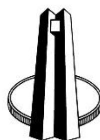

Public lecture by Lesetja Kganyago,
Governor of the South African Reserve Bank,
at the University of the Free State

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Sound policy is an imperative for growth

Good evening, ladies and gentlemen.

Thank you for inviting me here today to speak about the South African economy.

I am going to focus on how we should see macroeconomic policy and its role in our economic growth problem.

There is a principle in economics, known as Dornbusch's Rule, that a crisis takes longer to happen than you expect, but then occurs faster than you can believe. It is the macroeconomic version of the old rule about how you go bankrupt: slowly, then quickly. The point is that you get a lot of bad data before the system breaks. Experts will warn about a crisis, and after a while, these warnings will become part of the background noise. But when the crisis comes, its timing will still surprise everyone.

In South Africa, we are getting used to talking about a crisis. Every time the Minister of Finance presents a new Budget or MTBPS[1] to Parliament, the press calls it a 'make or break' event, or the most important budget since the dawn of democracy. I have been answering questions about a Moody's downgrade for years. We are even discussing distant possibilities, like an IMF programme, as if they were imminent. Actually, while our debt to GDP ratio has more than doubled over 10 years, it is still in the region of the emerging market average, which is 55%. Our debt has a long maturity profile, and is mostly denominated in rands, which minimises the risk of losing market access and being forced to ask the IMF for help.

The debt problem is not *where we are*. The problem is *where we are going*.

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[1] Medium Term Budget Policy Statement

A debt-to-GDP ratio of 60% isn't a disaster. But our fiscal deficits are over 6% of GDP, and National Treasury expects a deficit of nearly 7% of GDP for 2020/2021.[2] At that rate of borrowing, it doesn't take long to get to a dangerous level of debt. Some analysts suggest we could get to a 100% debt-to-GDP ratio within a few years. In that scenario, lenders might give up on us. Or we could see our interest bill claim even more of our scarce resources.

But we haven't locked in that path yet. We are suffering the consequences of past mistakes, but we still have time to make better decisions. It's crucial we use this time wisely. In economic terms, our problems can be addressed. But there is a real danger of getting our narrative wrong, so we end up having the wrong discussion, we don't solve our problems, and we learn our mistake the hard way, by having a crisis. This talk is my contribution to prevent that, by getting the narrative right.

Let's start with the macroeconomic stance. I only have responsibility for one part of the macro mix, which is monetary policy, but the Constitution enjoins me to consult regularly with the Minister of Finance, so that fiscal and monetary policies are in sync. It's therefore important that we understand what fiscal policy is doing and how it interacts with monetary policy. Accordingly, we as the SARB have invested considerable time and effort in this task.

By our calculations, the fiscal impulse to growth was around 0.6% last year.[3] This estimate *excludes* bailouts for state-owned enterprises as well as interest payments. A positive fiscal impulse shows that policy is not austere. And yet overall growth was just 0.2%, suggesting that the economy experienced a contractionary fiscal expansion – despite the fiscal impulse, the growth rate of the economy slowed. This combination of looser fiscal policy and worse growth points to policy side-effects that cancelled out the fiscal impulse, leaving the economy poorer overall.

What are these indirect effects? One is confidence. We can see in surveys that both household and business confidence is near long-term lows at the moment. People have seen taxes go up, they see debt rising, but they do not see this spending producing better services. It is a discouraging picture. Businesses are still investing, but they are not ramping up production. Households are holding off on major purchases. There is also evidence more highly skilled people are leaving the country.[4]

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[2] The 2020 Budget projects 6.8% for 2020/21.

[3] This calculation is based on the methodology developed by the Hutchins Center at the Brookings Institution, described here: https://www.brookings.edu/interactives/hutchins-center-fiscal-impact-measure/

[4] Faulkner, D and Mosadi, T. 11 November 2019. *South Africa: the economic implications of high-skill emigration*. Available at https://www.research.hsbc.com/R/20/7gNXQNqHnC2d. See also Kaplan, D. 3 October 2019. *Packing for Perth: skills flight is a reality, and we must plan for it*. Available at https://www.dailymaverick.co.za/article/2019-10-03-packing-for-perth-skills-flight-is-a-reality-and-we-must-plan-for-it/.

A second indirect effect is through long-term interest rates. As you know, we at the SARB have reduced the repo rate lately, with cuts in July 2019 and January 2020. We have also tried to steer inflation expectations lower, towards the middle of our target range – and we have seen results, with all measures of inflation expectations declining. Both these changes would normally have shifted long-term interest rates lower. As financial analysts would say, they should have lowered the whole yield curve.

Unfortunately, the yield curve has actually steepened: the gap between short rates and long rates is now the widest on record.[5] This is the result of country risk. It is the markets sending a message that there is too much borrowing. It is not about tight monetary policy. As I have explained, lower short rates and lower inflation expectations, which are the main channels between monetary policy and long-term rates, have both been working to *reduce* rates. Indeed, if it weren't for these factors, the long-term rate would likely be around 100-200 basis points *higher* than it is now, making our interest costs even more burdensome.

As it is, interest costs are reducing the real money available for government to spend – reducing the real value of budgets. And these costs have also doubled in the past five years, to nearly 5% of GDP. Furthermore, a higher risk premium has spread through the rest of the economy, disincentivising investment by raising the cost of capital.

Simply put, our fiscal situation isn't a problem of austerity. It isn't about tight monetary policy. It isn't because growth just mysteriously slowed down. Weak growth is endogenous in our fiscal problems. We cannot keep doing what we're doing and just hope that growth will recover and save us. Growth is low, in large part, because of unsustainable policies.

My friend, the Finance Minister Tito Mboweni is a man who says things that are true even when they are unpopular. His message is that we have to reduce spending, and he is right to put this at the centre of our macroeconomic debate. We can all shout at him and resist his proposals, and in the end he will at least have the satisfaction of being proved right. Or we can follow his advice, solve this problem, and avoid a crisis.

Now let me move to my core responsibility, which is monetary policy. Once again, I'd like to start with a major misunderstanding, one which has plagued us for many years. It is the deep-seated belief that there is a trade-off between growth and inflation. This conviction has exposed us to something economists call 'stagflation' – in other words, economic stagnation – low growth – and high inflation happening at the same time.

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[5] Based on the gap between the 2021 and the 2048 instruments. The yield curve is also unusually steep comparing other instruments, such as the 2-year and 10-year bonds.

At the SARB, we have often had to fight against the tide of opinions which says: let's cut interest rates, we need more growth, so let's just tolerate more inflation. The tragedy is that this instinct has left us looking in the wrong direction. In fact, there is a better space, one that many other countries have reached, where inflation is low, where interest rates are therefore lower, and where central banks can be more sensitive to growth precisely because inflation is better anchored. In this space, you don't need to choose between growth and inflation. You can have growth *without* high inflation.

Over the past few years, we at the SARB have undertaken a major strategic initiative to get closer to this good space. Our starting point was stagflation. In 2016, growth had slowed to 0.4%, but we also had inflation outside of our target range, above 6%, and core inflation was nearly 6%, having trended steadily higher over the preceding five years – even as the economy decelerated.

To return inflation to target, we had raised rates, to a peak of 7% in 2016. Then, as inflation began moderating, we were patient, and we communicated that we would prefer to see inflation stabilise at around the middle of the target range. Inflation has since largely cooperated: over the past three years, it has averaged 4.6%. Progress has been somewhat more rapid than we had expected, in part due to lower food prices and an exchange rate recovery, which helped to bring down underlying inflation. That has created extra space to lower the repo rate. With the January MPC cut, the repo rate is now down to 6.25%, its lowest level since 2015.

The key point is, we are now in a place where we have got inflation lower, and we have been able to cut rates without sacrificing our credibility. This is how monetary policy is meant to work: you cut rates from a position of strength, because you have inflation under control, not out of weakness, because you have given up trying.

That's the good news. The bad news is that monetary policy alone cannot turn this economy around. As yesterday's GDP figures reminded us, the supply-side of this economy is in deep trouble. We experienced a technical recession in the second half of the year, and growth for 2019 as a whole was just 0.2%, the worst rate since the Global Financial Crisis. Analysts have focused on electricity shortages as an important contributor to these bad outcomes, with good reason. Unfortunately, these kinds of growth constraints are beyond the reach of monetary policy.

The scope for monetary policy is also limited by the fact that inflation has stayed relatively high. In South Africa, we tend to think inflation has collapsed when it's below 4.5%, but in much of the rest of the world, this is not considered low inflation. The median emerging market had inflation of 2.9% last year, compared to our 4.1%. Brazil, a country much like South Africa, but with a history of significantly higher inflation, was at 3.8%. Advanced economies are lower still; the United States

(US), for example, was at 1.5% in 2019.[6] If South African inflation were to moderate further, we would have more space to lower interest rates. But even with extremely low growth, inflation does not appear to be slowing further, and we see almost no risk of inflation missing our target from below, which has been a problem for many other countries.

Given that inflation does not appear to be falling much further, gaining more space for interest rate cuts means we would need to reduce the impact of country risk. Global rates are low, and that helps. But South Africa borrows heavily from the world. Our current account deficit, which is equal to the foreign savings that come into South Africa, is close to 4% of GDP. Almost all our peer countries borrow less. If we try to cut rates too far, despite the country risk, investors won't have enough reason to be in South Africa. They would be better off investing in less risky places. So we need to become less risky, to enjoy more of the benefits of low global rates. Key public-sector drivers of inflation, like the public sector wage bill and administered prices, could also help ease inflation. This is where fiscal and monetary policies need to be in sync.

Finally, and more fundamentally, we need to appreciate the limits on what any monetary toolbox can do for growth. Let me give you the example of Italy. Italy is part of the euro zone. Euro area inflation has been very low, and the European Central Bank has made a major effort to push it back up again, with policies including negative interest rates and quantitative easing. But Italy has a large debt burden. It has problems of political and fiscal policy uncertainty.

Over the past five years, Italy has had average growth of less than 1%. Germany, with the exact same monetary policy, has had average growth closer to 2%. Spain, which, like Italy, was a major victim of the 2011-2012 euro crisis, has averaged nearly 3%.[7] Clearly, the tailwind of easy monetary policy was not enough to overcome the headwinds of Italy's other challenges. Of course, South Africa is a different country. But what you should take away from this is that there is much more to growth than monetary policy, and it is still possible to stagnate with the loosest monetary policy imaginable.

The fact of the matter is, South Africa has not made itself a high-growth country. We do not save enough to fund adequate levels of investment. We invest less than 20% of GDP; to sustain strong growth, we should have investment of at least 25% of GDP. We have focused on domestic

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[6] This number refers to the change in the Private Consumption Expenditure deflator, the Federal Reserve's targeted measure of inflation.

[7] The exact averages are 1.7% for Germany, 0.9% for Italy, and 2.9% for Spain, for the period 2015-2019. The data are drawn from the IMF *World Economic Outlook* database.

consumption as a growth driver, on the grounds that it is the largest part of the economy. This effort has raised household consumption to its highest ever share of GDP.[8]

But we are growing more slowly than ever. We have accumulated debt faster than almost all our peer countries, on the grounds that fiscal policy has to be supportive of growth. But growth stimulus works for *smoothing out* business cycles; it's *not* a long-run growth strategy. Long-run growth is about savings, investment and exports. It is about raising productivity. We in South Africa have deliberately run down savings, focused on consumption, and pulled in imports. Our productivity growth is exceptionally low, perhaps negative. We should therefore not be surprised that growth has stagnated.

Ladies and gentlemen, to conclude: we in South Africa have got to reform. It will involve some pain, but the longer we delay, the more painful it will be. We can tell ourselves comforting stories about how there are pain-free alternatives, but these narratives are misleading. We have spent a lot of time searching for easy options. These schemes don't stand up to scrutiny.

Here's what we can really do about mitigating the pain of necessary reform.

First, we can take the edge off with the interest rate tool. Provided we have lower inflation, and if country risk comes down, we can keep rates low, and maybe go lower.

Second, we can devise a credible plan for making things better again. In macroeconomics, as in so many things, it's not about where you are, so much as where you're going.

The story of the last few years has been that South Africa is drifting into a crisis. This has been the South African story before. We have, in the past, been able to change the narrative. South Africa has many friends, and there is a lot of money out there desperate for good growth economies to invest in. We can be one of those winning countries again.

Thank you.

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[8] In the third quarter of 2019, household consumption reached 62.1% of GDP (using real, seasonally adjusted and annualised data). Over the past 20 years, the average has been slightly below 60% of GDP. Investment and government consumption are also above long-run averages, while net exports are lower.