NWU Business School

Policy Uncertainty Index (PUI)

3Q 2018

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EXECUTIVE SUMMARY

* The PUI for 3Q 2018 rose to 52.2 (baseline 50) compared to 51.0 in 2Q 2018, thus moving further into negative territory

* The emergence of a 'technical recession' in SA in 1H 2018 in particular increased the level of economic uncertainty. In the past few months there was also a heavy spell of risk aversion from emerging markets, triggered mainly by the economic troubles in Turkey

* Economic activity in SA may improve in 2H 2018 off a low base – but the economy continues to struggle with policy and political uncertainty, despite a broadly supportive global economic growth backdrop. The SA growth forecast for 2018 is now about 0.7% and for next year about 1.8%

* How the land reform issue is managed from now on remains a significant determinant of future levels of policy uncertainty and investor confidence in SA

* The Medium Term Budget Policy Statement (MTBPS) on October 24 remains crucial in this regard in striking the right balance between fiscal discipline and growth

* There is no 'quick fix' for the SA economy, as the National Planning Commission's latest economic report confirms

* International experience suggests that policy uncertainty usually rises prior to elections. Although SA's general election in 1H 2019 will inevitably also generate political and policy uncertainty, interim steps to boost investor confidence and growth must continue to seek to create a more favourable economic environment

* Ahead the prospects for a global 'trade war', higher international interest rates and a 'hard' Brexit may create headwinds for the SA economy in general and its exchange rate in particular. The more SA's house is in order, the better its ability to manage any global economic headwinds

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NWU BUSINESS SCHOOL POLICY UNCERTAINTY INDEX (PUI) RISES FROM 51.0 IN 2Q 2018 TO 52.2 IN 3Q 2018 (BASELINE 50)

NWU BUSINESS SCHOOL POLICY UNCERTAINTY INDEX (PUI)

1. INTRODUCTION

As outlined when the PUI was launched in early 2016, 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 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 over time and builds a track record.*

2. PUI RESULTS FOR 3Q2018 - WHAT DOES IT SAY?

The aggregate PUI for the quarterly period July to September 2018 is the average of:

- a news-based uncertainty,
- economists' views on uncertainty,
- manufacturers surveyed by the BER survey and their 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
Oct – Dec 2017	55.4
Jan – Mar 2018	49.6

Apr – June 2018	**51.0**
July – Sept 2018	**52.2**

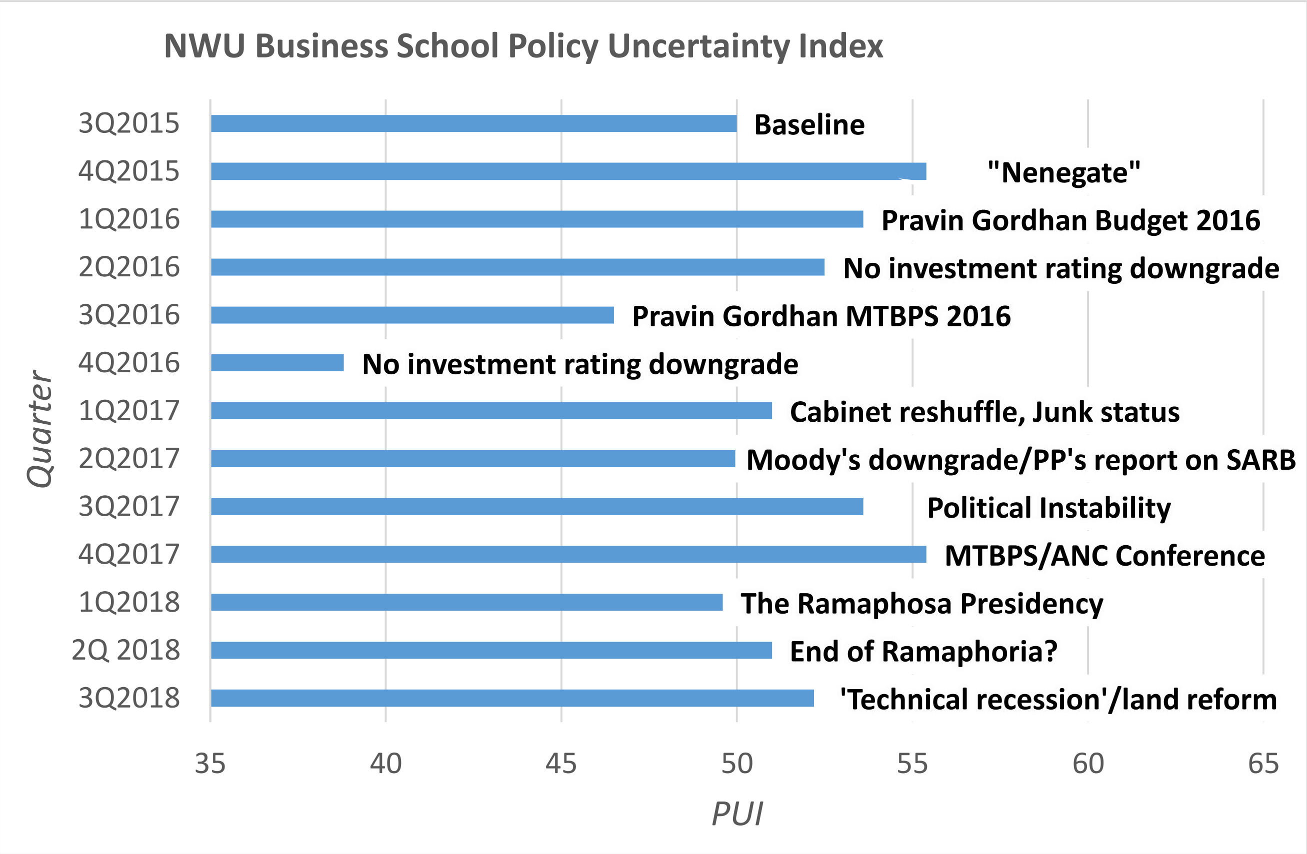
The PUI is the *net* outcome of *positive* and *negative* factors influencing the perceptions of policy uncertainty over the relevant period. The outcome for 3Q 2018 shows an average score of 52.2, reflecting an increase over the PUI of 51.0 in 2Q 2018. *Hence the PUI has moved further into negative territory.*

Unpacking the three elements of the latest index shows the following:

2.1. In the media data there was a modest increase in the level of reporting about 'policy uncertainty'

2.2. The survey of economists shows that their view is that the level of uncertainty was more or less the same compared with 2Q 2018

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 rose from 72 to 78.



3. NARRATIVE ON SOME FACTORS INFLUENCING ECONOMIC/POLICY UNCERTAINTY

3.1 Global Economic Outlook and South Africa

In the past few months the developing threats and risks to the global economic outlook identified in the 2Q PUI narrative assumed a more concrete form, *especially for emerging markets.* Dearer oil is also catching emerging economies at a vulnerable moment. Fortunately, world economic growth - largely because of the continued strong performance of the US economy - has not yet been negatively affected by shaky emerging markets. Many emerging markets saw their exchange rates tumble in 3Q 2018. The risk aversion and sell-off was widespread. It included parts of Asia, Turkey, Brazil, Mexico and South Africa. Indeed, in June 2018 the Bank for International Settlements (BIS) was among those institutions warning that 'financial vulnerabilities have been building up, in their usual gradual and persistent way'. *The global credit cycle has again become important to capital outflows from emerging markets.*

Yet as 3Q 2018 drew to a close it seemed that investors had so far distinguished between the emerging economies that had serious, and largely domestic problems, and those ones which had better fundamentals. The emerging market volatility has therefore been largely contained and the 'contagion effect' limited for the time being. In any case, it seems the emerging market world is already priced for slower growth. Those economies that have minimized their external vulnerabilities, such as reducing current account deficits and limiting borrowing in dollars are better placed to ride out any external shocks. Emerging markets that have weak fundamentals, together with a confluence of recent events in a country like Turkey, are highly exposed when risk aversion strikes.

Emerging economies, however, have even more to fear if recent developments around US and Chinese 'protectionism' tariffs degenerate into a full-out years' long 'trade war'. In that event the collateral damage to the world's trading system would ultimately be high. A trade war is the worst of many threats to global growth. Emerging economies have benefited most from globalization and lower trade barriers and stand to lose the most from a reversal, especially if economic growth in the US and China should then have substantial slowdowns. Global growth is poised to slow in 2019, according to a new forecast by the OECD. It would also cause waves of renewed uncertainty in already unsettled world trade and financial scenarios if the UK should eventually 'crash out' of the EU without a deal in March 2019, including economic implications for South Africa.

In the meantime, South Africa's economic performance has been weak, having experienced a 'technical recession' in 1H 2018. South Africa's public finances are vulnerable by global standards, as well as its lagging economic growth compared with many other emerging market competitors. Rand weakness has been intensified by bond and equity outflows. As the rand recovers from time to time in relation to other emerging market currencies, so more emphasis falls on the status of the domestic economy and the key political and economic factors which influence its performance. *The more South Africa's economic house is in order, the stronger its ability to deal with any global economic headwinds.*

3.2 Recession, Recovery and Reform in the South African Economy

The extent to which the latest GDP figures confirmed that the SA economy was in a 'technical recession' in 1H 2018 was bad news for business confidence as well as for economic certainty. On the consumer side much higher fuel prices in particular have reduced disposable income. But both the inventory 'destocking' and the sharp fall in agricultural output which featured strongly in the poor 1H 2018 GDP figures are reversible in 2H 2018. Economic activity is generally expected to improve in 2H 2018 off a low base, although some recent high frequency data suggest there may have been downside risks even in 3Q 2018. *While the economy will not rapidly self-correct, there is still the prospect that SA could end this year with a small but positive growth rate.*

On present evidence SA's growth rate for 2018 could therefore be about *0.7%,* rising to, say, about *1.8%* next year if certain more positive factors steadily fall into place. This growth performance is widely recognized as remaining well below what SA needs to successfully tackle the on-going challenges of unemployment, poverty and inequality. The danger of a 'low growth trap' remains. Policy uncertainty and a public sector hollowed out by state capture and corruption have come at a huge cost. *It is clear that SA has greatly underestimated the damage inflicted on the economy in recent years by economic mismanagement, state capture and other forms of corruption, and on how long it will realistically take to turn the economy around.*

Then, as the 3Q PUI reflects, there is also the impact of persistent levels of policy uncertainty, ranging from land reform to mining rights, which have dominated most of the past three months. 'Lack of policy certainty overshadows Ramaphosa's good work', says Nedbank's Nicky Weimar (*Fin 24, 11/9/18*). The domestic economy continues to struggle with policy uncertainty despite a broadly supportive global economic growth backdrop - and needs remedial action.

In rightly deciding to leave interest rates unchanged at its meeting on September 22, the MPC also cut its forecast of growth in 2018 to 0.7%, but retained its growth expectations of 1.9% and 2.0% for 2019 and 2020 respectively. The SARB 'might have made a different decision if economic growth was not so weak', said Deputy Governor Kuben Naidoo subsequently. And SARB Governor Lesetja Kganyago said at the same event that the MPC decision had been close, with 3 members preferring a 25-basis points hike, and 4 members choosing to leave rates unaltered (*Fin 24, 21/9/18*).

This narrow margin may create a new source of economic uncertainty, if there is now a risk of a *premature* rise in interest rates in SA. 'With demand as depressed as it is and inflation outside of regulated prices as low as it is, given the weak pricing power of firms one can only wonder at the logic that called for even less demand' (Brian Kantor, *Business Day, 28/9/18*) *The SARB needs to delay raising interest rates for as long as possible*.

However, this nevertheless underscores not only the extent to which SA's current economic malaise is *structural* rather than cyclical, but also emphasizes the degree to which the solutions lie in our own hands. The IMF again stressed earlier this year that, without economic reforms, the country was unlikely to exceed 2% growth over the medium term (*Fin 24, 12/6/18*). And the National Treasury said in the February 2018 Budget that 'more rapid and sustainable growth require government to finalize many outstanding policy and administrative reforms'.

3.3 Continued cross-currents in policy uncertainty and consistency

The latest PUI reflects the extent to which negative factors still prevailed over positive ones in shaping the level of policy uncertainty during the past three months. And the most dominating elements have been *the emergence of a 'technical recession' and the highly divisive nature of the land reform debate. Seen as a whole the general outlook merely confirms that there will be no 'quick fix' for the SA economy and solutions will take time.*

Some events and interactions that could help to reduce policy and economic uncertainty and gradually promote the investment climate needed to drive growth and employment include:

- the commitment by government to raise $100 billion in new domestic and foreign investment over the next five years
- the announcement of an economic 'stimulus' package to boost growth and employment announced by President Cyril Ramaphosa on September 21
- the jobs summit and investment summits being held on October 4 and October 25 respectively
- any positive announcements by credit rating agencies later in the year
- the Medium Term Budget Policy Statement (MTBPS) or 'mini-Budget' on October 24

3.4 Significance of the forthcoming 2018 MTBPS

The economic events of the 3Q 2018 and the recently announced stimulus package have set the scene for the MTBPS on October 24. In SA's present economic situation most roads now run through perceptions about the vulnerable state of SA 's public finances and in particular what the forthcoming MTBPS will reveal. The Treasury remains under pressure. The costs of the past decade of stagnation and the urgency of renewing economic growth are nowhere more apparent than in the government's finances.

Finance Minister Nene has already warned that tax revenue may be lower because of the recession - potentially putting SA's last investment-grade at risk. Growing the economy is 'now critical' to expand the tax base. The ability of a government to borrow at reasonable interest rates is underpinned by tax collections, Nene said (*National, 10/9/18*). The shortfall could even be greater if 'tax buoyancy' (i.e. tax revenue growth relative to GDP growth) declines further.

The IMF also warns that 'time is slipping away for SA if public sector debt continues to spiral......while the Treasury's return to fiscal consolidation in the 2018 Budget is a move in the right direction, with current growth projections debt is still expected to rise in the medium term (*Business Day, 13/6/18*). The challenge therefore facing the MTBPS is avert recurrent fiscal debts becoming cumulative, which combined with weak growth, mean that the share of government debt in the GDP grows at an increasing place. SA must thus avoid falling into a 'debt trap'.

On the spending side the MTBPS has to add details to the stimulus plan announced by President Cyril Ramaphosa on September 21. President Ramaphosa acknowledged there was limited fiscal space to increase spending or borrowing and that the centrality of the plan lay *mainly in reprioritisation of spending*. As such, there can be no new stimulus of aggregate demand, but it will be aimed at growth and job creation. There was also the establishment of a R400 billion SA Infrastructure Fund, but it is yet unclear how much of this will be new spending.

4. CONCLUSION

It is inevitable that a period of political and economic change will produce an initial ebb and flow in the level of policy uncertainty. In SA's instance this is reinforced by the fact that general elections are now pending in 1H 2019 and that the dynamics of election campaigning make an optimal level of policy certainty difficult for the time being. Research has shown that many overseas policy uncertainty indices usually spike before elections, so SA's scenario is not unusual in this respect.

In SA's case 'Cyril Ramaphosa's hands are tied until he has a firmer mandate', believes Moody's, 'and the foreign investment community is waiting for the outcome of SA's general election in 2019 and to judge what policies will be formulated and enacted before committing to the country. There's a lot of side-lining going on and the outside investment community is appreciative that things cannot suddenly change' (*Business Day, 12/9/18*).

This should *not* be interpreted to mean that other interim steps such as those outlined in 3.3 above should not be pursued to bolster policy certainty and to show that the economic environment still has encouraging aspects for business and investors. But inevitably a high element of political and policy uncertainty is going to be the 'new normal' until at least after the 2019 elections and the dust settles on a number of key issues of importance to investor confidence.

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