Macroeconomic Theory and Policy

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(1) Fiscal Policy

- Fiscal policy, more particularly a reconstructive fiscal policy, is South Africa’s most important instrument for macro economic management and for social and economic transformation.
- A major long-term fiscal goal has been the reprioritisation of expenditures away from race-based access to public services, which were mainly reserved for the minority white population under apartheid, towards more racially equitable pattern of expenditure.
- Related to this has been a strong emphasis on the need to improve the quality of spending and service delivery.
- Fiscal policy is heavily impacted upon by domestic and international economic conditions, such as, fluctuations in economic growth and in global commodity prices.

Key objectives of fiscal policy

- *Counter-cyclical demand management*
- *Addressing inequities*
- *Avoidance of inappropriately rising national debt.*
- *Driving infrastructure expansion and maintenance*, which in turn assists in shaping the structure of opportunity and supply-side potential of the economy.

Current drivers of inequality

- South Africa’s apartheid history has mean that our economy suffers from high levels of unemployment and inequality, but there are also current factors in the global capitalist system that are driving rising inequality in South Africa and around the world:
  - Some, such as Piketty (2013), have ascribed rising inequality to the fact that the long-term dynamics of the capitalist system are such that the return on assets held by the by the wealthy (r) is greater than the rate of economic growth (g).
  - Others, such as Brynjolfsson and McAfee (2011), have argued that the recent ongoing wave of technological change is tantamount to a Great Restructuring in which the acceleration of technology has negative consequences for wages and jobs and that, while digital progress grows the overall size of the economy, it does this while leaving the majority of people in a poorer position.
  - In the South African context, Burger (2015) has suggested that labour’s falling share of income is due to financialisation and aggressive returns-oriented investment strategies that have resulted in greater investment in capital-augmenting labour-saving technologies.

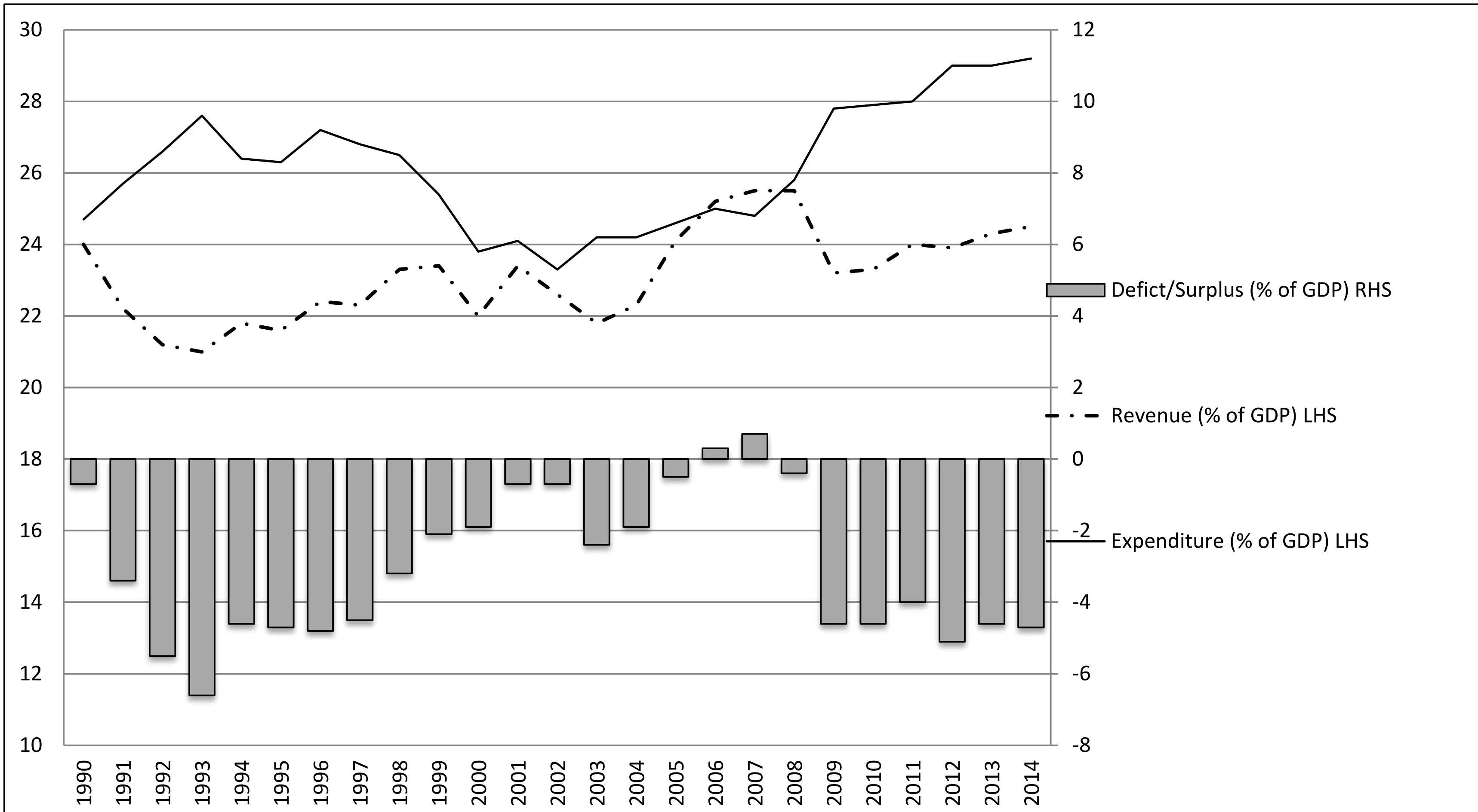
Role of infrastructure in socio-economic transformation

- Infrastructure expansion is transformative – it can serve to push back against SA's unequal history and against some of the economy's current drivers of inequality.
- Infrastructure expansion is a necessary part of the solution, but to be sufficient, it must also take into account:
  – The fact that that there must be expanded access for the poor and unemployed, as this majority of people cannot afford private services
  – Increased public-private cooperation must serve to protect and strengthen the quality of public services and not undermine them
  – Quality, efficiency and return on investment are key tools in fostering and managing economic development
- Such a programme of radical economic transformation is to be judged on its radical impact in improving people's lives, not on how radical the instruments proposed seem to sound

Key period's in recent SA fiscal policy

- Phase 1 from 1994 to early 2000's
- Phase 2 from early 2000's to 2008-09 crisis
- Phase 3 from 2008-09 crisis to 2014
- Current phase of fiscal consolidation from 2014-15

Expenditure, revenue and deficit trends 1990 2014



Phases of SA fiscal policy

- First phase from 1994 to the early 2000's, government prioritized fiscal stabilization and put in place policies to reduce South Africa's fiscal deficit. This was achieved mainly through controlling government expenditure, from around 28% of GDP to around 24% of GDP
- Second phase, in the early to mid-2000's, fueled by a relatively rapid economic growth and a global commodity boom, the budget balance improved sharply, moving into a fiscal surplus position in 2006 and 2007, when tax revenues exceeded expenditure. In this phase, both government expenditure and revenue rose as a percentage of GDP, with revenue growing more rapidly than expenditure. Tax revenues grew from around 22% of GDP in 2003 to just under 26% of GDP in 2008.
- The third phase began with the global financial crisis of 2008-09 and the Great Recession that followed in its wake and continued until 2014-15 when the emphasis begun to fall on the need for fiscal consolidation. During this third phase, South Africa's fiscal policy played a strongly counter-cyclical role, with the budget deficit rising sharply as growth faltered, tax revenues fell and expenditure continued to rise.

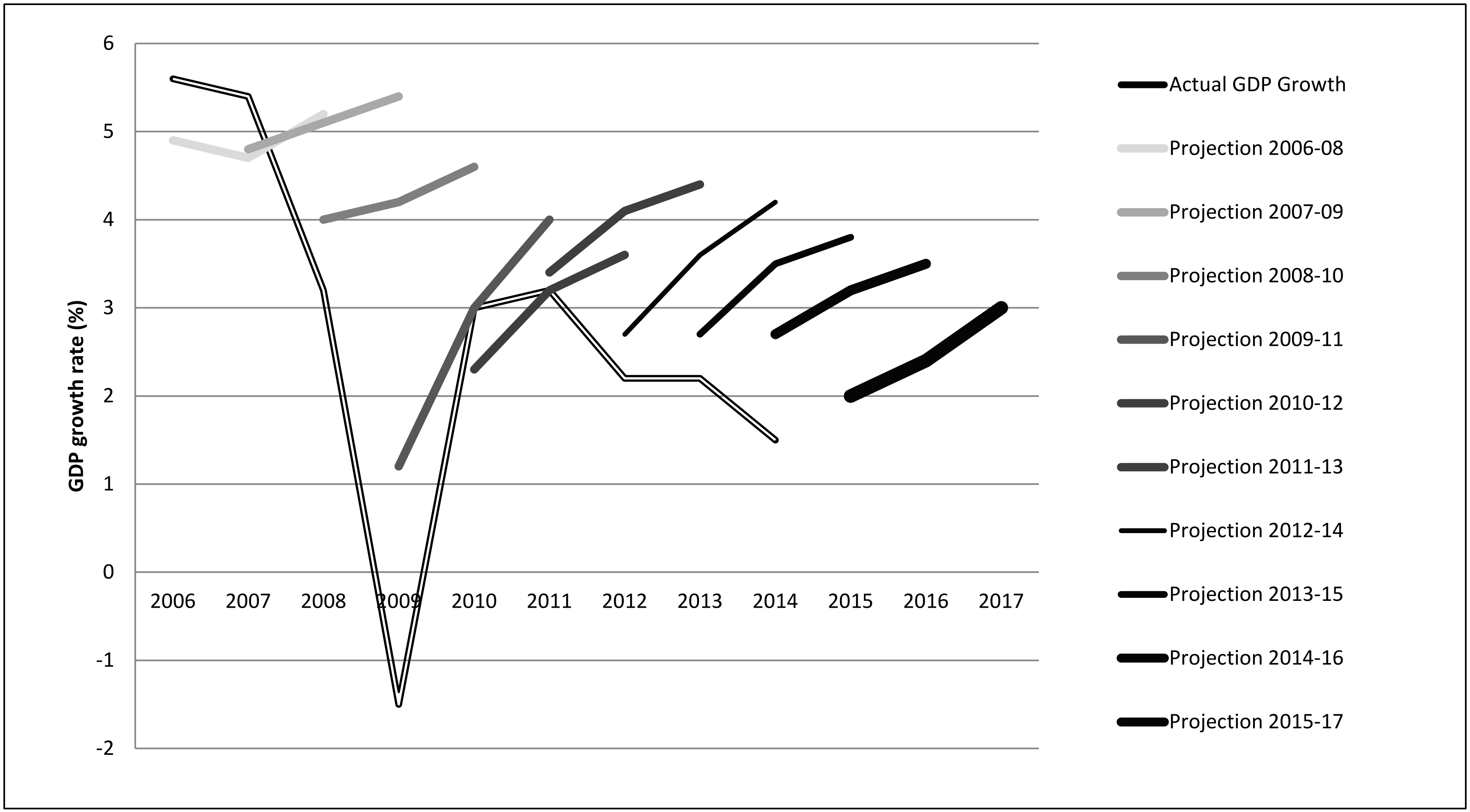
Current phase of fiscal consolidation

- The primary reason for this change in fiscal stance is that the economy is experiencing persistently low levels of economic growth.
- Lower than expected economic growth has a number of serious negative consequences for fiscal policy.
- It puts downward pressure on tax revenues, it pro-longs and deepens budget deficits, raises the quantum of related borrowing and pushes up the country's national debt.
- If the fall in tax revenues coincides with rising expenditure, which has been the case in SA, then the situation is exacerbated.

The problem of low growth in SA

- A clear indication that economic growth in South Africa has since 2008-09 been performing worse than expected, is given by the fact that in every budget presented by government from 2008 to 2015 the projected GDP growth rate has turned out to be an over-estimation, when compared to the growth rate that actually has occurred.
- A typical example of this tendency to over-estimate growth occurred along with the announcement of the 2012 budget, in which government projected that the GDP would grow by 2,7% in 2012, 3,6% in 2013 and 4,2% in 2014, whereas the actual GDP growth rates for those years turned out to be 2,2%, 2,2% and 1,5% respectively.
- The fiscal authorities have displayed a tendency to over-estimate future economic growth over the past ten years.

Growth rates lower than projected



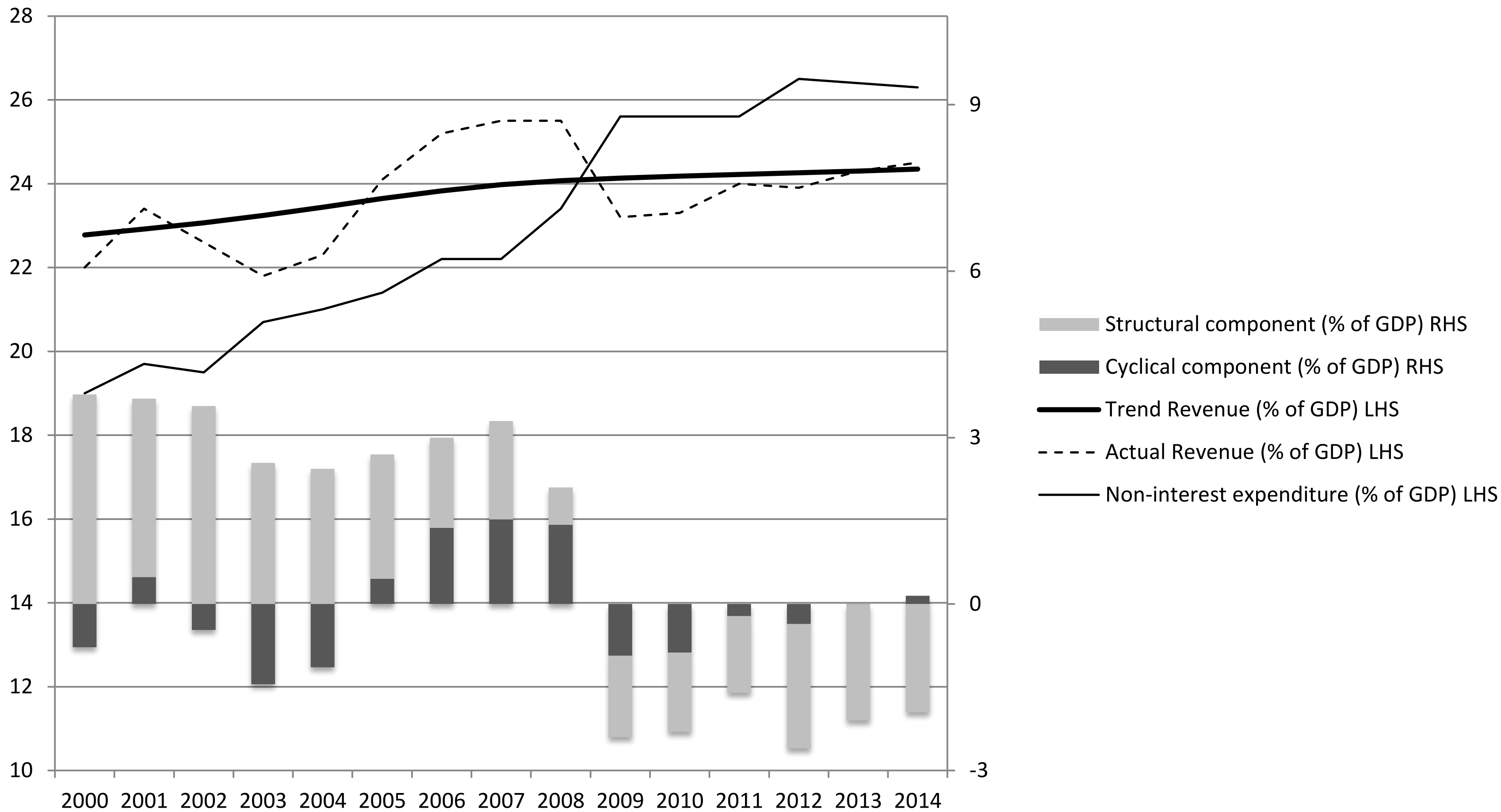
Consequences of incorrect growth projections

- The the tendency to consistently overestimate future economic growth rates, impacts negatively on the budgeting process.
- It feeds into rising indebtedness, as:
  - the overestimation of future growth rates results in an overestimation of future revenues and
  - an underestimation of future deficit size and borrowing requirements.
- Overly optimistic forecasting also creates an unreliable basis for planning future expenditure. This is currently major weakness in South Africa’s budgeting process.

Cyclical and structural budget components of budget deficit

- The budget deficit can be decomposed into two components – a structural component and a cyclical component.
  - The cyclical component is driven by the business cycle.
  - The structural component reveals what size the budget deficit would be if the economy was operating at full potential, being neither in a boom phase or in a recession.
- In many countries, as economic growth quickens, tax revenues rise and expenditures fall leading to a cyclically-driven reduction in the size of the budget deficit.
- In South Africa, such a cyclical pattern occurs mainly due to the fact that tax revenues and growth are positively related.
- South African expenditures are less cyclical as social security payments, like old aged pensions and child maintenance payments, are not highly correlated with economic growth, as are unemployment benefits in certain other countries.

Structural and cyclical components of primary deficit



SA's budget deficit is structural

- The previous figure shows an estimate of the structural primary balance for South Africa for the period from 2000 to 2014 using a methodology whereby non-interest expenditure is subtracted from tax revenues that have been cyclically adjusted.
- What this reveals is the fact that, during the period from 2009 to 2014, South Africa has consistently begun to run a primary structural deficit.
- Increasing expenditure has resulted in spending levels in excess, not only of actual revenues, but also of trend (or structural) revenues.

Structural deficits are dangerous

- A typical Keynesian argument in favour of counter-cyclical fiscal policy advances the view that an increased budget deficit during times of reduced growth and falling aggregate demand allows government to stimulate demand, encourage growth and thereby preserve investment and employment during a down-turn.
- It is not a desirable situation for the structural component of the budget deficit to be rising as it implies that even if the economy were to no longer be in low growth conditions, there would continue to be a sizeable, structural primary budget deficit.
- This leads to a problem of rising national debt.

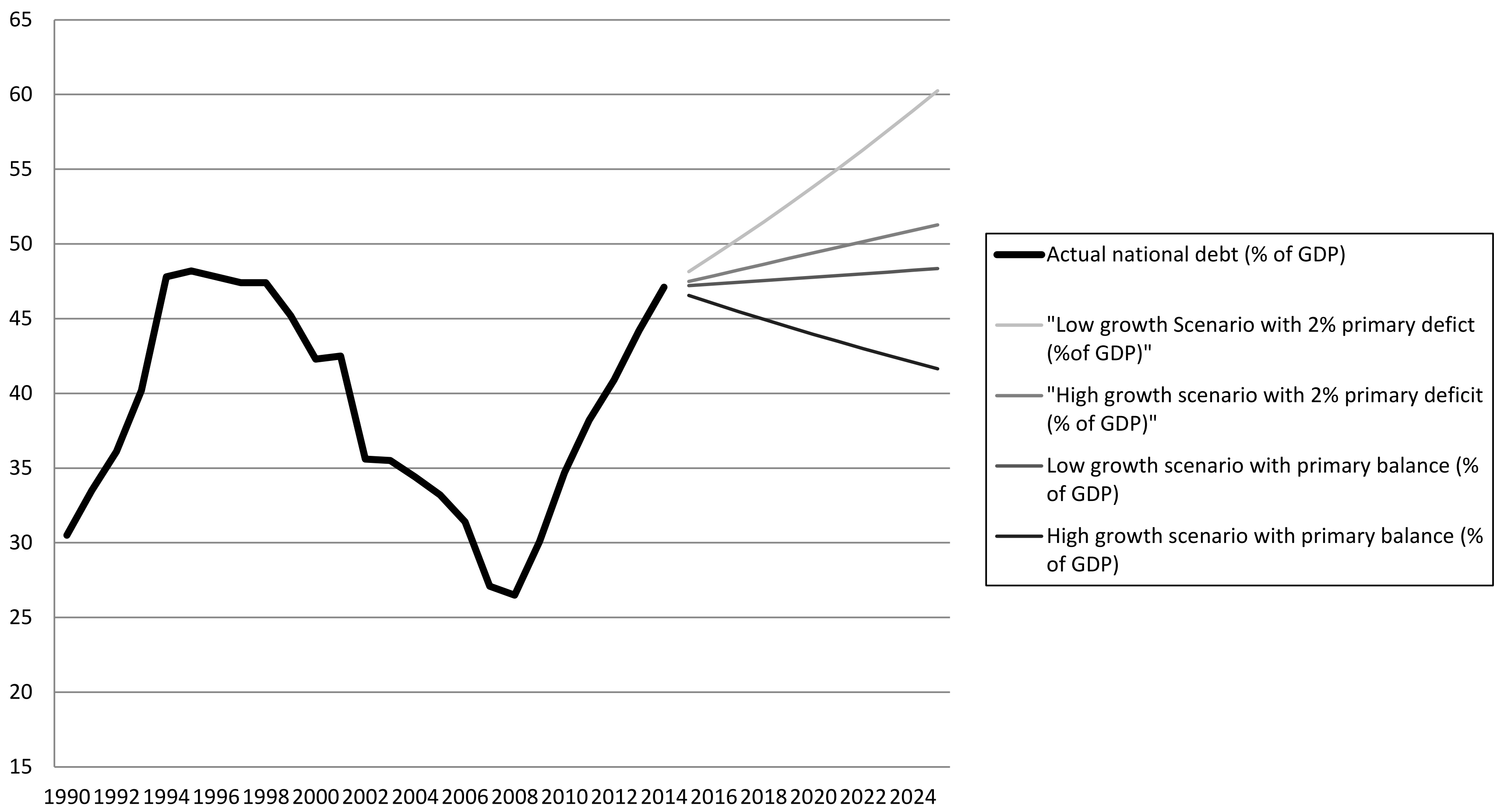
If low growth is the new normal

- If low growth is the new normal, then South Africa will have to make adjustments to its fiscal policy in order to avoid rising indebtedness.
- This has motivated South Africa's recent commitment to fiscal consolidation, including:
  - marginally increased tax rates for higher income earners and
  - plans to a slow down real government expenditure growth, as announced in the 2015-16 Budget.

Debt scenarios

- Gross national debt is driven higher by a combination of govt borrowing, low growth and high interest rates - $\Delta b = d + (r - \Delta y)b$
- The diagram indicates the impact which low economic growth has on the projected level of the national debt between 2015 and 2025.
- Initial scenarios, with no fiscal consolidation,
  - In the low growth scenario, with a real GDP growth rate of 1.5%, the national debt rises to 60,3% of GDP by 2025.
  - In the high growth scenario, with a real GDP growth rate of 4,5%, national debt rises to 51,3% of GDP by 2025.
- If the country's fiscal position is successfully consolidated and the primary deficit is reduced from 2% to zero, that is, where non-interest expenditure is fully funded by tax revenues, then:
  - under the low growth scenario (1,5% GDP growth) national debt would rise only marginally, from the 2014 actual level of 47,1% of GDP, to 48,3% of GDP by 2025.
  - Under the high growth scenario (4,5% GDP growth), fiscal consolidation would see national debt fall to 41,6% of GDP by 2025.

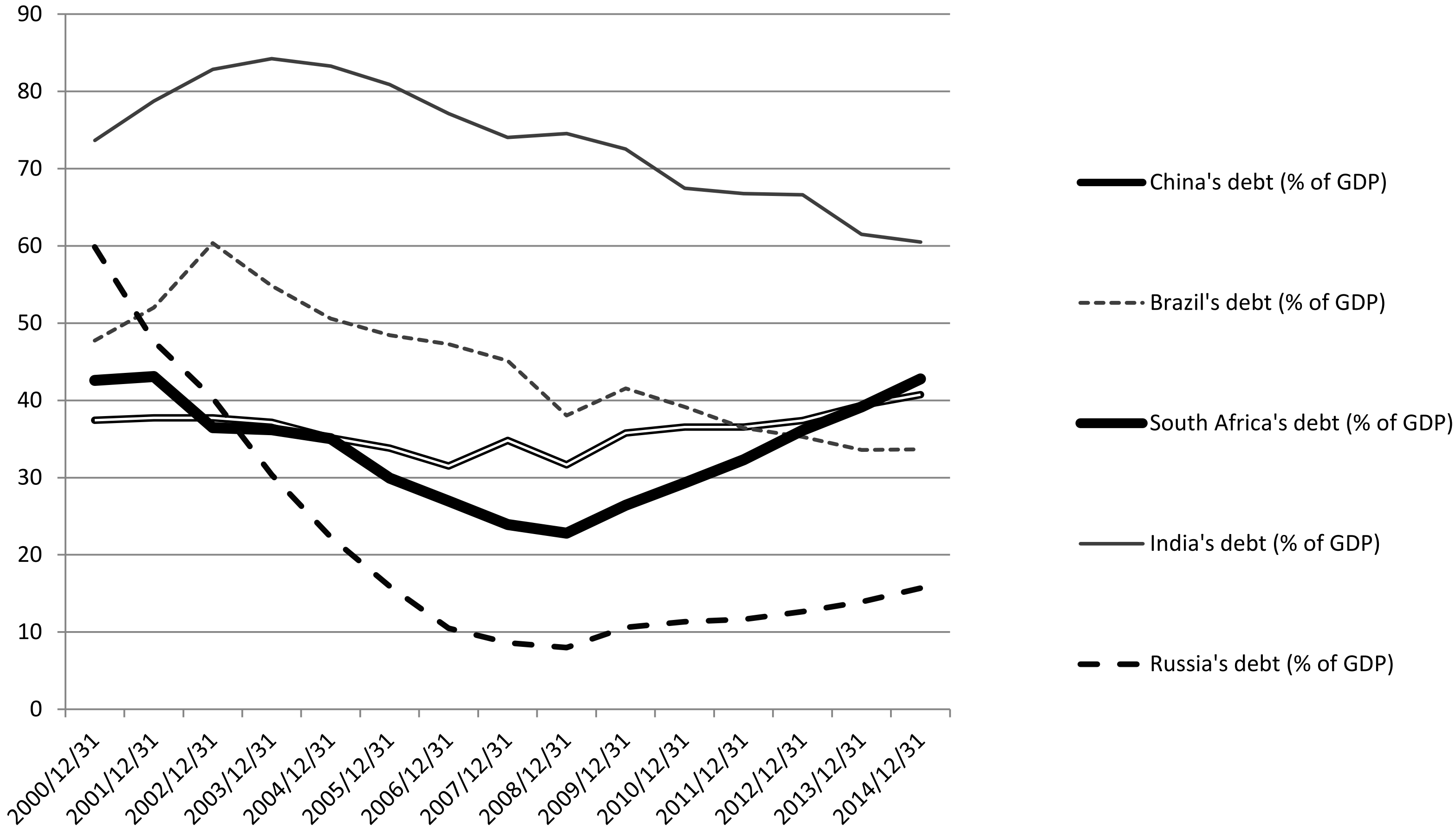
Impact of growth on SA's national debt projections



SA’s debt rise needs to be halted

- SA’s debt to GDP ratio is not particularly high as compared to other country’s. Of concern is the fact that the trajectory of South Africa’s national debt is rising more sharply than for most other countries
- A consequence of South Africa’s rising debt levels is that interest repayments have begun crowding out expenditure on other items
- Interest payments rose nominally from around R56-billion in 2009 to just over R110-billion in 2014, or from 8,1% to 10% of all government spending.

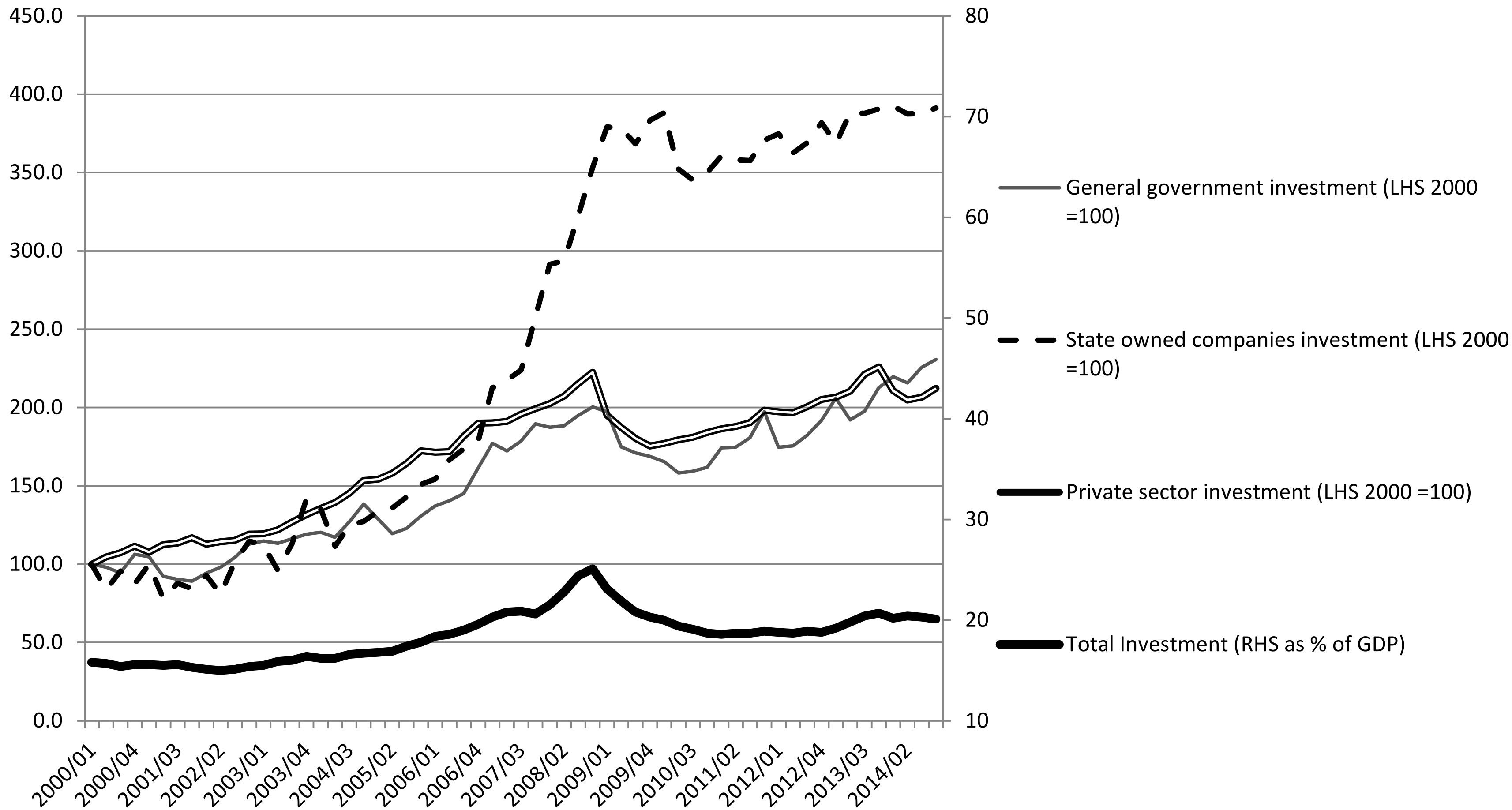
Comparative national debt positions for BRICS countries



Promoting investment

- A key economic intervention of the developmental state in South Africa has been via significantly expanded public-sector-led investment.
- The basic vision being that state borrowing, and borrowing by state owned companies sometimes backed by government guarantees, would be used to fund investment in infrastructure and people, which in turn would ‘crowd-in’ further investment, stimulating growth, increasing tax revenues and thereby avoiding rising debt.
- As per the diagram, it can be seen that investment by state owned companies, such as Eskom and Transnet, rose sharply from 2009 onwards.
- Investment by general government rose, but not as sharply as the rise in investment by public corporations.
- Private sector investment has not been growing as sharply as envisaged, but in 2014 private sector investment remained the largest contributor to overall investment.

Significant increase in investment by public corporations



Impact of fiscal consolidation on investment

- There is a risk that fiscal consolidation could impact negatively on such plans – as reduced public resources would be available for investment.
- On the other hand, there could be a positive impact, as successful fiscal consolidation has the potential to contain, or even reduce, the cost of borrowing for state owned companies, as the cost of such borrowing is usually linked to the credit ratings which rating agencies stipulate for South Africa as a whole and for certain specific state owned companies.
- It is likely that a successful fiscal consolidation phase will halt the phase of credit rating downgrades that South Africa has recently been experiencing, and possibly even reverse course allowing for positive re-ratings in future.
- Such re-rating would lower the cost of borrowing and potentially stimulate increased investment in the economy more widely.

Impact on social protection

- Another possible risk posed by fiscal consolidation is that it could reverse gains that have been made in reducing poverty in South Africa.
- Significant increases in public expenditure on social security, education, health, electricity and sanitation services have been shown to have reduced multidimensional poverty in the country. According to one study, in 1993, 37% of South Africa's population could be defined as falling under a multidimensional poverty line. By 2010, the proportion of people living below the same multi-dimensional poverty line had fallen to 8% once expanded access to social security, education, health, electricity and sanitation services had been taken into account.
- Using a money-only metric, one which does not take into account the effects of increased access to public services, those living below the poverty line had only decreased from 37% in 1993 to 28% in 2010.

Impact on social protection

- A 2015 World Bank report broadly supports the finding that South Africa's fiscal policy has been effective in reducing poverty and income inequality.
- Although South Africa remains one of the world's most unequal societies, as result of the country's fiscal system:
  - 3,6 million people in 2010 were lifted above the poverty line of living on less than USD2,50 per day (PPP adjusted).
  - Fiscal transfers also reduce inequality to a point where the incomes of the richest decile were reduced from being over 1000 times higher than those in the poorest decile to where they were 66 times higher.
  - The Gini coefficient fell from 0,77 before taxes and social spending were taken into account, to 0,659 after such transfers were taken into account.
  - The Gini coefficient declines further, to 0,59 (indicating greater equality), if the monetised value of health and education spending is included. The inclusion of such expenditures is controversial, though, as such inclusion would imply that increasing expenditure on such items as teachers' and health workers' salaries would, by definition, play a role in reducing income inequality.

Fiscal consolidation is a political challenge

- SA fiscal policy is at a cross-roads – consolidation or debt
- Fiscal consolidation will put pressure on South Africa's programme of poverty alleviation and will limit the resources available for the kind of infrastructure expansion and maintenance that have been a key driver of investment in recent years.
- Such pressure may result in political problems for a government if it fails to successfully face many of its challenges in service delivery and in building effective administrative capabilities and anti-corruption and good governance structures.
- If these pressures and contradictions prove to be overwhelming and the path of fiscal consolidation is not followed, this will lead to serious financial problems entailing even more politically, socially and economically costly adjustments in future.

Monetary and exchange rate policies

- Background: In 1999 South Africa announced the adoption of an inflation-targeting framework to guide the conduct of its monetary policy.
- This decision was against the backdrop of the emerging market contagion that followed the so-called Asian crisis of 1997-98, which had lead to a loss of confidence in emerging market economies and related sharp currency depreciations in these economies.
- In the heat of the crisis (SARB) burnt its fingers in attempting to prop-up the value of the Rand by purchasing Rands with about USD25-billion worth of forward borrowed funds and sharply increasing the interest rate, to over 20 percent, in order to promote capital inflows with the ultimate objective of strengthening the rapidly depreciating Rand.
- At the time the SARB followed an eclectic monetary policy mandate, pursuing a range of goals including low inflation, economic growth, targeting the growth in monetary aggregates and intervening in the currency market.
- Against this background, inflation targeting provided an alternative framework, focused primarily on achieving an inflation target and which explicitly excluded interventions to target a particular value of the Rand.

Debates on inflation targeting

- Advocates of the inflation-targeting framework argue that the policy effectively facilitates the kind of low-inflation macro-stability, which leads to low short-term and long-term interest rates, and which encourages the investment required to stimulate growth and employment creation.
- Critics of the inflation targeting argue that the framework's narrow focus on low inflation is not appropriate, particularly given South Africa's high unemployment rate. They argue that the framework will result in unnecessarily high interest rates and will lead to low levels of economic growth.
- The data comes down on the side of advocates of inflation targeting

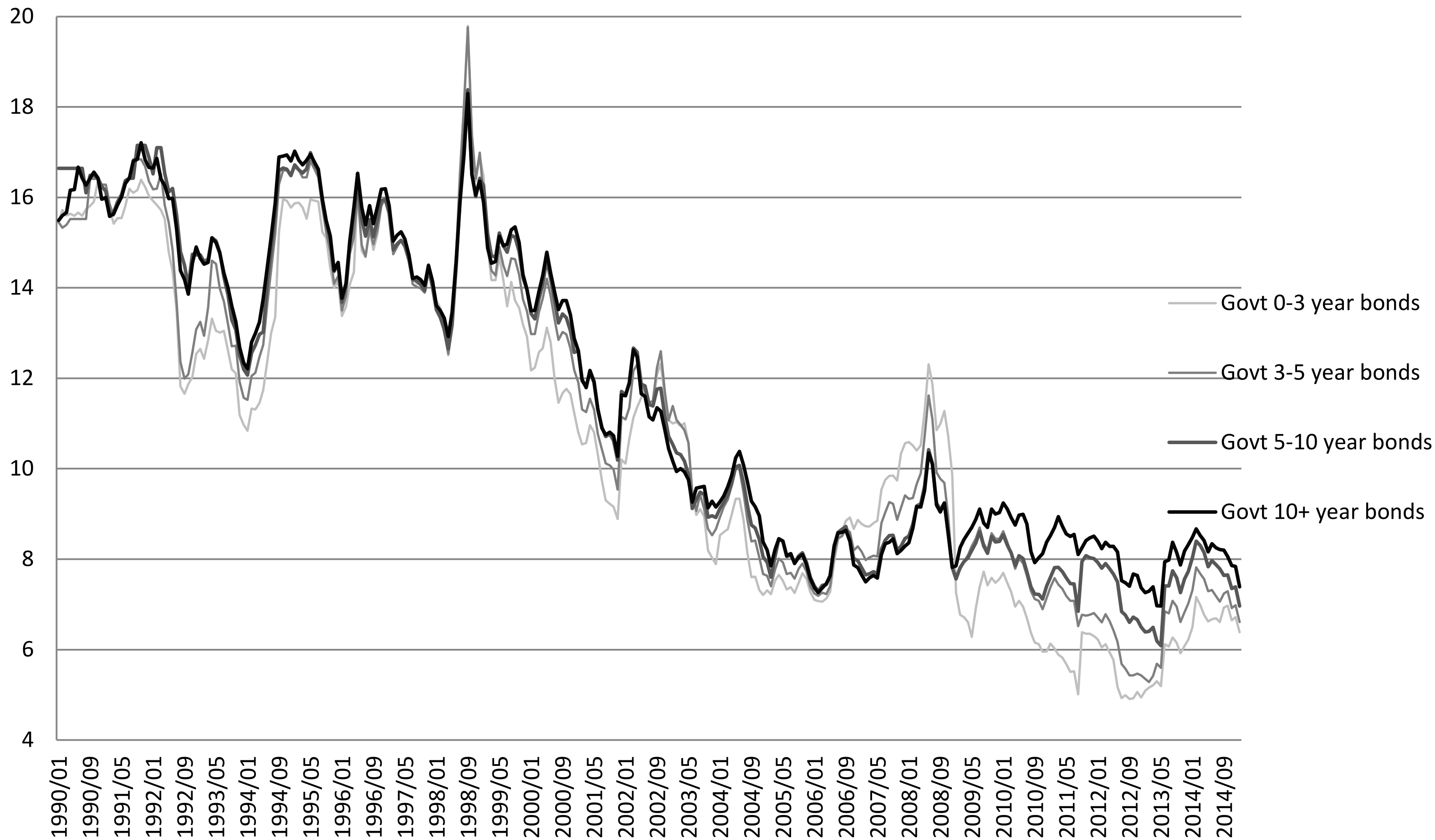
Table 1 Comparison of pre- and post- inflation targeting economic indicators

	Mean (%)	Standard Deviation
Inflation		
Pre-inflation targeting period 1990-99	9.9	3.3
Inflation targeting period 2000-14	5.9	2.3
GDP growth		
Pre-inflation targeting period 1990-99	1.4	2.0
Inflation targeting period 2000-14	3.2	1.7
Real Short-run interest rates		
Pre-inflation targeting period 1990-99	4.5	3.4
Inflation targeting period 2000-14	2.1	2.4

Interest rates and investment

- As per the next diagram it can be seen that the inflation-targeting framework heralded in a period of sharply reduced long-run interest rates.
- Such lower long-run rates are a key factor in reducing borrowing costs and promoting new investments.
- Although non-interest rate factors have also proven to be important in shaping investment decisions.
- Non-interest factors include the economic growth rate, the existence of appropriate infrastructure and logistical systems, as well as the general level of business confidence.
- Furthermore, the retention of high cash holdings by South African companies, which enables companies to fund investments, not by borrowing but from their retained earnings, may also have contributed to a reduced interest rate sensitivity of investment decisions.

Long term interest rates



Growth and unemployment

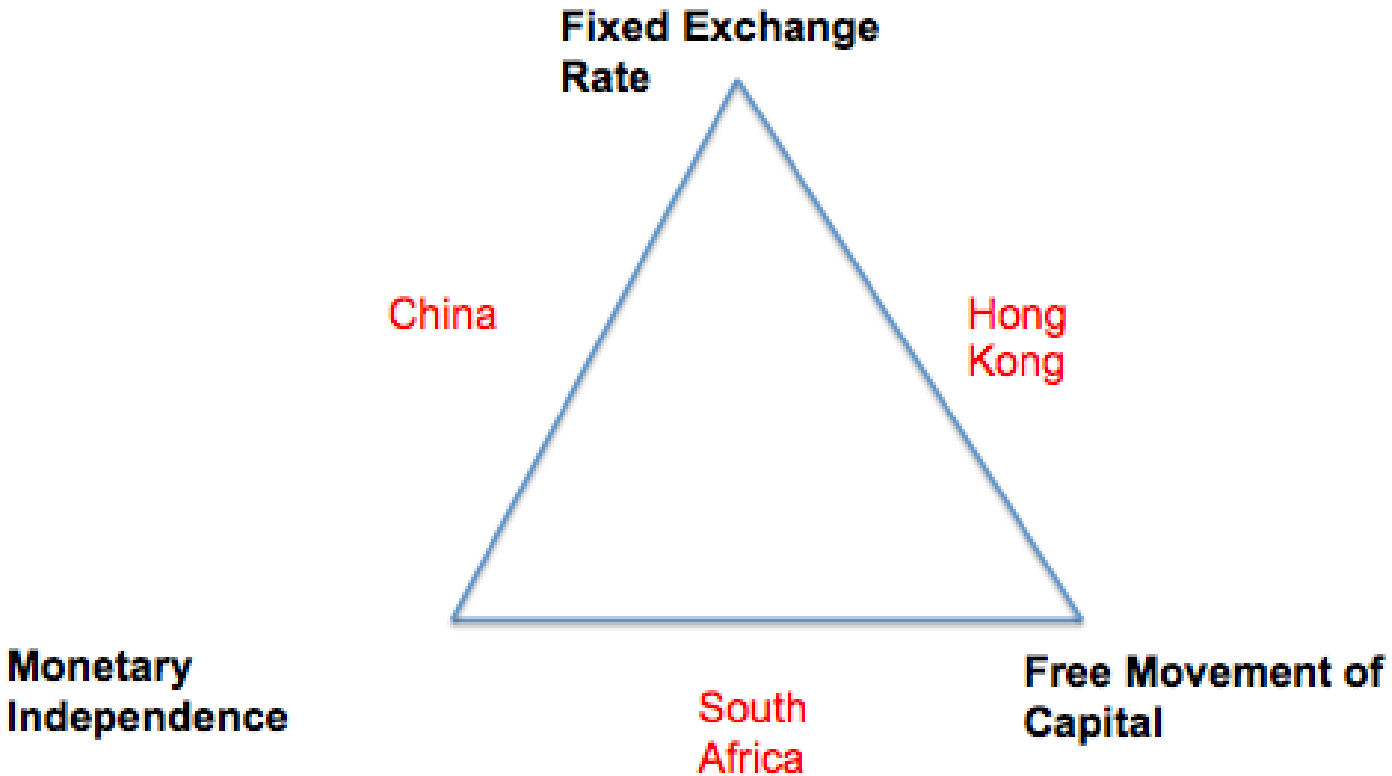
- South Africa’s unemployment rate has remained stubbornly high throughout the inflation-targeting period,
- But it would be misplaced to blame inflation targeting for persistent unemployment.
- Monetary policy is chiefly an instrument capable of bringing price stability in the medium to long run this contributes to higher levels of growth and investment.
- A correlation exists between an increased growth rate and decreased unemployment rates, for example in the growth period from 2003 to 2007, the unemployment rate fell by close to 5 percentage points.
- To the extent that lower inflation, and lower interest rates, facilitate increased investment, monetary policy can assist in fostering long-run growth and employment.
- Any attempt to boost the economy with ongoing monetary expansion will serve only to fuel inflation and, beyond a short-run stimulus, will not assist in promoting economic growth and employment creation in a sustainable manner.
- In fact, at some point, attempts at sustained monetary stimulus will become counter-productive, risking high levels of inflation that are detrimental to economic growth, or even hyper-inflation.

Unemployment rate and GDP growth rate

Exchange rate policy

- A more pertinent critique of South Africa's monetary policy framework has been that it leaves the country vulnerable to the vagaries of currency volatility
- The argument has been made by South African exporters that there is a contradiction between government's stated commitment to export promotion and the tendency for prolonged periods of Rand strength and Rand volatility.
- In terms of the well-known 'open economy trilemma', only two, of three, beneficial policies can be pursued simultaneously. Under the inflation targeting framework, the two favoured policy objectives are free capital flows and monetary policy independence.
- As a result the SARB's freedom to target a more competitive value for the Rand has been limited.

Open economy tri-lemma



Policy constraints – A tri-lemma

- In terms of the open economy tri-lemma, only two out of three of the following policy options may be pursued at once:
  - to have an open capital market, in which foreign finance can flow freely into and out of the economy;
  - to have monetary policy autonomy, where interest rates are set by the Central Bank based on the conditions and goals of the domestic economy rather than based on the interest rate decisions of another country's monetary authorities, and
  - to peg or manage the country's exchange rate, that is to set the exchange rate at a competitive level to promote a country's exports and avoid exchange rate volatility.

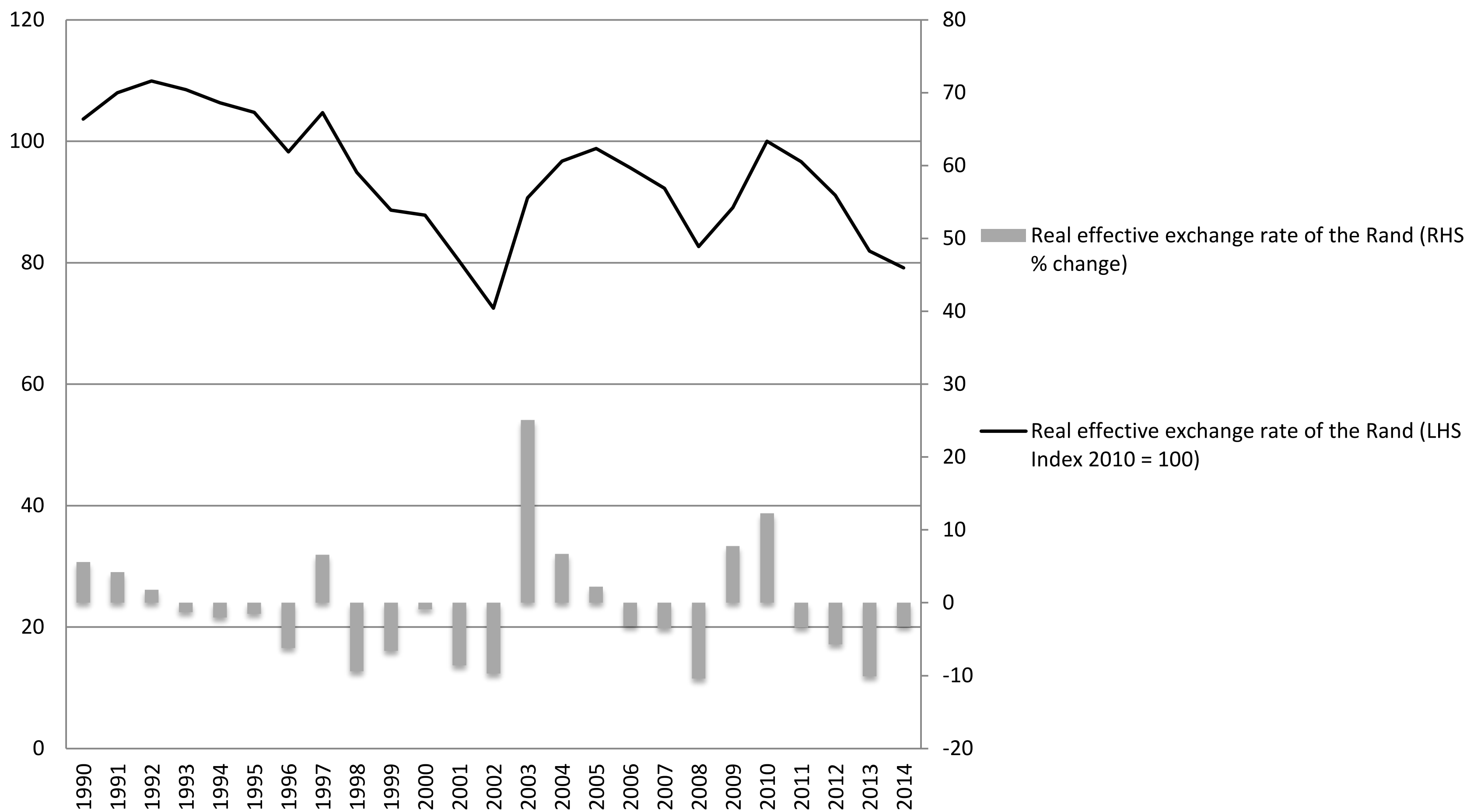
Space to manage the exchange rate

- More recently, the strict interpretation of the trade-off implied by the ‘open economy trilemma’ has been tempered somewhat.
- IMF researchers have suggested that, with careful application, two targets can be pursued using two separate instruments.
  - Firstly, the interest rate can be used as the instrument aimed at achieving low inflation, which is regarded as the primary target.
  - Secondly, sterilised foreign exchange market interventions can be used as an instrument to ameliorate volatile currency movements, but such amelioration of currency movements must be clearly understood to be a secondary target.

Managing the exchange rate

- During periods when the Rand strengthened sharply, such as, by 7,8% in 2009 and by 12,3% in 2010,
- The SARB begun to responded with an active policy of building up South Africa’s holdings of foreign exchange reserves in order to maneuver against what was perceived as excessive Rand strength
- This would have the effect of reducing the competitiveness of South Africa’s exports and putting pressure on local industry as imports became relatively cheaper.
- A letter written by the then Minister of Finance to the SARB Governor in 2009 in which the government’s mandate to the SARB was clarified to explicitly include to objective of balanced and sustainable economic growth, and thus made the inflation targeting framework more flexible and open to the secondary objective of influencing the level of the exchange rate.

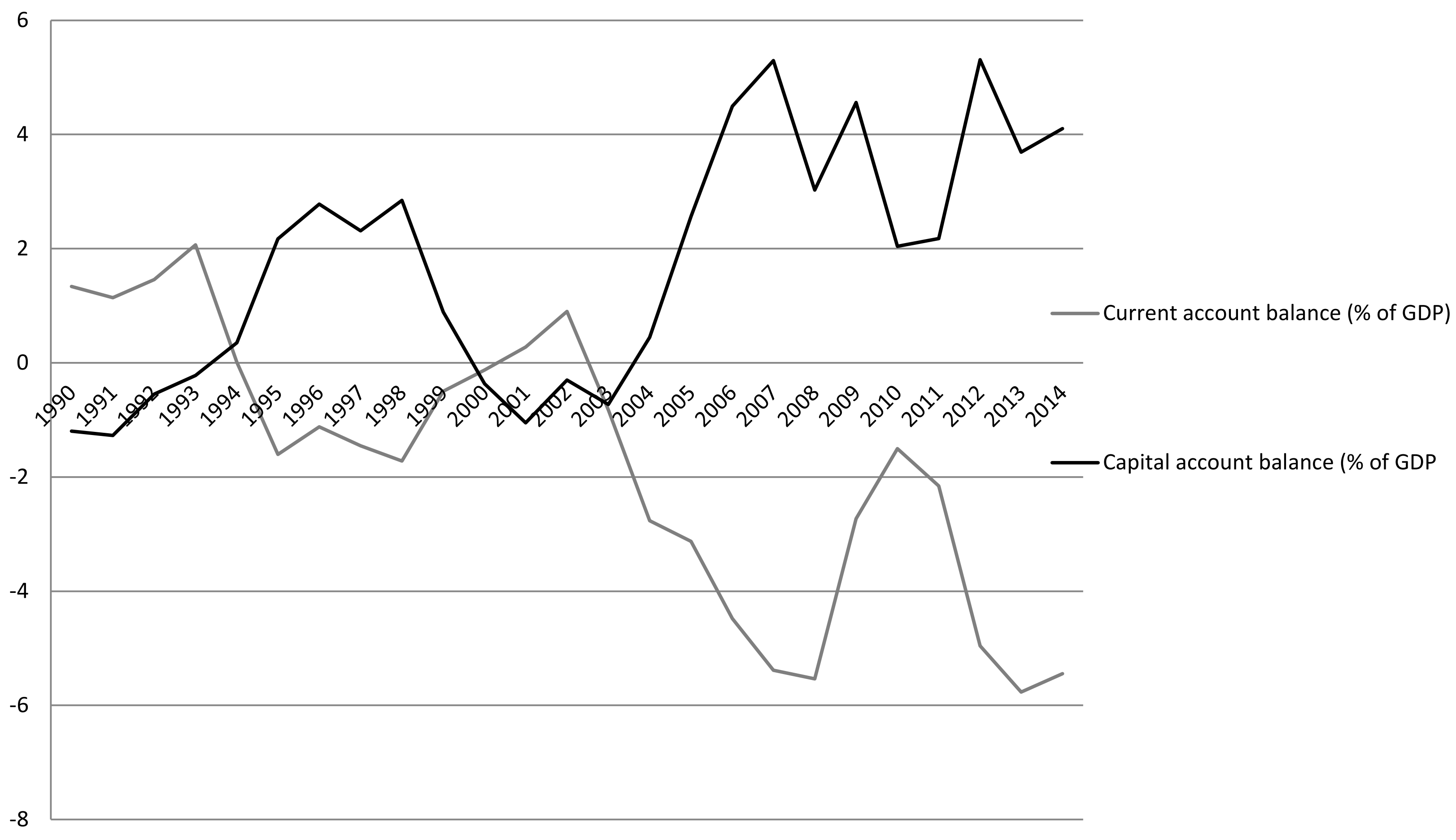
Real effective exchange rate of the Rand



Alternative approaches

- Certain other approaches to targeting the exchange rate have been mooted. For example, some have argued that volatile short-run inflows and outflows of capital have the potential to be highly disruptive, distort the economy towards debt, consumption and financialisation and lead to periods of excessive currency strength.
- One policy prescription of this approach is that short-term financial flows, or so-called ‘hot-money’ flows, should be more highly regulated, through interventions such the levying of small taxes on capital flows, the so-called Tobin tax, or through stipulated minimum time-limits for investments which aim to prevent rapid flow reversals.
- The theoretical arguments regarding the pro-cyclical distortions of unfettered capital flows are attractive
- But in practice the structural characteristics of the South African economy, with its persistent current account deficit and capital account surplus, mean that limitations on capital inflows are likely to have serious negative consequences and would come with significant adjustment costs.

South Africa's Balance of Payments



SA is dependent on capital inflows

- The imposition of restrictions on capital inflows would almost certainly result in a sharp depreciation of the Rand and would raise the specter of a balance of payments constraint on economic growth – as South Africa's exports do not earn sufficient foreign currency to pay for imports and growth would have to be slowed in order to reduce the demand for imports (a situation not altogether dissimilar the position that the apartheid state found itself in during the 1980's, when financial sanctions were intensified).
- Capital scarcity and exchange rate pressures would also likely lead to sharp interest rates hikes, which would further raise the cost of investment and suppress growth and employment in the economy.
- A significant slow-down in capital inflows would also probably be disruptive to the financing of South Africa's current phase of infrastructure expansion, in key cross-cutting network sectors, such as, energy and transport infrastructure, and this too would have wider negative consequences for economic growth and employment.

SA is dependent on capital inflows

- On the balance of evidence, it would appear that the benefits of unregulated capital inflows outweigh the costs, and that both the benefits and the costs are fairly substantial.
  - On the benefits side, continuing access to foreign financial flows assists in freeing South Africa from a balance of payments constraint and contributes a steady flow of foreign savings which means that interest rates are lower than the would be if only the domestic pool of savings was available.
  - On the costs side, allowing unregulated capital inflows will lead to increasing levels of foreign ownership of South African assets, which in turn will lead to future dividend outflows. A further problem is that such inflows can distort the economy towards consumption and financialisation and away from production and industrialisation. Unregulated capital inflows are also associated with higher levels of exchange rate volatility and potential currency misalignment, which can put pressure on export industries if the Rand over-appreciates.
- Lastly, the adjustment costs, if South Africa were to attempt to change policy and begin to regulate capital inflows costs, would be significant, probably including a sharp currency depreciation and higher interest rates.

Macro-prudential regulation

- Another line of critique against the inflation-targeting framework is that under the framework the monetary authorities fail to properly monitor and act against the development of non-inflation macroeconomic instabilities, such as, asset price bubbles and over-leveraging in the financial system.
- A flaw with the inflation targeting framework, revealed very clearly by the 2008-09 financial crisis, is that it is possible that during periods of inflation moderation the seeds of macroeconomic instability will be sown.
- This phenomenon, described in Minskian terms as the 'paradox of credibility', arises when there is a general economy-wide perception of reduced risk, inducing economic actors to behave in such a way as to make the system riskier.
- Central banks are responding to this weakness in erstwhile orthodox monetary policy by taking on new responsibilities and developing new instruments which will assist them in the task of macro-prudential management.

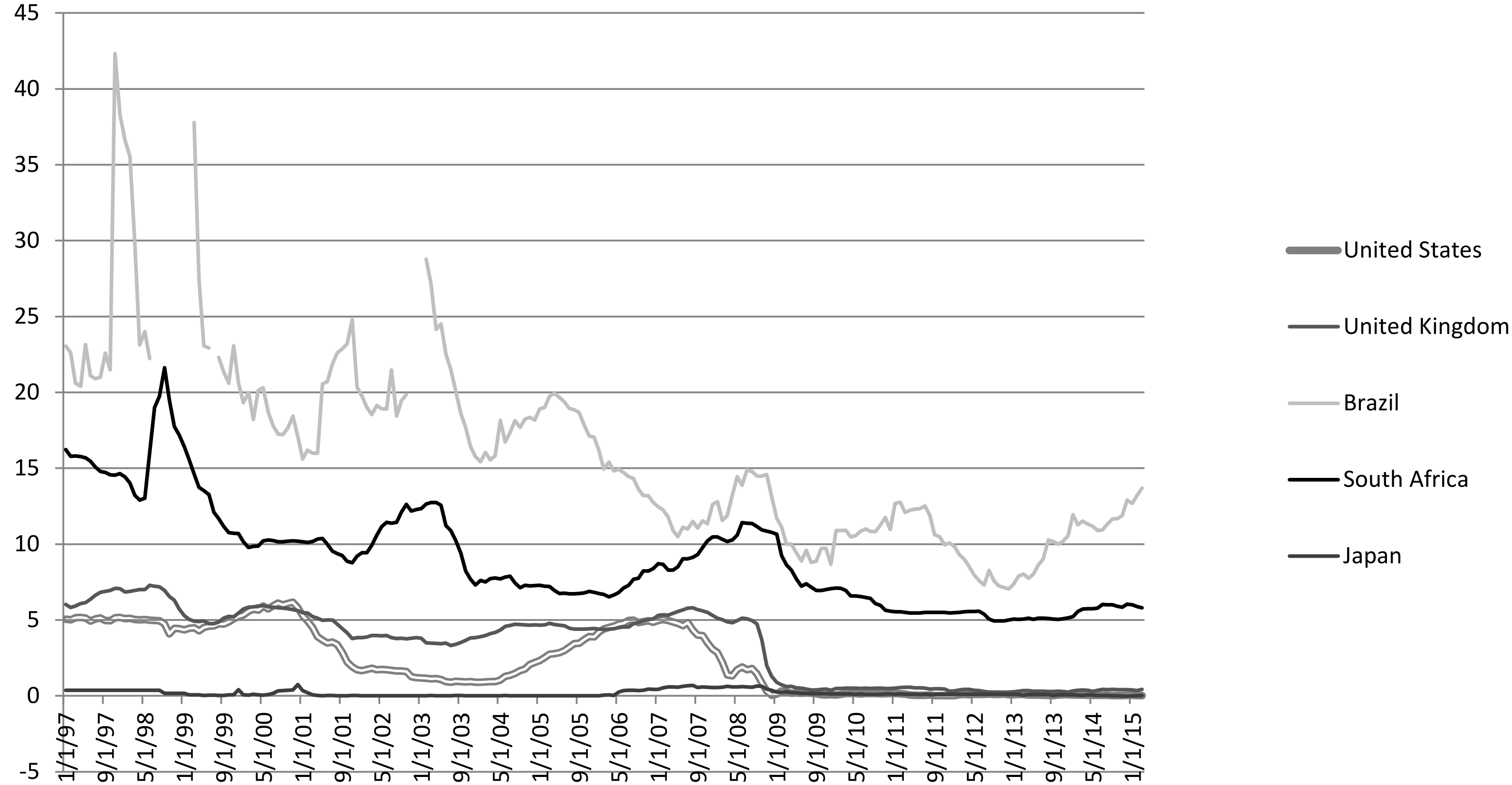
Macro-prudential policy in SA

- In line with this, the SARB has begun to place more emphasis on the need for improved macro-prudential surveillance and regulation.
- In addition to monitoring the compliance of South African banks with minimum capital requirements, such as, those outlined in the Basel II and Basel III accords, the SARB has sought to involve itself in interventions aimed, not just at achieving its inflation target, but also those aimed at trying to avoid the build up of potentially dangerous imbalances in the financial sector.
- An example of the types of interventions that the SARB will undertake, if it detects an emerging bubble in housing prices, would be to decrease the permissible loan to value ratio for those borrowing money to fund house purchases, say from 100% to 80%. This will mean that home buyers will need to pay a 20% deposit, which will have an effect in subduing house prices and in decreasing household leverage ratios.
- There is some risk that an effect of Basle III will be to limit resources available via the commercial banks for long term investment (a double-whammy in the context of fiscal consolidation)

Current monetary policy challenges

- In the current phase, South Africa continues with interest rates that are low by historical standard. This is in line with the global situation, as since the 2008-09 Great Recession most countries have experienced historically low interest rates for a pro-longed period of time, and Japan for even longer, see diagram
- In fact, with nominal interest rates being at, or very close to, the zero lower-bound, countries such as the United States, Japan and the United Kingdom, and the Euro-zone countries have adopted unconventional monetary stances,
- Such as the massive purchase of bonds and other financial assets in secondary markets, in a process known as quantitative easing (QE), with the aim of lowering longer-run interest rates (as short-term nominal rates can go no lower then zero.
- An important objective of such unconventional approaches is to use lower long-term rates to try and stimulate investment and other elements of demand and thereby also introduce a degree of inflation expectations back into economies that are flirting with deflation.

Comparative 90-day short-run T-Bill rates



Risk of deflation

- Deflation is regarded as a significant macroeconomic threat.
- Falling prices would have the effect of subduing and delaying consumption and investment demand.
- Deflation would also put the financial system at risk, as debt and debt repayments are typically fixed in nominal terms, so these repayments would rise in real terms, as prices and wages fell, leading to the likelihood of widespread default and financial distress, particularly for the banks.

Risks when interest rates rise in the rest of the world

- It is much anticipated that monetary policy will 'normalise' at some stage in the future and that the current global period of historically low interest rates will come to an end, but there is a high degree of uncertainty as to the likely timing of such an eventuality. It is also possible that 'normalisation' will not occur in a simultaneous and coordinated manner and that, for example, the United States will begin rising interest rates before the Euro-zone.
- South Africa is highly linked into the global interest rates cycle. When the United States indicated that it would begin tapering-back on its QE in 2013, this resulted in a flow-back to the of United States of QE-generated liquidity, which had sought returns worldwide and which was then attracted back to the United States by the prospect of future interest rate increases.
- South Africa, along with other developing countries, experienced significant exchange rate weakening. Due to currency deprecations and related inflationary pressures, these countries also had to face the related possibility of their own interest rate hikes, even if demand in their domestic economies remained weak.

Near-term future interest rates in SA

- Rey (2013) has empirically challenged the characterisation offered by the ‘open economy tri-lemma’ and has suggested that the true open-economy characterisation faced by countries is a ‘dilemma’, that is, a choice of either free capital flows or monetary policy independence, regardless of whether the exchange rate is fixed or floating.
- Rey argues that due to the existence of a global financial cycle, where asset prices in emerging markets and developed economies move together, countries like South Africa, which allow relatively free movement of foreign capital in and out of the country, are tightly bound to the global interest rate cycle and do not enjoy a significant degree of monetary policy independence, despite having a free-floating exchange rate.

Near-term future interest rates in SA

- All these factors indicate that South Africa is likely in the not too distant future to enter an upward phase in its interest rate cycle. Despite the fact that the country is planning to enter a phase of fiscal consolidation, which will have a disinflationary effect, it is likely that international factors, rather than domestic factors, will serve as the main prompt to pushing up interest rates.
- This process will be re-enforced if the raising of interest rates in the United States, and other relevant countries, leads to an outflow, or reduced inflow, of capital resulting in Rand weakness and imported inflation pressures.
- The main domestic driver of inflation will be on-going sharp increases in electricity prices, which are required in order to fund expanded power generation infrastructure. It is unlikely, though, that the SARB would take action as a result of the first-round effects of rising electricity prices. Analogously, to oil price shocks experienced by South Africa in the past, the SARB is likely to focus on containing second-round inflationary effects resulting from the electricity price increases.
- In other words, it is understood that no amount of interest rate increases will impact directly on the electricity price, but if South African consumers respond to the rising electricity price by seeking higher wages and adjust their overall spending upwards, then it is the inflationary effects of such developments that monetary policy is better equipped to deal with.

Risk of stagflation in SA

- Given South Africa’s low growth prospects and the effect of likely external and internal drivers of inflation, South Africa may begin to be faced with a ‘stagflation’ scenario, where inflation rises above its target, but where growth remains low or below potential.
- Stagflation will present a dilemma for South African policy makers, as the SARB will be mandated to contain inflation by raising interest rates, despite the fact that rising interest rates will impact negatively on short-run growth prospects.
- The problem is best resolved by separating short-run and long-run effects. In the short-run, high interest rates will impact negatively on growth and demand, but in the long-run it is to be expected that the maintenance of low inflation will contribute positively to the investment climate and that this will foster higher levels of growth.
- The alternative approach of allowing inflation to rise significantly, and so avoid interest rate increases in the short-term, is less attractive, as in order to avoid the growth-inhibiting effects of ever-rising prices, inflation will, at a later stage, need to be brought under control.
- This will result in larger future increases in interest rates and the even higher costs to output and employment associated with such disinflationary interventions.