NWU School of Business and Governance

Policy Uncertainty Index (PUI)

4Q2016

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NWU POLICY UNCERTAINTY INDEX (PUI) DECLINED IN 4Q2016 TO 38.8 FROM 46.5 IN 3Q2016 (BASELINE 50)

NWU-SBG POLICY UNCERTAINTY INDEX (PUI)

1. INTRODUCTION

As outlined when the PUI was launched last 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 hopefully fill a gap in our monitoring of the economic environment.

A NWU team therefore 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 suggests that uncertainty is very different across economies. Developing countries seem to have about one-third more macro-economic uncertainty than developed countries.

However, this may now be changing with events such as Brexit and the election of US president Donald Trump.

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 RESULTS FOR 4Q2016 - WHAT DOES IT SAY?

The aggregate PUI for the quarterly period October to December 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**
Oct – Dec 2016	**38.8**

The results for the fourth quarter of 2016 shows an average index score of 38.8. This means there was less uncertainty than in the third quarter of 2016. The PUI is therefore the *net* outcome of *positive* and *negative* factors affecting the perceptions of policy uncertainty over the relevant period.

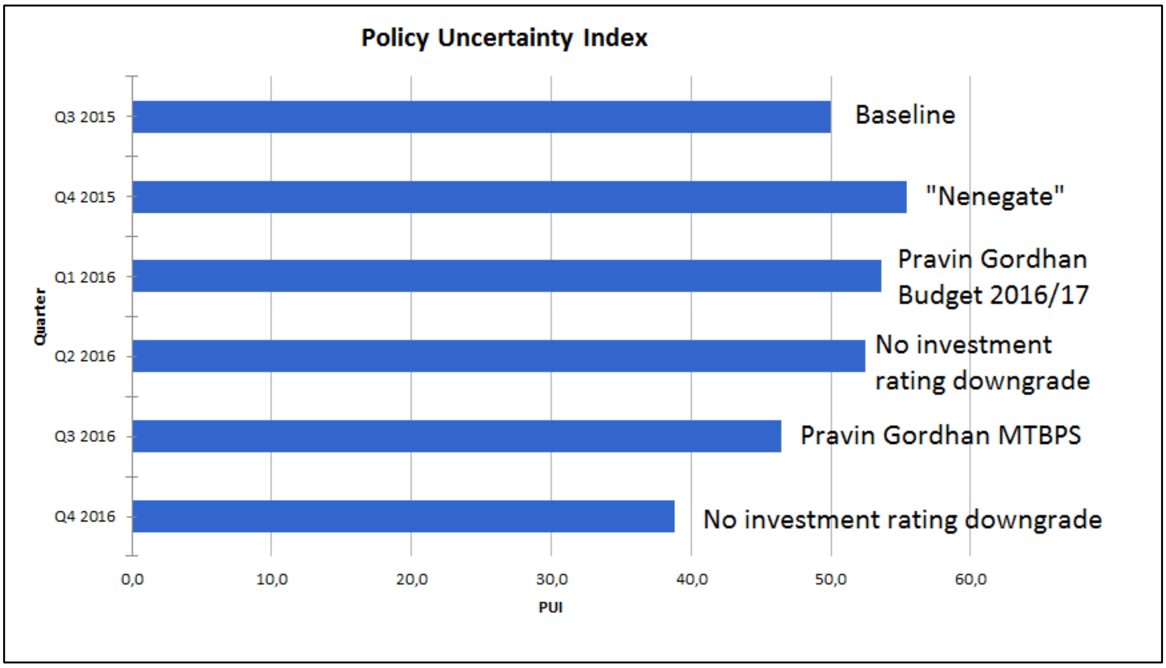
Unpacking the three elements of the index shows the following:

2.1. In the media data there were proportionally less articles that mentioned policy and uncertainty in South Africa

2.2. The survey of the economists found that the majority of the economists feel that the level of policy uncertainty remained the same in the fourth quarter. Slightly more than half of the sample felt that politics was more uncertain. Three quarters of the economists reported that consumers faced increased uncertainty in the second quarter.

2.3. The Bureau of Economic Research's number on the proportion of manufacturers that indicated that politics is a constraint to doing business was unchanged at 75 in the fourth quarter.

Overall it seems that reporting and sentiment in the fourth quarter to a degree reflected the 'green shoots' seen in international and local economic prospects, the Medium Term Budget Policy Statement (MTBPS) by the Minister of Finance and the reprieve offered by the credit rating agencies. Though a number of longer term unknowns persist, the short-term uncertainty declined. *Both domestic and global experience of the response of policy uncertainty indices to shocks suggests that such indices rise in the wake of large negative shocks and respond relatively minimally to small ones.* Hence the PUI reacted strongly to 'Nenegate' in December 2015 but has moderated since.



3. NARRATIVE ON SOME FACTORS INFLUENCING POLICY UNCERTAINTY

3.1. Broad Economic Outlook

Despite the significant uncertainties caused by the U.S. Presidential election and the U.K.'s planned Brexit from the European Union, the growth outlook for the world economy remains positive. The IMF has left its latest forecasts for world economic growth unchanged and a recent survey of international business confidence was at its highest since the Great Recession of 2008. The interim reaction of specifically U.S. markets to the Trump Presidency has been positive. South Africa marked a second consecutive quarter of growth in the third quarter and the fourth quarter had prospects of a stable inflation outlook, somewhat stronger exchange rate, and better forecasts for rain. Business confidence also increased marginally.

In the 2016 MTBPS Finance Minister Gordhan showed fiscal prudence in the face of numerous constraints and challenges. The MTBPS emphasized cost containment measures, reprioritization of spending (e.g. financing higher education) and anticipated additional revenue through tax policy measures in the 2017/2018 Budget. In addition, the Minister led a delegation to New York in early October to convince investors and ratings agencies of the efforts to avoid a ratings downgrade. In the event, SA was not downgraded in December 2016, *though all three rating agencies now have SA on 'negative outlook'.*

As 2017 unfolds and South Africa mulls over the country's economic prospects for the year, the interaction of positive and negative factors therefore still yields one dominant characteristic: uncertainty. "You've got to expect the unexpected" is the mantra inherited from 2016, when a series of roller-coaster political and economic events shaped much of the national mood. The uncertainty surrounding the outcome of the ratings agency assessments of SA in 2016 encapsulated the factors that were identified in a tumultuous economic and political landscape. But is the worst over now?

Although the MPC decision on January 24 to again leave interest rates unchanged was widely expected, the realistic and comprehensive assessment of the economic outlook by SARB Governor Lesetja Kgnayago included several cautionary notes. The SARB has again lowered its forecast for economic growth in 2016 to 1.1% and it indicated that the growth outlook remains well below potential. There was also reference to the low level of fixed capital investment, especially by the private sector, and of the need to implement structural reforms to improve investor confidence. And while the SARB hopes that both inflation and interest rates in SA may now have peaked, it recognized that global and domestic uncertainties may yet cause the best forecasts to be wrong.

3.2. The 2016/17 Budget

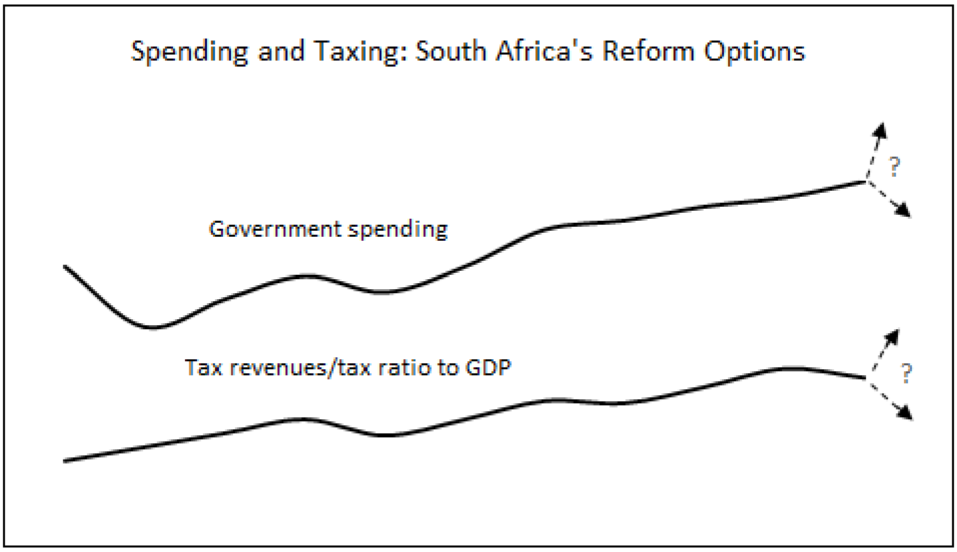
In 2017 SA should therefore start to vigorously implement those structural reforms that would at least begin to raise the country's outlook from *negative* to *stable*. Apart from the forthcoming *state of the nation address*, the next major economic policy event that will need to reinforce such an approach is the *2017/2018 Budget* at the end of February. The Treasury, the credit ratings agencies and most economists agree on the need for *continued fiscal consolidation.*

As indicated above, the MTBPS, or mini-budget, took the further step in October 2016, with discipline being targeted in both government spending and in public sector borrowing limits. The next phase is due in February, with tax increases promised to help close the rest of the fiscal gap of about R28bn. A rough estimate suggests that one-third of the fiscal consolidation is intended to come from fiscal discipline and about two-thirds from increased tax revenues.

But how can higher taxation be good for growth? The reality is that, unless state spending in particular can be further disciplined, solutions will have to be found in higher taxes, new taxes or more efficient tax collection. By international standards, SA already has excellent tax compliance, and the South African Revenue Service has a good track record in collection. Overall, tax revenues have held up reasonably so far, given a weak economy. However, serious doubt have been expressed by competent economic authorities about the sustainability of tax revenues, with slightly better yet low economic growth rates projected for the 2017/2018 period.

While the business cycle appears to have stabilised, the growth rate in 2016 was probably only about 0.5% and the economy narrowly escaped a technical recession. On current trends, SA can expect economic growth of about 1% in 2017 and just over 1.5% in 2018. These performances are below population growth and woefully inadequate to support SA's socioeconomic needs. One increasingly common view is that SA's long-term potential rate of economic growth has, in fact fallen.

The fiscal gap nonetheless remains. *We therefore need a tax mix in the forthcoming budget that will do the least harm to growth and employment.* The risk is that SA will drift into a chronic 'tax-and-spend' cycle, which has been the bane of several other economies. And in the search for revenue, should the emphasis fall on direct taxes or indirect taxes? All tax reformers seek the golden mean between direct taxes and indirect taxes, and SA is no exception.



Research by the Davis Tax Committee suggested that, of the three tax big-ticket revenue generators – corporate taxes, personal taxes and value-added taxes (VAT) – an increase in the VAT was the least of the evils. The latter, however, is likely to meet an insurmountable political roadblock. Thus, with a troubled economy and a small tax base, there remains an acute challenge in the next budget on how best to balance the books. The MPC statement of 24 January also referred to the possible impact of tax rises on consumption spending. *The risk of getting it wrong, while trying to do the right thing, is real.*

A pivotal consideration is the extent to which trust may be deteriorating between tax payers and tax gatherers, which is, in turn, linked to negative perceptions of corruption and excessive and wasteful state spending. Public opinion is important because public support for the tax system is necessary for its effective functioning. *What is expected from the government is not big spending but rather wise spending.* It is economic common sense that mega projects such as nuclear power should be affordable and the finances of key state-owned enterprises should now be put on a sound basis.

In assessing the fiscal options, it is yet again apparent that however we unpack SA's socioeconomic challenges, ultimately all roads lead through a much higher inclusive growth rate. Economic growth is not 'a cure for all diseases, an end to all distress'. But a growing economy makes other aims easier to achieve and softens conflict among them. Tax revenues, job creation and redistribution can all benefit if underpinned by positive real growth. *"Growthmanship" should therefore be the lodestar for the 2017/2018 Budget message.*

4. CONCLUSION

2017 is a politically decisive year for the country, with the factional battles and the ANC contestation gathering momentum. There is also the risk that a future Cabinet reshuffle may not be investor friendly. In addition, the inauguration of President Donald Trump and the Brexit scenarios inject new uncertainty into the global outlook. It is therefore even more important now that SA should strengthen its economy and reduce its vulnerabilities as far as possible. *This requires policies to be clear, consistent and growth-orientated, for both external* *and domestic reasons.* During his recent visit to Davos for the World Economic Forum's annual meeting, Deputy President Cyril Ramaphosa assured investors that South Africa would "do all in its power to ensure economic policy certainty".

It is also clear that a recovery in private investment and investor confidence remains an essential factor in SA's economic growth. The promised economic reforms pose a dilemma, especially when they include structural and micro-economic features. On the one hand, business needs to respond to the interim signals generated by the promised reforms. On the other hand, reaction by the private sector is to withhold investment until much of the residual uncertainty about the reform is removed. *Experience in SA (and elsewhere) has shown that even moderate amounts of policy uncertainty can be regarded as 'a tax on investment'.* Even otherwise acceptable reforms may be damaging to economic performance if they create doubt about their implementation or permanence.

Yet there is a positive dimension. At a deeper level the causal role of policy uncertainty remains quite nuanced. *Sound institutions and policy regimes create predictable policy responses, even in the face of large negative shocks*. In this way, good institutions and policy regimes can lessen the scope for policy to act as a source of uncertainty impulses. The rating agencies are therefore right to identify SA's institutional strengths as a bulwark in the economic outlook for the country.

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North-West University School of Business and Governance

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