NWU School of Business and Governance

Policy Uncertainty Index (PUI)

2Q2017

IMMEDIATE RELEASE

11 July 2017

NWU-SBG POLICY UNCERTAINTY INDEX (PUI) RISES FROM 51.0 IN 1Q2017 TO 53.1 IN 2Q2017 (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 is now changing with events such as Brexit and the controversial policies 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
Apr – June 2017	53.1

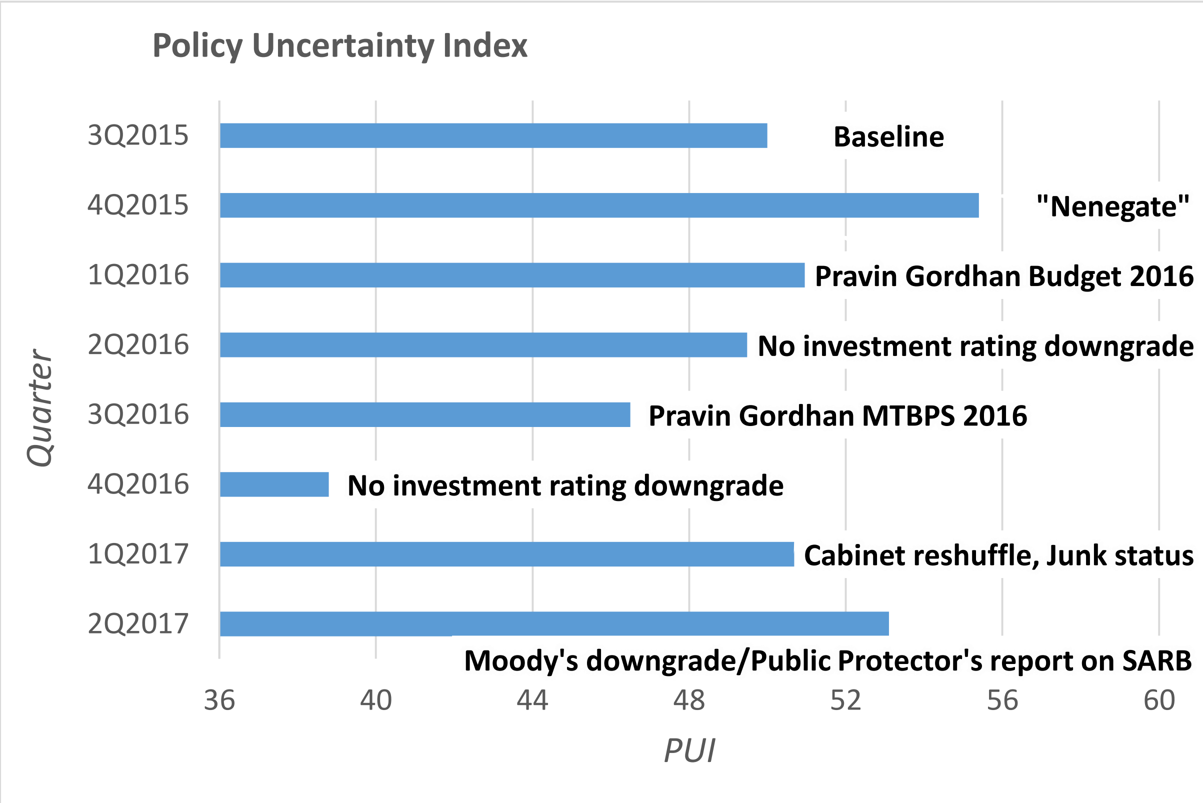
The PUI is the *net* outcome of positive and negative factors influencing the perceptions of policy uncertainty over the relevant period. *The results for 2Q 2017 show an average index* *score of 53.1, reflecting a further rise over the PUI of 51.0 in 1Q2017. Hence the PUI has risen further into negative territory.*

Unpacking the three elements of the index shows the following:

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

2.2. The survey of the economists found heightened perceptions 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 increased from 76 to 87.



3. NARRATIVE ON SOME FACTORS INFLUENCING POLICY UNCERTAINTY

3.1. Global Economic Outlook

Global economic activity is reported to be picking up, with widespread evidence of a long awaited cyclical recovery in investment, manufacturing and trade in most parts of the world economy. World economic growth is expected to be about 3.5% in 2017 and slightly higher in 2018. Among the upside expectations in several markets in which SA has a stake include higher economic activity, more robust global demand, reduced deflationary pressures and optimistic financial markets. *Most international agencies and commentators are reporting better global economic news.*

For instance, the Bank for International Settlements (BIS - an umbrella body for leading central banks) in a recent strong upbeat report on the world economic outlook said that global growth could soon be back at long term levels, after a sharp improvement in confidence over past twelve months. Although the better global economic performance is not evenly spread over developed and developing economies - and pockets of risk undoubtedly exist in certain areas of the world - the overall outlook is clearly superior to what it had been since the Great Recession of 2008.

On a *cautionary note for SA*, with its big trade and investment stake in the U.K. and the EU, the latest developments regarding the Brexit negotiations will still need to be carefully monitored. But for the moment the current economic arrangements - which SA has with both the U.K. and the EU - remain intact for as long negotiations continue. And it seems that likely that the U.K.-EU negotiations will be protracted, leaving SA sufficient time to make contingency plans in the light of further developments. A potentially damaging factor for SA would be if U.K. economic growth should decline over the next couple of years and hence its markets shrink.

Another factor in the period ahead is the pace at which interest rates rise in the US and its possible implications for SA capital flows. If the tide of capital flows to emerging markets should retreat globally, SA would be particularly vulnerable, given its dependence on capital inflows to cover its balance of payments gap.

On the face of it, for SA and many other oil importing economies, the current low level in the international oil price should on balance help to contain inflation and improve growth prospects. But the economic impact is not necessarily universally benign. Even developed economies may experience mixed effects, with consumers gaining but with concerns developing about lower capital spending and profits from energy companies and public utilities. The real danger lies, though, lie in emerging markets which rely heavily on oil exports and for whom a persistently low oil prices mean economic headwinds for both them and their neighbours. These countries include Nigeria, Angola and the Gulf States. If oil prices are sustained at too low levels, negative pressures on these economies will inevitably increase.

But seen as a whole the global economic outlook remains supportive of the SA economy, which augurs well for those sectors which are dependent on favourable international economic trends. As the SARB Governor said in an address in Johannesburg on 19 June while reviewing the respective roles of domestic and external factors driving SA's recent economic performance: 'Yet, now the global economy looks as healthy as it has been in years - but the SA economy is still struggling. So why are we doing so badly? And what can be done about it?'

3.2. The Advent of Recession in SA

The business cycle has been in a downswing for about 44 months, making it the second longest in SA history, surpassed only by the one over the period 1989 – 1993. Although the negative growth figures in 1Q 2017 confirming that SA was in a 'technical recession' was presaged by the 1Q 2017 PUI it nonetheless came as a shock, as many analysts had not expected the economic news to be quite so bad. The technical definition of a recession is two successive quarters of negative growth, which SA experienced in the fourth quarter of 2016 (-0.3) and the first quarter of 2017 (-0.7%).

The main culprits driving SA into recession in that quarter were generally poor exports, low government expenditures, higher unemployment, weak consumer spending and stagnating private sector investment. Real investment in 2016 declined by 3.9%, comparable to the fall recorded during the global financial crisis. In addition, the latest Quarterly Employment Survey, for instance, showed employment declining by 48,000 in March y-y. *This has resulted in expectations for GDP growth for 2017 in SA being reduced, but with uncertainty as to whether even the best forecasts may turn out to be wrong.*

The economic trends for the early months of the quarter are mixed but not helpful. Key trends like vehicle sales, manufacturing production, business confidence, purchasing managers' indices and the SARB's leading indicators have been dominantly in negative territory in 2Q 2017, with very little positive data to offset their sub-optimal impact. The trade account on the balance of payments remained in surplus in May 2017. Agricultural production and its marketing prospects also remained the main bright spots in SA's economic scenario. *But downgrades and slow growth could negate benefits of the record maize crop.*

Furthermore, the SA economy also entered the second quarter of 2017 off a very low base and still had to absorb the after-shocks of the late March Cabinet reshuffle and other subsequent negative developments in 2Q 2017. *Present economic evidence suggests that economic growth in 2Q 2017 could well be close to zero. SA will be fortunate to reach an economic growth rate of about 0.5% this year as a whole, despite better production figures for both agriculture and mining.*

3.3. Moody's downgrade - June 9

Although Moody's downgraded SA's sovereign risk credit rating by one notch and kept SA on negative outlook, their ranking still remains just above junk status. Standard & Poor and Fitch downgraded SA to 'junk status' in April. In a balanced but critical narrative Moody's had a downbeat assessment of SA's economic prospects and offered advice as to where they thought things had gone wrong. Their familiar concerns echoed those articulated previously by the other two rating agencies.

To the extent that Moody's findings again underscore the importance of policy uncertainty, as captured by the PUI, they will recur during the course of this narrative. They must also include the recent harsh political rhetoric on 'White monopoly capital' and 'radical economic transformation', and the degree to which these poorly defined concepts aggravated policy uncertainty. *Although it may be argued that much of what is being proposed is impossible to* *do, that does not mean that it is also harmless. Today's highly polarized political climate and pervasive uncertainty about future policies is exacting an economic price.*

3.4. The New Mining Charter – June 15

The impact of the final Mining Charter in mid-June on markets and the mining sector was highly negative, with several critics immediately believing it would cause 'economic havoc'. *In any event, a big wave of uncertainty was immediately generated among decision makers as to its broader implications for investment and employment in a key sector like mining. With the Chamber of Mines taking the Mining Charter on judicial review it also underscores the extent to which trust in policy making in that sector (and in others) has deteriorated in recent months.*

3.5. The Role and Status of the SA Reserve Bank (SARB)

3.5.1. The Public Protector's Report on the SARB

In mid-June the Public Protector (PP), in releasing her report on the ABSA and Bankorp 'lifeboat', went on to recommend that the mandate of the SARB should be changed to replace the emphasis on 'protecting the value of the currency' with a 'transformation-led' agenda. This would require a constitutional change, for which the PP provided specific wording for Parliament to consider. This development has unleashed widespread negative reaction on both legal and economic grounds, including from the ANC itself. Several stakeholders, including the SARB, are strongly challenging these recommendations in court. The SARB has called for an urgent intervention by the courts, as the continued uncertainty pertaining to remedial action has had a negative impact on markets.

The PP's proposal has thus opened up a Pandora's Box of additional risks for markets and rating agencies, at least over the longer term. Standard and Poor has warned that SA's credit rating would be downgraded further if the government was to eventually act on the PP's proposal about the SARB. Subsequently Deputy Finance Minister Buthelezi has also now suggested that the commitment to inflation targeting should also be reviewed (see 3.4.2 below). Even though there is no immediate prospect of changing the SARB's constitutional position, these developments generate mounting and additional unwanted pressures on the Bank. All this injects an unnecessary additional element of uncertainty into the economic debate when SA can least afford it, and when levels of confidence need to be boosted instead.

3.5.2. SA and Inflation Targeting

Setting the context, SA officially introduced inflation targeting in February 2000, seventeen years ago, when Tito Mboweni was Governor and Trevor Manuel was Finance Minister. Deputy Finance Minister Buthelezi recently said that, following on the PP's proposal to change the SARB's basic mandate, SA should also revisit the appropriateness of the SARB's inflation targeting regime of 3%-6%. 'Is it a policy for all seasons....do we still need inflation targeting?' he asks.

Under normal circumstances any country should be able to have a sensible technical discussion on a policy matter such as inflation targeting and its future. *But it is perhaps a reflection of the low levels of trust and confidence in SA at present that the motives and intentions of such a suggestion should elicit much unease and future uncertainty.*

The inflation target, unlike the SARB' constitutional mandate, is in any case a Cabinet decision, taken in consultation with the SARB. The SARB then has 'operational independence' to implement monetary policy in ways which achieve that target, which it has done quite successfully for several years. SA's existing inflation target range is, in any case, among the highest in the world, and it is assumed that the proposal to review is not intended to lower it. The question now will be at what point might the Cabinet eventually be persuaded to revisit inflation targeting and what position will the National Treasury (NT) then take. (See also 3.5.3 below). *Although all this may well still be well ahead in time, it nonetheless adds another degree of unnecessary uncertainty to the future policy environment.*

3.5.3. The Role of Finance Minister Gigaba

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 has in recent years 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. Good news for market confidence is that long serving NT official Dondo Mogajane has been appointed as new Director-General of the NT.

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. Economic growth is weak and hence tax revenues may decline. *The real test of fiscal management will be reflected in the Medium Term Budget Policy Statement (MTBPS) in October to see whether any fiscal shocks emerge, especially from oversight issues on SOEs, such as Eskom and SAA.* 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'. *The current headwinds facing the economy are shaping a new threshold for the NT in the October MTBPS.*

Minister Gigaba will also need to generally reassure investors, business and the markets that he supports the independence of the SARB. Then on the question of inflation targeting it is not yet clear which way Minister Gigaba will jump regarding the suggestion by his Deputy Minister that the inflation targeting regime should be reviewed. Once again, while it completely legitimate for the issue to be responsibly debated, the NT needs to address the issue on its technical merits, and not because of unreasonable political pressure.

Unfortunately there is a credibility problem here and a longer term power play is apparent. *These developments will need to be carefully scrutinized to see whether they add to future policy uncertainty and whether Minister Gigaba impresses investors and the markets in particular with his handling of these challenges.*

4. THE SARB AND CURRENT MONETARY POLICY – WILL INTEREST RATES BE CUT?

In the meantime, the SARB still has to take decisions on monetary policy at the next meeting of its Monetary Policy Committee (MPC) towards the end of this month. The pace of inflation has eased, thanks partly to lower food prices and less aggressive electricity tariff hikes. Have interest rates now peaked? Having previously stated that a recession was unlikely, but with inflation coming down below 6%, together with a relatively stable rand and lower fuel prices (combined with an unanticipated 'recession') is the SARB closer to the moment it might consider beginning to cut interest rates?

While a small cut in rates may have more of a psychological impact rather than a real one on the economy, the SARB may want to see more gains on the inflation front as well as a better anchoring of inflationary expectations, together with more political certainty, before it acts. There was also a slight uptick in the Producer Price Index in May. There are plausible reasons for expecting the MPC to remain cautious at this stage, given both external and domestic factors.

In his speech on June 19 referred to above the SARB Governor wanted inflation to be within 'the middle part of the target range....that should in turn generate a lower rate of interest to support the economy', he said. As SA is not quite there yet, the MPC may not cut rates in July but later in the year or perhaps even only in early 2018. *This turning point in interest rates may nevertheless still become an issue in monetary policy and as to how soon it would be appropriate to reduce interest rates.*

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

What is there to put on the other side of this rather uncertain and sombre PUI outlook, given the balance of factors driving it? The global business cycle remains supportive of SA’s economic prospects. The outcomes of the ANC policy conference will only be reflected in the next PUI and will no doubt influence perceptions about policy uncertainty for better or worse. *The fact remains that even a fluid and uncertain economic situation provides not only risks but opportunities. Uncertainty does not automatically mean negativity.*

While for the time being policy uncertainty may have become the 'new normal', business strategies can be adapted to accommodate the situation. Adapting to policy environment ‘shocks’ is a capability all businesses have to develop in order to survive, as there is always scope for remedial action.

It is encouraging to see Business Unity South Africa (BUSA) releasing far-reaching long term commitments on how business can actively promote economic transformation. And Business Leadership South Africa (BLSA) met with COSATU recently to forge a pact to deal with state capture and to promote economic stability. A truly collaborative effort remains highly necessary to reach better outcomes, for which trust and confidence need to be rebuilt. Yet there is no silver bullet or magic wand to resolve the SA situation. *And it cannot be gainsaid that SA has now clearly reached a stage where SA needs to get the politics 'right' in order to the economics 'right' - so as to promote the policy certainty needed for inclusive growth.*

11 July 2017

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