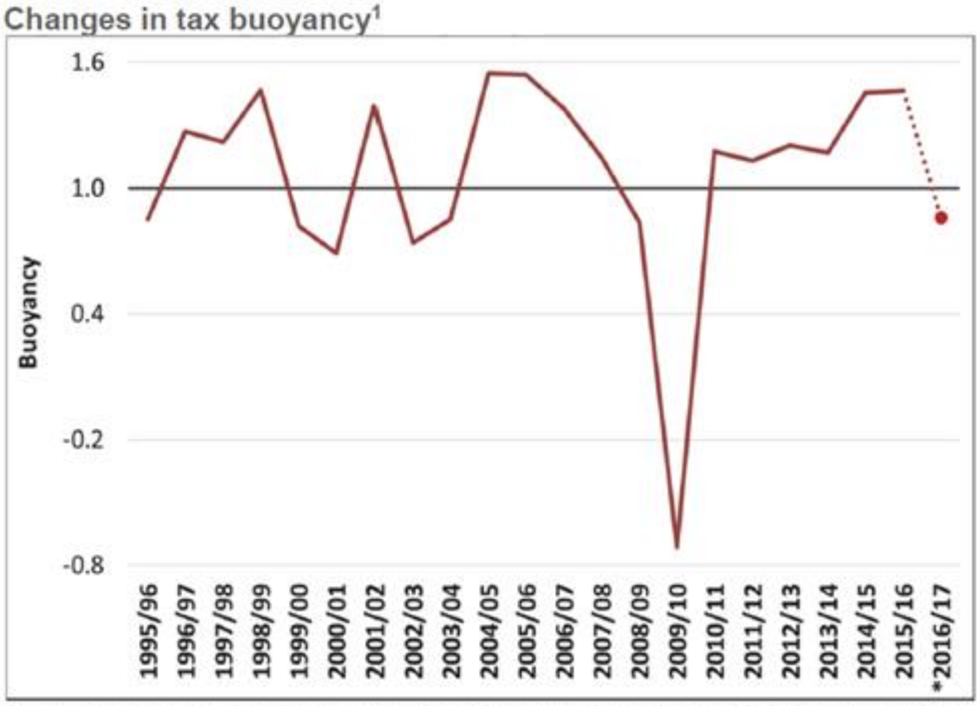
What is noteworthy in the recent WEF Global Competitiveness Index survey in its latest list of *the most problematic factors for doing business in SA* is that corruption has moved right to the top of the agenda, together with crime and theft as well as political uncertainty, followed by tax rates. While these WEF concerns largely resonate with much of what has already been revealed in other external and internal assessments of the SA economy, they are stark reminders of what needs to be urgently addressed if SA if to break out of its 'low growth trap' and boost investor confidence.

The issues of *state capture* and *corruption* therefore continue to have a toxic effect on economic perceptions of SA, its governance, and on obstacles to doing business in SA.

3.3. The next Medium Term Budget Policy Statement (MTBPS) – a watershed for Finance Minister Gigaba

Finance Minister Gigaba faces his first major fiscal policy test in the MTBPS on October 25.

Although the MTBPS is only late in October, uncertainties about both the revenue and spending sides of SA's public finances were already apparent in 3Q 2017. Much lower economic growth (see 3.2 above) has consequently also seen declining tax revenues. The so-called tax buoyancy measure fell from 1.47 to 0.88 - as tax revenues grew slower than the economy. Several experts have projected that the shortfall could be in the region of about R40bn -R50bn. Some challenging decisions arise from this fiscal situation, which makes the next MTBPS not only a very salient one, *but also a strategic opportunity to clarify policy.*



[1]Percentage change in gross tax revenue divided by percentage change in nominal GDP
**Estimated outcome*
Source: National Treasury and Reserve Bank

On the spending side there have been additional commitments that were not envisaged in the 2017/18 Budget. These uncertainties include just how much will ultimately be diverted to shoring up SOEs like SAA and Eskom, as well as financial provision for the outcome of the 'fees must fall' campaign. These will determine to what extent it will be possible for the National Treasury to keep the commitment to fiscal consolidation on track. How this increasingly limited fiscal space will be reflected in the various key debt ratios that the markets and credit rating agencies take seriously remains to be seen. But slippage seems inevitable. The chance of SA being hit by further investment downgrades is high. *The perception that will matter is whether overall state spending is broadly perceived to be under control and that wasteful expenditure is being meaningfully addressed.*

However skilfully Gigaba crafts the MTBPS, there is still likely to be a significant residual shortfall that can only be addressed in the main Budget in February 2018. In an effort to 'balance the books' earlier this year personal taxes and the fuel levy were the principal tax increases in that Budget. Whatever the fiscal adjustments that emerge from the pending MTBPS, there is the real prospect that individuals and business will face substantial uncertainty from a host of tax decisions in the main Budget later, some of which emanate from the on-going work of the Davis Committee on tax reform. The tax agenda for the

2018/19 will also be influenced by political factors, bearing in mind that by then SA will be another year closer to the general election of 2019.

This balancing act will therefore not only be between the future burden of different taxes, but also between the fiscal consolidation required by the credit agencies, on the one hand, and what is needed for inclusive economic growth and job creation, on the other. Unless SA is going to drift into a negative 'tax-and-spend' cycle it needs to implement the structural reforms required to promote sustained growth and employment. While it may be unlikely that the MTBPS is the place to look for such reforms, it would be necessary for Gigaba to at least give an update on his recent 14-point plan with its deadlines, as he needs to prove the sceptics wrong. *Above all, Gigaba must ensure that the message of the MTBPS is credible and builds confidence in the road ahead for the SA economy in ways which reduce policy uncertainty.*

4. MONETARY POLICY AND INTEREST RATES

4.1 The fact that, contrary to wide-spread expectations, the MPC at its meeting on September 21 felt unable to follow through on its previous cut in interest rates in July, was a pity yet understandable. Seeing that the MPC was evenly split on the decision shows there was room for legitimate differences of opinion on the balance of risks facing the economy and on whether a further modest cut in rates was possible. It also reflected the high level of uncertainty in prevailing economic assessments. The SARB had earlier created the impression that, with inflation broadly under control and the economy in a 'low growth trap', the stage had been reached where gradual declines in interest rates were possible in the second half of 2017.

The MPC was right to warn that there remain serious risks for SA on the economic horizon. But a further modest reduction in borrowing costs at this stage would have been helpful to improve business and consumer confidence. There was indeed another opportunity for the MPC to take advantage of declining rates of inflation (as well as expected inflation), combined with weak growth, to lower interest rates again. The MPC in its wisdom decided to do nothing. Yet the latest *SARB Monetary Policy Review* agrees that SA's weak economic growth may provide some scope for lower interest rates.

The problem with the MPC decision is that, if rates are not reduced *now*, then when? Certainly it should not be expected that the MPC should cut interest rates at its November meeting, which is on the eve of the highly conflicted ANC elective conference. Even the MPC's January 2018 meeting might be compromised. If a further reduction in rates was feasible, it had to be now. 'Slack - an economy operating below its potential - is, therefore, the price that might have to be paid to achieve low rates of inflation, as the economy is now experiencing', says Investec's Brian Kantor (*Business Day*, 29/9/2017).

4.2 Although the threats to SARB's mandate and independence have not entirely dissipated, the fact that the Public Protector's attack on the Bank in April has generated strong opposition in influential circles and has been reversed by the courts, are positive developments. The credit rating agency Moody's recently again warned that that recent threats to the independence of the SARB and the judiciary, if not contained, might see Moody's closer to also reducing SA to junk status soon. Other credit rating agencies have also issued warnings on these developments.

5. CONCLUSION - POLICY UNCERTAINTY IS THE 'NEW NORMAL' IN SA

What is there to put on the other side of this rather persistent uncertain and sombre PUI outlook? The global economic outlook is positive, which is good for exporting regions like SA. Institutions such as the SARB and the courts continue to play robust role in upholding the right 'rules of the game' for good governance and stability in their respective spheres of influence. Organized business is being more pro-active and vocal in addressing the socio-economic challenges now facing SA. *While for the time being policy uncertainty has become the 'new normal' in SA, business strategies can, and must, be adapted to accommodate and address the realities of situation.*

But it would also be prudent *not* to assume that the ANC elective Conference in December will necessarily bring the certainty that many stakeholders hope will materialize then, assuming the Conference goes ahead. It is not inconceivable that the factional battles currently dividing the governing ANC will not be resolved at the conference and will continue thereafter. In that event, the new leadership needed to reduce policy uncertainty and promote growth reform is unlikely to emerge from a fractured political process. And then, of course, by 2018 SA will also be a year closer the next general election in 2019.

The next PUI for 4Q 2017 will seek to capture the immediate aftermath of the ANC conference in December.

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