South African Reserve Bank

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THE ROLE OF MACROECONOMIC POLICY IN ACHIEVING HIGH RATES OF ECONOMIC GROWTH IN SOUTH AFRICA

Address by Mr Lesetja Kganyago, Deputy Governor, South African Reserve Bank at an ABSIP Dinner, Sandton Sun, Johannesburg

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INTRODUCTION

Ladies and gentlemen, thank you for allowing me to address you tonight. As South Africans we spend much time and energy debating the key issues of our times, in particular how to understand and act upon the challenges of poverty, unemployment and economic growth. The core message i want to convey to you is this... despite our many gains as a democracy and a society, our resolution of poverty and unemployment must come as part of a long-term process of economic growth at sustained rates well over 5% a year, an average we achieved in the boom years of the past decade. The process will be long, primarily because we are a society of vested interests – which makes policy formulation hard and drawn-out – and because our human capital, public infrastructure and technological needs are also very large. We cannot have all of these needs addressed immediately – they must be planned and financed over realistic periods of time.

So on the one hand we need an economic reform process that consistently puts economic growth at the forefront – understanding that growth as the Commission on Growth and Development shows is necessary for job creation and poverty reduction. And on the other hand we need to unlock the economy’s potential to generate the public funds needed for government to provide the means of developing human capital and infrastructure.

Growth in itself is not an end – rather it is the vehicle that allows governments and societies to realise other important socio-economic objectives. Growth is necessary for economies to develop, to create jobs, reduce poverty, and provide sufficient resources needed to support other fundamental goals like improved health care and education.

In thinking about how to address our challenges, it is worth recognising that it has been rapid sustained growth in countries such as China and India that has fostered the sharp downward trajectory in global poverty, with hundreds of millions lifted out of poverty over the past two decades.[1]

The South African economy desperately needs faster, sustained growth in order to tackle its critical socio-economic challenges of poverty and very high unemployment, particularly among younger and less skilled individuals. There are currently over 4.3 million unemployed – one-in-four-of those willing to work and looking for a job are unemployed. A further 2.2 million are discouraged.

High unemployment means there is a latent supply of labour that is not acquiring the skills or experience needed to drive the economy forward. This inhibits our economic development and imposes a larger burden on the state to provide social assistance.

To tackle poverty and unemployment we need sustained high growth.

What is sustained, high economic growth? The Commission for Growth and Development, led by the Nobel-prize winning economist Michael Spence, provide an intuitive guide by using an average GDP growth rate of 7 per cent a year sustained for a period of 25 years. At this pace, an economy almost doubles in size every 10 years.

Since 1950, there have been 13 examples of these growth champions – Botswana; Brazil; China; Hong Kong, Indonesia; Japan; Korea; Malaysia; Malta; Oman; Singapore; Taiwan; and Thailand.

[1] Between 1990 and 2010 China grew at an average rate of 10.1 per cent a year while India expanded at an average rate of 6.5 per cent a year. Over this period GDP per capita has risen by 522 per cent in China and by 152 per cent in India. The World Bank estimates that over the period 1990 to 2015, more than 600 million Chinese and almost 160 million would have been lifted out of absolute poverty (less than US$1.25 a day).

THE RECENT GROWTH EXPERIENCE IN SOUTH AFRICA: A BRIEF SYNOPSIS OF THE LAST 25 YEARS

The experience in South Africa does not compare to these economies, but since 1994 there has been a marked improvement in the rate of economic growth.

After averaging a mere 1 per cent during the final decade of Apartheid, GDP growth rose to an average of 3 per cent between 1994 and 2003 before accelerating to average almost 5 per cent between 2004 and 2008.

During this five-year period, the economy created more than 2 million jobs, helping to lower the unemployment rate by 5 percentage points. Real per capita GDP was 30 per cent higher in 2008 than at the time of the first democratic elections.

This progress was halted abruptly by the worst global financial and economic crisis since the great depression. South Africa was unable to escape its impact and the economy suffered its first recession for 17 years as output fell between the third quarter of 2008 and the second quarter of 2009. The economy contracted by 2.7 per cent during this period and by 2010 there were one million fewer people working than at the end of 2008.

Since mid-2009, the economy has begun to improve and expand. However, the recovery has been relatively slow. On an annualised basis, quarterly growth has averaged 3.1 per cent over the last 18 months. The first quarter 2011 figures come out on Tuesday. High frequency indicators, particularly for the manufacturing sector, suggest robust expansion, and there is tentative evidence of a nascent recovery in the labour market.

Looking ahead, it is important to understand what determines economic growth and remove the obstacles that prevent the economy from growing faster.

WHAT MATTERS FOR GROWTH?

Growth can be distilled into a triple formula of technology, capital and human capital. These in turn depend on a number of subsidiary factors including labour productivity, health and education, finance, market structures, regulations and other microeconomic policies, economic growth in trading partners, and the macroeconomic management of the economy through the business cycle.

Political factors are also crucial. Committed, credible and capable governments are instrumental in providing the institutional governance and leadership that supports growth enhancing policies. As the Commission for Growth and Development states:

> "Fast, sustained growth does not happen spontaneously. It requires a long-term commitment by a country's political leaders, a commitment pursued with patience, perseverance and pragmatism."[2]

MACROECONOMIC POLICY AND GROWTH

Macroeconomic policies are important because they provide the framework for growth. Fiscal and monetary policy set the pace of growth in aggregate demand and ensure that this pace matches growth in the supply side of the economy without creating pressures that could derail growth.

In the short-run macroeconomic policy should provide stability and certainty, helping manage the ups and downs of the economic cycle and maintaining growth in productivity. Over the long run, bad macroeconomic policy decisions can have a negative effect on economic growth – as high inflation or large changes in the exchange rate, the interest rate, or the tax burden reduce private savings, investment and economic activity.

A credible and stable macroeconomic policy – meaning minimizing large changes to key variables – allows households and businesses to be more confident when planning for the future. This induces more saving and investment, more rapid economic growth and greater job creation.

Growth is more stable if fiscal and monetary policies aim to moderate price movements over the business cycle by managing aggregate demand. In good times, when the economy is booming, demand and confidence, production and employment, salaries and wages, and capacity utilisation are rising, which can result in inflationary pressures. Countercyclical macroeconomic policies – such as budget surpluses and tighter monetary policy – act to

[2] Commission for Growth and Development, 2008

counterbalance the build up of these potentially distorting pressures and imbalances by helping reduce aggregate demand. In doing so, these policies further ease upward pressure on the real exchange rate.

When the economy is contracting, the opposite occurs. This was evident during the recession as confidence levels fell and household consumption and business investment declined sharply. Expansionary fiscal and monetary policies were implemented through sustaining government expenditure and running a budget deficit and a cumulative 650 basis point reduction in the repo rate that helped stimulate the economy and ensure the decline in output was lower than it would otherwise have been.

At this stage, our economy is recovering more or less in pace with the recovery in the world economy. The weaknesses in our recovery in some ways reflect the unusual pattern of recovery we see in the rest of the world.

Advanced economies by and large continue to recover slowly, held down by the need to address large housing market overhangs and sharp increases in unemployment. Their policy settings continue to reflect the need for sustained exchange rate depreciation and support for domestic economic activity. In due course both monetary and fiscal settings will need to reverse to avoid the perils of high public debt levels and too much liquidity.

In Asia and some parts of Latin America, however, we see robust economic growth. Some of this may prove unsustainable, and already the major economies have instituted policy adjustments to tighten. Higher inflation in some of these surplus economies pushes up their real exchange rates, and therefore, alongside the depreciation in deficit countries, needs to be understood as a critical component of reducing macroeconomic imbalances at the global level.

The pattern of growth in the rest of the world is reflected here in South Africa. On the one hand we benefit from exceedingly strong terms of trade, which have risen by about 20% since 2009. And on the other hand, we remain constrained by concerns about energy supply, weaker infrastructure spending, and an equally weak job creation trajectory.

Our monetary and fiscal settings and terms of trade gains remain strongly supportive of aggregate demand. Our export performance, notwithstanding the rise in the value of commodities and commodity-related manufactured goods, has remained weak and has fallen behind the rebound in trade performance in the rest of the world. Our capacity utilisation and investment rates are too low.

Part of the answer to our economic growth challenge is, like the reforms conducted in recent years in other BRIC economies, to get more serious about the reforms we need internally to lower costs, increase productivity and make more rapid job creation possible. These economies have achieved robust growth rates in recent times in part through extensive reform programmes and despite the fact that their exchange rates have appreciated much more than has the rand in recent years.

Private sector investment enthusiasm could be generated by ensuring that public sector plans at all levels continue to roll out and new initiatives for future years continue to be articulated in credible ways. Productivity raising reform and stronger public infrastructure development would also support our more export-oriented sectors and help them to become more competitive.

The relatively stronger exchange rate of recent times is only one part of our lack of competitiveness, and probably only a small part of the story, especially if we reflect on the stronger appreciations experienced in some other parts of the world over the past 10 years. Yet it is a variable that our monetary and fiscal policies can have some effect on.

Our inflation targeting framework allows for a float of the nominal rate, allowing the exchange rate to absorb international financial and economic shocks without requiring drastic movements in our interest rates. This is a critically important benefit of the float and one largely under-recognised in our current public discourse. Over the long term, this has enabled the rand to depreciate in both nominal and real terms. Since 2006, for instance, the time of the previous peak in exchange rates, the nominal effective exchange rate has depreciated by 20%, while the real effective exchange rate has declined by 8.7%.

Counting from 2008, the real effective exchange rate peaked in strength in December 2010.[3] A large part of our worsening competitive position in recent years has been the sharp rise in inflation experienced between 2007 and into 2010. Headline CPI inflation rose

[3] The REER depreciated again by 8% between December 2010 and February 2011.

by 11.3% in 2008, 7.1% in 2009 and 4.3% in 2010. These high inflation rates were driven by excessively strong growth in domestic demand, sharp increases in food and oil prices, and as the recession unfolded, higher electricity prices and sharp increases in unit labour costs averaging 9% per year from 2008 to 2010.[4]

Under these circumstances, to maintain a stable level of competitiveness would have required a nominal rand depreciation of roughly 23%.[5] But, given the high rates of increase in inflation between 2007 and 2010, a weaker exchange rate would have sharply increased inflation and required a reversal of the monetary policy stance at the worst possible moment for the South African economy.

Some of the discourse on monetary policy seems to suggest that looser policy would increase growth both now and in the future. With stronger inflation pressures coming from imported food and oil prices presently, looser policy would be detrimental to our growth prospects and place an unacceptable burden of falling purchasing power on our poor.

A credible monetary framework and a counter-cyclical fiscal policy are therefore critical for moderating movements in the real exchange rate that are caused by inflation or the rise in our domestic price level. So from a macroeconomic perspective, we can support our general competitiveness by enhancing the degree of counter-cyclical policy we have in place. This is a key part of our macroeconomic policy challenge over the next year or two. The role of monetary policy in this challenge is clear.

CONCLUSION

Allow me to conclude by noting that monetary policy cannot be used to affect the potential growth rate of the economy over the longer term. It is not a panacea for addressing our structural challenges, a point that is made repeatedly in the vast international literature on economic growth. An economy can only grow faster on a sustained basis if it addresses the binding constraints to growth. These are the microeconomic and structural impediments to higher levels of competition, investment, innovation, skills development, and employment that determine the economy's long run competitiveness, productivity and capacity to grow.

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[4] Resulting from high wage demands & settlements and falling productivity as GDP declined.

[5] This is equal to South African cumulative inflation minus the cumulative inflation rate of our trading partners (assumed here to be zero).

Countries that are more productive grow faster and permanently raise the standard of living of their people. This implies that productivity growth must feature as a fundamental objective of our policies.

There are no short-cuts; no easy solutions; no ifs or buts; only difficult policy decisions to be made.

Thank you