NWU School of Business and Governance

Policy Uncertainty Index (PUI)

1Q2017

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NWU-SBG POLICY UNCERTAINTY INDEX (PUI) RISES FROM 38.8 IN 4Q2016 TO 51.0 IN 1Q2017 (BASELINE 50)

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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.

A NWU team therefore spent much of 2015 interrogating the policy uncertainty models used elsewhere in the world, adapting various elements to South African circumstances, and then conducting a series of trial runs using a new, tailored design.

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 may now be changing with events such as Brexit and the election of US president Donald Trump.

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 1Q2017 - WHAT DOES IT SAY?

The aggregate PUI for the quarterly period October to December 2016 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

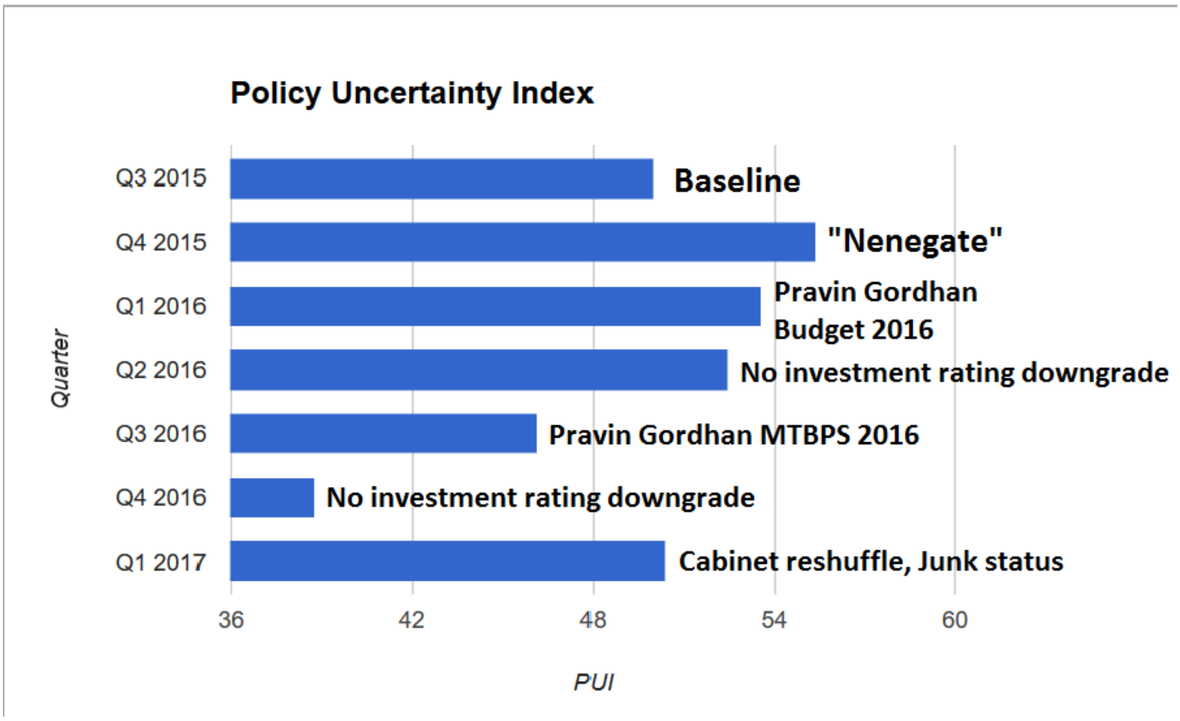
The results for 1Q 2017 show an average index score of 51.0, reflecting a sharp rise over the PUI of 38.8 in 4Q 2016. *Hence the PUI is back in negative territory*. The PUI is the *net* outcome of positive and negative factors influencing the perceptions of policy uncertainty over the relevant period.

Unpacking the three elements of the index shows the following:

2.1. In the media data there were proportionally more articles that mentioned policy and uncertainty in South Africa

2.2. The survey of the economists found a unanimous view that policy uncertainty had risen.

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 increased from 75 to 76.



3. NARRATIVE ON SOME FACTORS INFLUENCING POLICY UNCERTAINTY

3.1. Global Economic Outlook

A synchronized global economic upturn is currently underway, despite on-going uncertainties for the international economy emanating from factors like geopolitical tensions, anti-globalization sentiment, 'Trumpanomics' in the U.S., as well as Brexit. While the global political mood may be quite negative there is an unmistakable broad-based economic upswing presently still taking place in the world economy. This is happening after nearly a decade since the 'Great Recession' of 2008 was the biggest setback to the global economy after the Depression years of the 1930s and, indeed, after several 'false dawns' of putative recoveries in recent years.

Economic indices in the U.S., Europe, Asia and many emerging markets are now generally reflecting a rebound in economic growth. The IMF has raised its projection of global growth in 2017 to 3.5%, up from 3.4%. These signals have also been most positive from the more cyclical sectors of the world economy, notably manufacturing. But the good news has not been confined to manufacturing but by all accounts is also well spread to other sectors. A recent international survey of business confidence was at its highest since the economic fall-out of 2008. Commodity prices are on average about 10% higher than they were in 2016, but many commodity exporters remain challenged.

The international economic recovery has not been spread evenly over different countries. The picture is mixed. India and Indonesia, for example, have shown fairly strong and positive growth. On the other hand, Turkey and South Africa have performed far less well. Even two of the largest emerging markets, Russia and Brazil, are beginning to shake off the worst effects of their recent acute 'stagflation'. Nonetheless, it remains possible that the negative international political cycle referred to earlier may eventually catch up with the global economic cycle and derail it.

For a small open economy like SA these are positive developments which augur well for those sectors which are dependent on favourable international economic trends. The extent to which SA can exploit these supportive global economic tendencies will depend on its competitiveness and degree of diversification which facilitate identifying business opportunities. An expanding world economy also reduces the risks of external economic shocks and enables SA to concentrate on the domestic factors affecting its economic performance over which it has control, and about which there should be the minimum of uncertainty.

3.2. The 2017/18 National Budget / ANC documentation

Earlier in the first quarter the biggest economic policy news story was the Budget speech. In the State of the Nation Address, President Zuma spoke of radical economic transformation, but the Budget was all about the policy certainties of continued fiscal consolidation.

The Minister of Finance continued with the tone of spending and borrowing limits set out in the MTBPS in October and in a fine balancing act introduced the tax increases that are to close a substantial gap between spending and income. The corporate tax rate and Vat rate remained unchanged, but the personal income tax rate, on those earning more than R1.5 million per annum, was increased to 45 per cent. There was also an increase of 30 cent per litre in the general fuel levy. The balancing act was not only between the burdens of the different taxes, but also between the fiscal discipline required by the ratings agencies and what is required for economic growth.

Analysts agreed that the budget staved off a credit rating down grade in the first half of 2017. However, no one made the “confidence fairy” argument that the austerity will improve business confidence and in that way improve investment and growth. And growth is exactly what is needed to improve the macro ratios that the ratings agencies are concerned about.

Analysts worried that the higher taxes, with little off set of bracket creep, will further limit household spending. With government and household spending growing very little and anaemic investment rates, the only hope seems to lie in the recovery of the international economy.

Other news that made the headlines and is directly related to our concept of policy uncertainty, was the release of the ANC’s nine policy discussion documents ahead of its policy conference in June. The documents reiterated the National Development Plan as its blueprint, but also emphasised radical socio-economic transformation. There are proposals for land reform, regulation of the private sector to improve competition and a targeted programme to assist black entrepreneurs. The most worrying proposal is that of transferring more power to set spending priorities to the Presidency, which if accepted could be a direct challenge to the authority of the Treasury and likely to eventually increase uncertainty.

3.3. Economic Data in 1Q2017

Reviewing the past quarter the real economic data has revealed a rather schizophrenic picture of SA's economic performance. Economic activity in most sectors of the economy proved much weaker in the earlier part of 2017 that many analysts expected, while inflation seems to have turned the corner, reinforced by declining food inflation as a result of a rebound in agricultural production following good summer rains generally. Employment has also weakened. A recent Credit Suisse Survey of SA and seven other emerging markets revealed that SA has one of lowest percentages of consumers who expect their personal finances to be better over the next six months. Both consumer and business confidence remain at low levels.

Yet, on the other hand, certain leading economic indicators held out promise of an improved economy in 2017 and of 'greenshoots of recovery' becoming apparent. These expectations were partly based on evidence that the business cycle bottomed out last year, in which SA eventually recorded a growth rate of only 0.3%. In fact, forecasts by both private sector and public sector analysts that growth in 2017 would be just over 1%, and possibly 2% next year, were predicated on a better outlook. Hence, for example, the SARB's leading indicator has been rising steadily since mid-2016 and recently returned to 2014 levels. And various Purchasing Managers' Indices have also been positive in recent months and, in addition, credit demand by business, for example, although not robust, has been positive.

It is possible that this dichotomy may be explained by time lags in the data. In other words, the shock of recent political and economic developments may yet have a delayed impact on leading economic indicators in the months ahead, perhaps showing up by 2H 2017. In short, the economy is becoming a casualty of political in-fighting. What can safely be said at this stage is that clearly the downside risks to the economy have risen, but that more than one economic scenario is possible.

3.4. Some economic consequences of recent political developments

The economic and political aftermath of the recent Cabinet reshuffle, and the removal of Pravin Gordhan as Finance Minister, has unsurprisingly caused the PUI to sharply spike again, even though the most dramatic events came towards the end 1Q 2017. While not entirely unexpected and already partially 'priced-in' by the markets, these political developments still have a potentially wide economic impact. *And looking ahead, a new balance must now be struck between the positive and negative factors that will affect future levels of policy uncertainty.*

This outcome will be shaped by the following key perspectives:

3.4.1 We must not underestimate the significance of the precedents which Gordhan and the National Treasury have successfully set for fiscal discipline and probity, and extent to which this has won the confidence of investors and credit rating agencies. Yet this broad assessment is less about personalities than institutions being seen to follow the right policies and implement anti-patronage decisions. It revolves around policies affecting procurement, nuclear power, state-owned enterprises and banking licenses, as influenced and managed by the Treasury. Much of this has been put into doubt by the political changes at the Treasury as well as by the replacement of senior staff. Hence the decisions by at least two of the three major rating agencies to immediately downgrade SA's investment rating selectively to junk status, with Mooody's to announce its decision in the near future, possibly taking SA down by one notch to the borderline of junk status.

3.4.2 Although the rand may eventually stabilize, a persistently weak rand will eventually filter through to the local cost structure, especially food and fuel prices, which will in due course hit those hardest who are least able to afford it, namely, the poor. And where until recently the SARB and most analysts were hoping that SA may have reached the end of the interest tightening cycle, the advent of junk status will probably lead to higher borrowing costs for both the public and private sectors. This injects an additional element of uncertainty into the outlook for both consumers and business.

3.4.3 Of importance to future levels of policy uncertainty will be how the previous commitment to fiscal consolidation fares with the new political team at the Treasury. We must recall that fiscal policy hitherto has been highly certain and predictable, as well as transparent. Finance Minister Gigaba has now repeatedly said that SA's fiscal policies would remain intact and that his surprise appointment did not signal a policy shift for the fiscus. But the guarantees given by the Treasury to underpin the contingent liabilities like Eskom, for example, remain a major high risk area and threaten to undermine fiscal stability. The real test of fiscal management will be reflected in the Medium Term Budget Policy Statement in October to see whether any fiscal shocks emerge, especially from oversight issues on SOEs. Only if SA broadly aligns its State expenditure to the size of its GDP, and to the size at which it grows, can it avoid a 'debt trap'.

3.4.4 An importance new source of policy uncertainty is what is precisely meant by the recent emphasis on 'radical economic transformation' as a policy priority. It has thus far created confusion, rather than clarity, as to where it fits into the framework of the National Development Plan (NDP), for example. The threats of land expropriation without compensation have already heightened uncertainty in the agricultural sector. In general, the persistent existence of policy uncertainty has hampered the level of private fixed investment that needs to mainly drive growth and job creation. A recovery in private investment and investor confidence remains an essential factor in SA's economic growth. *Policy uncertainty has become a tax on investment.* To change this situation requires that policies should become clear, consistent, coherent and growth-oriented, and indisputably linked to the NDP and its programmes.

3.4.5 The economic outlook has now become more uncertain, as the full impact of the latest developments unfolds slowly over time. If the new team at the Treasury is able to win back investor confidence SA might avert a 'worst case scenario', in which there are only downside risks. There is still scope for remedial action. But the strong prospect remains that the aftermath of the investment the investment downgrades will have a corrosive effect on SA's growth prospects, as well as on business confidence and employment. Job losses could then begin to show up in the next few months. Recent authoritative forecasts that SA should be able to grow at about 1.3% this year now look decidedly over optimistic.

If SA is unable to minimize the impact on the economy of recent political developments, it may have to prepare itself to see a growth rate of less than 1% in 2017. The latest IMF forecast for SA growth in 2017 is 0.8%. Whether the SA economy will actually drift into a 'technical recession' (two successive quarters of negative growth) this year, as several analysts are now suggesting, remains to be seen. It nevertheless could be a close call, especially if growth is again negative in 1Q2017, following on a poor 4Q 2016. The risks of a 'technical recession' have undoubtedly risen, but it depends on how resilient the SA economy proves to be in the face of recent new headwinds.

4. CONCLUSION

The latest sharp spike in the PUI is closely linked to the downside risks created by the Cabinet reshuffle and its likely economic consequences in both the short and long term. Whether we like it or not, the economy is entering rough seas, and the storm signals are up.

The IMF has reiterated that the country needs to institute urgent economic reforms or face stagnation. In the absence of such reforms SA would be unable to bolster confidence and investment, or improve growth.

The outlook suggests that the climate of political contestation in SA will continue to prevail while the ANC succession battle intensifies this year, with its potential collateral damage to the economy. Once again, *the emphasis by many analysists and commentators on the importance of SA's institutions in managing instability and absorbing shocks to the economy remains highly relevant in assessing the ultimate net effects.*

It confirms that sound institutions and policy regimes can foster predictable policy responses, even in the face of large negative shocks. In this manner, reliable institutions and credible policy regimes lessen the scope for policy to act as a source of uncertainty impulses, but failing those institutional safeguards, if there are uncertain policy factors, the shocks are amplified. These are the lessons to bear in mind, if SA wishes to successfully manage its shifting political realities in ways which minimize the cost to the economy.

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