NWU School of Business and Governance

Policy Uncertainty Index (PUI)

3Q2016

IMMEDIATE RELEASE

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NWU POLICY UNCERTAINTY INDEX (PUI) DECLINED IN 3Q2016 TO 46.5 FROM 52.5 IN 2Q2016 (BASELINE 50)

NWU-SBG POLICY UNCERTAINTY INDEX (PUI)

1. INTRODUCTION

As outlined when the PUI was launched earlier this 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 fill a gap in our monitoring of the economic environment. The NWU team 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 at one stage suggested that uncertainty is very different across economies. Developing countries seem to have about one-third more macro-economic uncertainty than developed countries. Low-income countries in regions like Africa and South America understandably tend to show more volatile growth rates, exchange rates and stock markets.

Yet if we unpack the present world economic outlook there is currently no fixed lump of 'uncertainty' to be distributed around the globe. On the contrary, *policy uncertainty seems on rise across much of the world today, generated by events such as Brexit and anti-globalisation sentiment.* In other words, more developed economies are also becoming more prone to policy uncertainty and its consequences. This was also a prominent concern at the recent G20 Summit, for example.

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 FOR 3Q2016 - WHAT DOES IT SAY?

The aggregate PUI for the quarterly period July to September 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

This gives an average PUI of 46.5 in 3Q2016 and *shows a decline in policy uncertainty over the previous quarter.* This is the *net* outcome of a combination of *positive* and *negative* factors affecting perceptions of policy uncertainty over the period July – September 2016. On balance, the PUI in 3Q2016 appears to be giving the short term positive factors in the economic and political outlook the benefit of the doubt.

3. NARRATIVE ON POSITIVE AND NEGATIVE FACTORS INFLUENCING THE 3Q2016 PUI

These are some of the key *positive* and *negative* factors that appear relevant to the PUI outcome in 3Q2016.

3.1. The Global Economic Outlook - one of greater uncertainty

The PUI has been introduced at a time when the global economy is much less supportive of the domestic economy. Even before Brexit, the IMF and other analysts again reduced the forecasts for global economic growth in 2016. The WTO and the IMF have also revised global trade forecasts downward. Although the growth outlook for the world economy is still positive, it remains modest. Like many other small open economies that benefit from the positive effects of globalisation, SA is vulnerable to its negative consequences. Yet although no country today is immune from unpredictable surges and swells in the global economy, several emerging economies have been able to ride the waves with more resilience and less vulnerability than SA.

The UK's decision to leave the EU inevitably heightens uncertainty and the risks for the world economy, finance chiefs said at the outcome of the G20 Summit in China recently. The outcome of the British referendum 'adds to the uncertainty' in the global economy, they said. The G20 nonetheless felt that it had the tools to cope with the potential economic and financial consequences, when in any case are likely to be spread over a period of years. G20 members agreed that, despite the Brexit decision, the global economy would improve in 2016 and 2017. In the meantime, the IMF has downgraded its forecast for UK economic growth form 1.9% to 1.7% in 2016, and for the global economy from 3.2% to 3.1%. The IMF has also noted that 2016 will be the fifth straight year of global growth below 3.7%, its average for nearly two decades for before the 2008 crisis.

As far as SA is concerned, *the status of existing trade agreements and financial arrangements between SA, the EU and the UK* remain stable. For the time being, and over the next couple of years - perhaps up to the end of 2018 - SA's economic relations with the UK and the EU remain intact. They will not be affected by the imminent trigger of the UK-EU separation process next March, nor during the time frames this will take to negotiate. To that extent firm and predictable trade relations and other partnership commitments remain in place with the UK and the EU, but the development in due course of contingency plans will help to manage uncertainty. Much depends on the kind of trade deal Britain can negotiate with the EU and how soon its outline will emerge.

Countries can do little about the drivers of international economic uncertainty but every effort should be made to keep uncertainty caused by domestic policy to a minimum. *Global economic uncertainty emphasises the need to reduce domestic uncertainty through factors that are under national control.* It is therefore important to recall the statement from the Presidency (23 January 2016) stressing that 'Team SA' at the World Economic Forum in Davos had been 'assuring investors of policy certainty and economic stability....*President Zuma emphasised SA's commitment to policy certainty....'*

At a regional level the *recent economic developments in Zimbabwe* may become a source of wider uncertainty later. During 3Q2016 Zimbabwe placed a unilateral ban on certain South African imports into that country. If economic instability occurs in an immediate neighbour, it usually has important socio economic implications for SA.

3.2. Signs of 'greenshoots' in the economy –growth outlook more certain?

The 3Q2016 has seen several encouraging factors that suggest (but do not yet confirm) that the SA economy has bottomed out and that, barring any more 'own goals', a technical recession has been avoided and mildly positive growth (say 0.4%) is possible in 2016. Looking further ahead, a growth rate of 1 – 1.5% is possible in 2017.

Perceptions about policy certainty were probably enhanced by a combination of the following factors:

- Better than expected growth figures in 2Q2016
- Signs that the drought may be receding
- Evidence that inflation may have stabilised
- Hints that the rising interest rate cycle may be coming to an end
- Electricity supply constraints have been ameliorated
- SA has moved up two places to 47 out of 138 in the WEF's latest annual Global Competitiveness Index
- Positive reaction to the outcome of the local elections on August 3
- Commodity prices appear to have stabilised
- SA's trade deficit seems to be declining
- The recent success of the National Treasury in raising overseas loans
- Strong assertions by Finance Minister Pravin Gordhan that there was 'more than a 50% chance' that SA would avert an investment downgrade at the end of 2016.

Yet there is no guarantee that all these positive developments will persist (see conclusion). It should also be noted that the recent MPC statement acknowledged that 'while the second quarter growth performance was more favourable… this improvement is unlikely to be sustained in the third quarter'. Recent manufacturing industry data, including new motor vehicle sales, remain weak.

3.3. The SARB and Monetary Policy

The SARB has increased the repo rate several times during its rising interest rate cycle over the past two years or so, but again left the rate unchanged at its last MPC meeting in September 2016. The SARB Governor recently emphasized the policy dilemma still faced by the SARB of balancing the upside risks of inflation with the downside risks of weak economic growth. *The Reserve Bank has nonetheless raised its growth forecast for 2016 from 0% to 0.4%.* It also seems likely that, partly because of Brexit, US interest rates will be left low for longer and perhaps only likely to rise further in December 2016. *In the bigger PUI picture monetary policy has remained largely predictable and certain, given the SARB's mandate.*

3.4. Credit rating agencies' revisit to SA in 2016

While SA was able to avoid 'junk status' from certain credit rating agencies in 2Q2016, the next test will come when they again reassess SA soon. *It therefore remains important for SA to be seen to be implementing policies and projects which will begin to turn negative perceptions about the economy around and to reduce policy uncertainty in the period ahead.*

It is widely anticipated that to improve SA's growth potential the government needs to soon deliver on the promises made to the rating agencies to stabilize the economy and make structural reforms, including in the highly regulated labour market. It is clear that these steps will need to be significant enough to boost investor confidence in ways that will move the economy out of its current malaise and set it firmly on a higher growth path. *This, rather than Brexit, is the immediate challenge for SA.* Crucial to this debate in SA's commitment to focus on the issues that have eroded the economy in recent years. The renewed and welcome collaboration between business, labour and government needs to show definite results soon.

The risk of 'junk status' thus remains a 'clear and present danger' for the economy. There is fortunately now a widespread recognition that government, labour and business need to collaborate to avert 'junk status' and to find common ground on which to move forward. Encouraging business investment by reducing policy uncertainty will come through tangible implementation of the National Development Plan, targeted infrastructural developments, as well as labour market stability.

The credit rating agency Moody's recently stressed that 'divisions in politics in SA are South Africa's major weakness'. This is mainly because it creates uncertainty about policy direction and whether these political tensions will impede structural reforms and undermine SA's credit rating. The impact of the recent local elections also needs to be assessed in this context. The credit rating agencies are likely to continue to mainly but not exclusively focus on (i) the content of the MTBPS on October 26 (ii) structural economic reforms and (iii) growth prospects.

3.5. The Medium Term Budget Policy Statement (MTBPS) in October 2016

All eyes will therefore be on the MTBPS on October 26 as the lodestar for the *fiscal consolidation* to which the National Treasury committed itself in the main Budget in February this year. Among the 'big ticket' items that need to be 'consolidated' into the fiscal targets are:

- Financing of state-owned enterprises, whether as loans or guarantees
- Curbing the public sector wage bill
- The status of the nuclear power project
- The health insurance scheme
- Financing the 'fees must fall' commitment

The general hope is that - given the fiscal commitments to date – together with the healthy flow of tax receipts (despite a weak economy) and the robust approach of the Finance Minister, the National Treasury will nonetheless be able to offer a credible fiscal story in the next MTBPS. *The expectation is that the National Treasury will insist on wise spending, not big spending.* 'A majority view seems to believe we remain a going concern', says one economic analyst.

Yet even a sound and conservative MTBPS will be a *necessary* condition, but *not a sufficient* one, to avoid an investment downgrade at the end of 2016. While the three credit rating agencies are unlikely to offer identical outcomes, they will be putting similar emphasis on the elements of good governance, structural reforms and growth prospects in arriving at their respective decisions. 'Without growth, ratings cut likely', says a recent newspaper headline. On the other hand, Turkey has recently been given 'junk status' by Moody's despite faster growth than SA. This confirms that growth alone may not always be the determining factor in credit rating agency decisions about troubled economies.

3.6. Conclusion

It is possible that perceptions around policy and policy uncertainty in 3Q2016 *may* have been unduly influenced by the widely held impression that the rebound in the economy in 2Q2016 will strongly continue for the rest of the year. Yet the favourable economic 'bounce' may have been the result of a specific combination of factors in that period, and does not necessarily reflect a stronger trend in the second half of 2016. The recent slowdown in credit growth, especially by business lending, does not augur well for a faster pace of domestic private sector fixed investment growth.*SA needs investment to grow.*

It remains necessary to allow for the future impact on the PUI of ongoing political uncertainty, a possible Cabinet reshuffle, regulatory issues, wage rises in several sectors and the outcome of the national minimum wage process. The reduction in policy uncertainty in 3Q2016 might be a positive but temporary response to an exceptional combination of factors - which may not be repeated. In short, the economy is not yet out of the woods.

5 October 2016