

François Groepe: Lessons to be learnt from progressive economies

Address by Mr François Groepe, Deputy Governor of the South African Reserve Bank, at the 18th Southern African Internal Audit Conference, hosted by the Institute of Internal Auditors South Africa, Johannesburg, 18 August 2015.

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Chairperson, ladies and gentlemen.

Thank you for inviting me to participate in the 18th Southern African Internal Audit Conference, hosted by the Institute of Internal Auditors, South Africa.

In my address this morning, I will spend some time discussing the lessons learnt from progressive economies and applying them to South Africa. Economies, and the factors affecting them, have generated much interest in our attempts to deepen our understanding of the most appropriate and efficient ways of organising the economy in an effort to optimise the allocation of scarce resources. At the outset, it must, however, be emphasised that the management and allocation of resources within an economic system does not happen in isolation or in some abstract manner. Factors such as culture, values, education, technology, social and other institutions, political structures and legal systems all provide content and context and set the backdrop and parameters in which the different economies function. In this regard, Douglas North writes, *“It is the admixture of formal rules, informal norms and enforcement characteristics that shape economic performance... And economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement”*.¹

There are clearly different schools of economic thought, with their own analytical frameworks, which in turn has a bearing on both the analyses of economic imbalances and the policy prescripts to remedy them. Despite certain reservations raised by some economist it can be argued that the United States (US) economy has made huge strides during the 20th century in growing to become the world’s largest economy and arguably one of the world’s more successful economies. One of the outcomes of this achievement was the establishment of a large middle class population following the Second World War.

Despite this strong economic performance, inequality has widened more recently. The average income of the top 1 per cent of the population in the US had increased by more than 250 per cent during the preceding two decades, while the income of most other Americans had stagnated. This may have contributed to President Obama pronouncing that, *“growing inequality is the defining issue of our time”*. He declared that it was a tipping point for the middle class in the US and all those aspiring to gain access into the middle class.

For an economy or any society to thrive one would need to acknowledge and redress both economic and political inequality. Measures of economic equality include, among other things, growth in gross domestic product per capita and a reduction in unemployment. The World Bank defined sustainable economic development as a situation under which extreme poverty is reduced to such an extent that the number of people making a living on less than US\$1,25 per day will eventually be lowered to less than 3 per cent of the total global population by 2030. Furthermore, prosperity should be promoted by improving the living standards of the bottom 40 per cent of the population in all countries. The latest World Bank Report indicates that growth in per capita income has taken place during the past decade, more specifically in the African region. Progress made is apparent in the world’s middle

¹ North, D.C (1993) “Economic performance through time” Prize lecture in Economic Sciences in memory of Alfred Nobel, December 9, 1993.

class, which is showing steady growth. According to Organisation for Economic Co-operation and Development (OECD) estimates, five billion people would have moved into the middle class, with about two-thirds residing in Asia, followed by the Middle East, Africa and Latin America. The shift towards the middle class is therefore expected to occur mostly in emerging markets, which supports the objective of inclusive growth.

The South African Institute of Race Relations estimates that the South African middle class realistically constitutes around 10 per cent of the total population. Efforts to expand and grow this number may, however, come under strain unless the South African growth trajectory can be lifted to the 5 per cent target set in the National Development Plan.

To judge the progressiveness of countries, from which lessons can be learnt, it is prudent to construct a continuum, from non-progressive countries on the one side to progressive countries on the other. Consistent with such an approach, the IMF expressed an opinion on the status of economies that could be used to place them on such a continuum, while also indicating what is required for these countries to become progressive.

It is worth noting that countries such as Canada and Singapore were rated as countries with solid growth, whilst Mexico has been acknowledged for undertaking significant structural reforms. Bolivia, interestingly has seen per capita income tripling over the past couple of years whilst Namibia has grown strongly. Poland is demonstrating that its macroeconomic policies are proving to be highly conducive towards growth, followed by New Zealand at the progressive side of this continuum. These countries are displaying good governance structures and the prudent management of national resources.

The following principles generally contribute towards establishing a progressive economy:

- Economic growth is essential, but it must be sustainable and inclusive, resulting in good-quality jobs and improve the living standards of the citizens of the country. Growth without this prerequisite will fall short of creating a prosperous society and will not be sustainable in the long run.
- High-income countries generally face challenges in terms of rising inequality due to technological progress, which has increased the wage dispersion in favour of higher-skilled workers. To address these matters, concerted efforts should be introduced to promote increased investments in human capital. Flexibility in the labour markets can contribute towards an enhance absorption of labour combined with appropriate social support systems. The environment should also receive attention to guard against environmental degradation.
- Developing economies face challenges to realise inclusive growth and should pursue policies that allow for the absorption of lower skilled labour. This can be done by investing in skills training that aligns the abilities of workers with the requirements of the labour market. Adequate social protection systems should also be put in place. In South Africa, despite the transformation of the economy during the past two decades, there are still too many citizens struggling to make ends meet and who are reliant of the social grant system.

Drawing on the latest round of Article IV consultations by the IMF, various good practices by progressive countries are referenced within their reports. Without referring to specific countries, the following general guidelines can be considered as good practice towards the development of a progressive economy:

- Raising labour productivity and increasing labour force participation would improve longer-term economic prospects by boosting potential growth.
- Increased access to financing for start-ups and the reduction of administrative barriers for new businesses could assist in expanding an economy's production frontier.

- Maintaining a flexible exchange rate is essential, both as a buffer against external shocks and to facilitate adjustment towards domestic sources of growth to reduce external imbalances. Furthermore, it is considered as advantageous to implement a broad-based set of policy actions when required, rather than incremental actions when confidence levels need to be shifted to a higher level.
- Pursuing structural reforms in a country should never be considered a trivial matter, as it can be a very challenging undertaking to balance the interests of different groups. It should, therefore, be approached in a circumspect manner. Fiscal sustainability should always be a key consideration in any undertaking towards the creation of a progressive economy. Governments should always address weaknesses in public infrastructure, including through new institutions, to enable better planning and coordination at the local level. Competition, in especially the services sector, should be encouraged as this will increase the overall level of productivity in an economy.
- Another prerequisite for a thriving economy is the establishment and maintenance of good industrial relations within the labour market towards an equitable distribution of income between the various constituencies. Quality education and training through apprenticeship programmes, as well as immigration policies aimed at accommodating scarce skills, have the tendency to alleviate skills mismatches in a country. Reduced regulatory burdens and increased competition through trade liberalisation assist in the reduction of the wage-productivity gap by lowering the cost of living, and contributing to enhanced productivity. A dedicated focus on research and development has proven beneficial to the advances made by progressive economies. The pursuance of regional free-trade arrangements is also helpful to harness the benefits of the dynamism of an adjacent region, when applicable. Government procurement practices should ideally be characterised by simplified bidding procedures, high levels of transparency, and standardised contracts that reduce costs with a focus on value for money. Performance-based budgeting practices generally also improve the impact of government programmes.

Experience in progressive economies has shown that a predictable legal framework is paramount to broad-based and inclusive growth, as it raises confidence in practices and processes and most importantly creates a strong degree of legal certainty. Comprehensive and regular evaluations of programmes being implemented should be undertaken to ensure the efficiency of execution. If found that the implementation procedures of such programmes need to be revised, or that implementation should be abandoned in totality, the necessary institutional leeway should be available to effect such changes.

A sound financial system supported by comprehensive macro-economic and micro-prudential policy measures, and well capitalised banks with solid liquidity buffers, contribute materially to sustainable growth within an economy. Moreover, authorities should strive towards the strengthening of their macro-prudential toolkits to better adhere to their financial stability mandates.

Some of the global regulatory reforms undertaken is aimed to ensure an even greater degree of transparency and include efforts to reduce potential conflicts of interest and the risks associated with moral hazard. Executive compensation remains firmly on the agenda, not only because of equality considerations, but because in certain instances it may give rise to excessive risk taking. An argument that the high levels of executive compensation is justified due to the value created for shareholders must also be closely examined against the exogenous factors, such as the liquidity overhang caused by the unconventional monetary policies pursued by many of the advanced economies.

Creating an enabling environment for small- and medium-sized enterprises, which are major sources of employment, should be part of any policy transformation attempt.

Academic research generally concludes that political freedom, strong institutions and quality regulation are significant contributors to economic growth. Effective, fair and accountable governments boost public confidence, raising the level of satisfaction among citizens. Likewise, citizens' access to public officials to voice their concerns is correlated with a higher state of well-being.

It is worth noting the most recent findings by the Institute for Management Development responsible for the publication of the *World Competitiveness Yearbook*. The 2015 Yearbook indicates that SA occupies position 53 in terms of its competitiveness within a group of 61 countries surveyed. The Yearbook ranks a mix of 61 industrialised and emerging economies in terms of ability to create and foster an environment sustaining competitive enterprises. Country data are evaluated based on specific criteria, categorised in terms of four competitiveness factors, namely government efficiency, business efficiency, economic performance and infrastructure.

South Africa's economic performance has improved by seven places to position 49 in 2015, following an improvement in international trade and attaining the lowest cost-of-living index that topped the world rankings. Government efficiency though is indicated to have dropped to position 40 in 2015, after having been at position 32 two years earlier. This is mainly attributable to the poor performance of public finance, a weak institutional framework and business legislation. The performance of businesses' efficiency also deteriorated further in 2015, as a result of a decline in productivity and efficiency, a further deterioration in labour market conditions, deteriorating management practices, and poor attitudes and values in the business sector. The ranking of technological infrastructure, health and environment infrastructure also deteriorated. The report states that business efficiency requires high productivity in order to thrive and, in the absence of that, it is difficult for an economy to be competitive. According to the report, it has been empirically proven that business efficiency and productivity have been the main drivers of the competitiveness gains in the US, with that country remaining the most competitive economy in 2015.

In dealing with our own challenges regarding competitiveness, it is important that we continue to pursue fair access to markets and more balanced global trade. Furthermore, although protectionism appears to be an attractive policy response against a backdrop of low growth and a structural current account deficit, it should be approached with a degree of circumspection as an important lesson to be taken from economic history is that the period that followed the Great Depression was marked by an outbreak of protectionist trade policies. These policies led to a sharp contraction in global trade in the 1930's, beyond the economic collapse itself, and a lacklustre rebound in trade despite the eventual worldwide economic recovery.² It is also worth acknowledging that trade protectionism often fails to adequately address the underlying challenges of competitiveness, or the lack thereof, within an economy and it may even lead to a decline in the degree of competitiveness as it could lead to higher input costs and hence contribute to price inflation. Lastly, it is unlikely to restore external balance if external demand is weak.

The International Monetary Fund (IMF) has developed sustainable growth indicators which focus on policy, democracy, and governance as the drivers of growth. The policy component encapsulates economic policies, while the governance component relates to accountability. This approach by the IMF enables a link between economic growth and the role of the South African Reserve Bank (the Bank) and bodies, such as the Institute of Internal Auditors, in fulfilling their respective mandates.

The contribution by the Bank enhances institutional capacity in the economy as it serves the South African society through maintaining price and financial stability in the interest of

² Eichengreen, B and Irving, D.A (2009) "The slide to protectionism in the Great Depression: Who succumbed and why?" NBER Working Paper No. 15142.

balanced and sustainable growth. In the policy sphere, it conducts monetary policy to contain price inflation. In doing this, the Bank assists in maintaining and improving competitiveness, protecting the purchasing power of the currency and, thus the living standards of all South Africans. Furthermore, this provides a favourable environment for employment creation through balanced growth. In addition, the Bank also has the mandate to oversee and maintain financial stability which is a distinct and separate policy objective from price stability.

We can feel very proud that South Africa was ranked first out of 144 countries ranked in the Global Competitive Index Report for our Strength of our Auditing Standards and Reporting, second for Accountability and third for the efficacy of our corporate boards. This is meaningful as the internal and external auditing profession forms an integral part of the international and domestic institutional capacity. These professions contribute to both the moral and legal frameworks that maintain and uphold ethics and standards, while forming an important line of defence in upholding good governance in both the public and private sector. The auditing profession contributes to a credible and thriving business environment, while acting as the custodians of international standards for professional conduct. Lastly, the comfort that investors get from the auditing professions, promotes investment and thus ultimately economic growth and therefor makes a difference to people's standards of living and hence their quality of life.

I wish to conclude my talk this morning, by quoting former President, Nelson Mandela, when he said *"There is no passion to be found playing small - in settling for a life that is less than the one you are capable of living"*. I hope we all would continuously strive towards a life that is nothing less than the one we are capable of. More importantly, I hope that we would all take hands and work tirelessly to create a future for our country that is reflective, not only of the rich endowments we enjoy as a country, but a future that is reflective of our true and full potential as a nation.

Thank you.