Macro policy in the pandemic

Fiscal imperatives and financial considerations

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CDE webinar: Covid-19 and SA's public finances

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Outline

- The macroeconomics of the coronavirus shock are unique
- This implies the need for large fiscal operations
- The cost of *not* financing these operations is unambiguously greater than the cost of financing them
- But government faces a binding financial constraint
- Responding to these imperatives means
  - Deploying external official creditors
  - Deploying the whole public sector balance sheet
  - Maintaining government access to capital markets
- Fundamental uncertainty about the pandemic and post pandemic world
- Without an effective reconstruction of South Africa's path of growth *and* distribution South Africa will face years of debt distress

1.

Coronavirus as a macroeconomic shock

Macroeconomics of a long shutdown

- Over an extended period (6 – 18 months)
  - *Normal* (albeit extreme):
    - External shock (export prices, external financing)
    - Domestic demand shock: consumer stay-at-home
  - *Extra-ordinary* shutdown of economic flows (output/employment)

- In a normal shock (e.g. great depression), macro policy objectives are
  - Offset the output gap (aggregate demand < capacity to supply)
  - Stabilize income (dampen multiplier effects)
  - Prevent hysteresis (maintain full employment of workers and capacity)

- But this an extra-ordinary shock
  - Social choice:
    - Reduce potential output and restrain aggregate demand
    - Minimum consistent with disease management objectives and social order
  - Output gap, stimulus is *not* the central issue
  - Instead: [*Regulated output/employment*] >< [*flows of income*]
  - Decoupling
  - Balance sheets of households and firms

Macro policy objectives

- Shape of the shock
  - V's and L's
  - Both "shocks" will extend over a 5 – 18 months in various forms
  - The shock will changed behaviour and structures in uncertain ways
  - Mega hysteresis risk: relationships and balance sheets
- Key macro objectives during the shutdown
  1. Stabilize income flows to prevent consumption shocks
  2. 'Bridging finance' to protect private balance sheets
  3. 'Breathing space' to adjust to lower income (flattening the income shock)
  4. Distribute the burden of adjustment equitably
- Issues
  - Using the public sector balance sheet
  - Fundamental uncertainty about solvency
  - Unwinding
  - Future path

2.
Fiscal imperatives

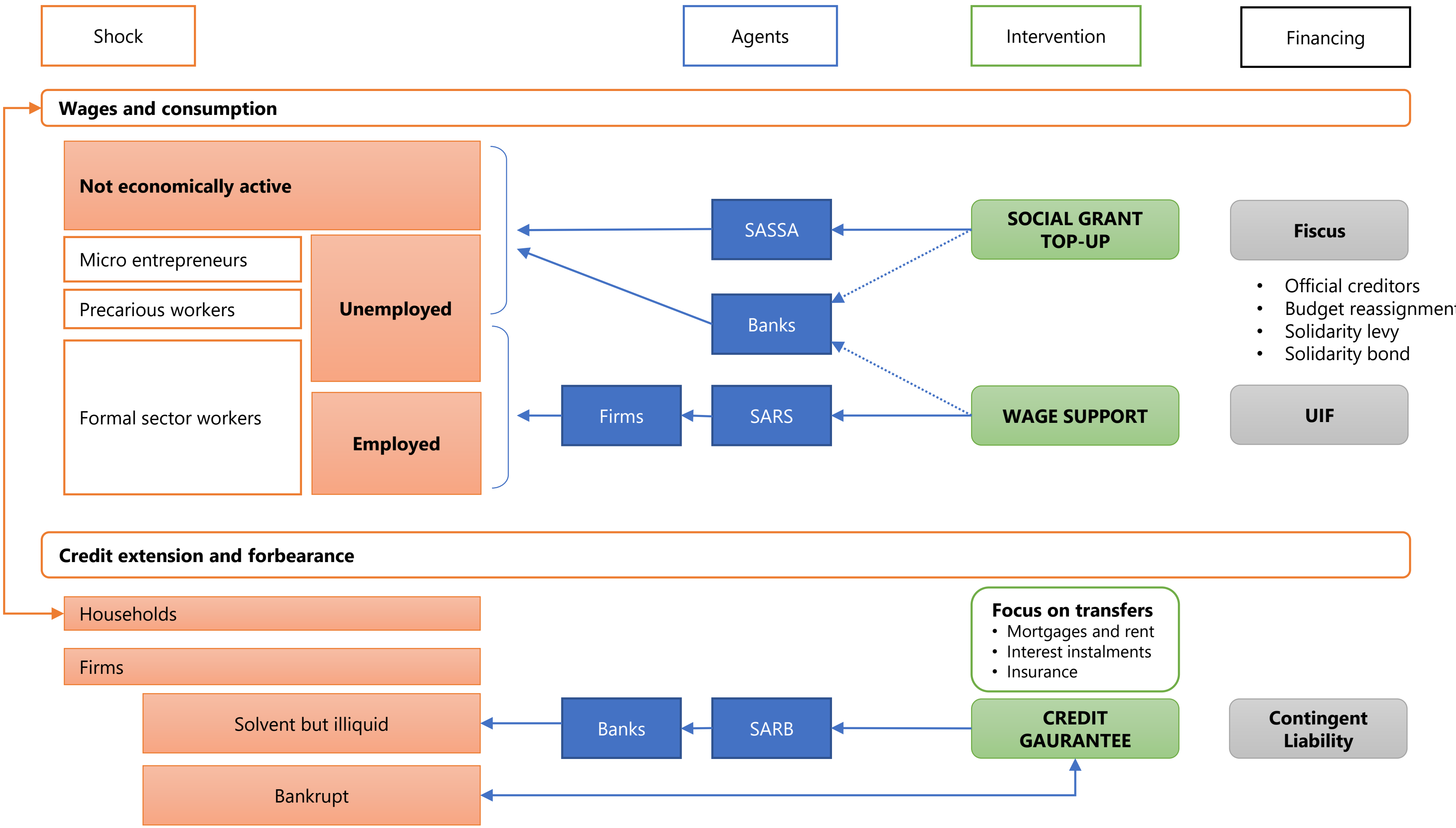
Initial fiscal response: imperatives

- Fight the virus
  - Public health system
  - Public finance for private health providers
- Relieve social distress
  - Existing social grants: broad, rapid, simple
  - Special grant
- Backstop wages
  - Public "payroll of last resort"
  - Employed workforce
  - Unemployed workforce of insolvent firms
  - Public sector wages
- Underwriting credit extension
  - Solvent but illiquid firms
  - Insolvent firms

Initial fiscal response: Design issues

- Initial response
  - Execute with speed (use existing channels)
  - Scale over targeting
  - Then plan for the long haul
- Temporary
  - Unwinding monetary positions
  - Reversibility of fiscal positions
  - Delayed downward adjustment
- Quarantined public finance
  - For effective post-crisis resolution
  - Separate budget presentation
  - Separate funding strategy attached to budget

Initial fiscal response: Policy framework

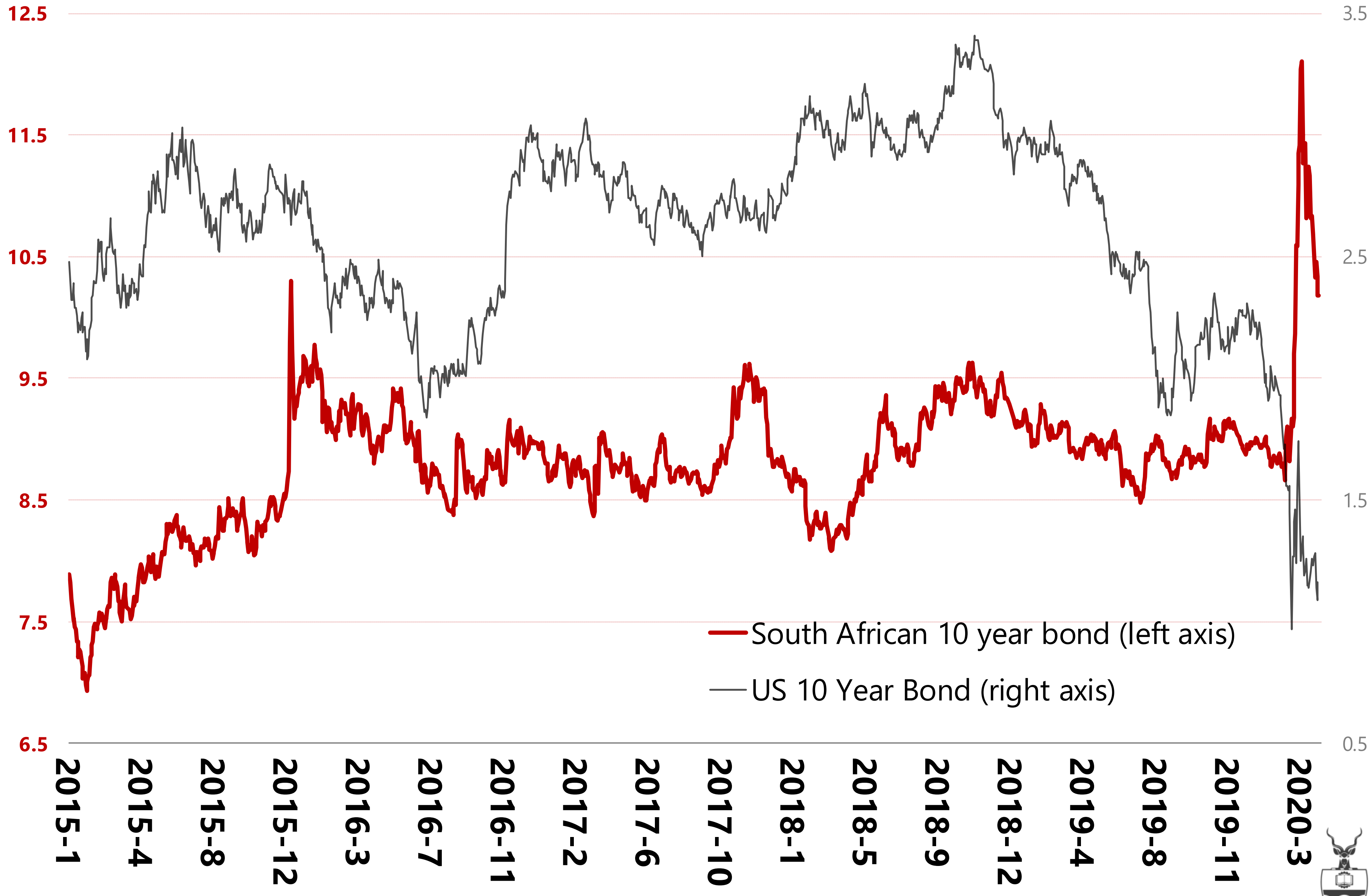


Source: Adapted from Van den Heever (2020)

3.

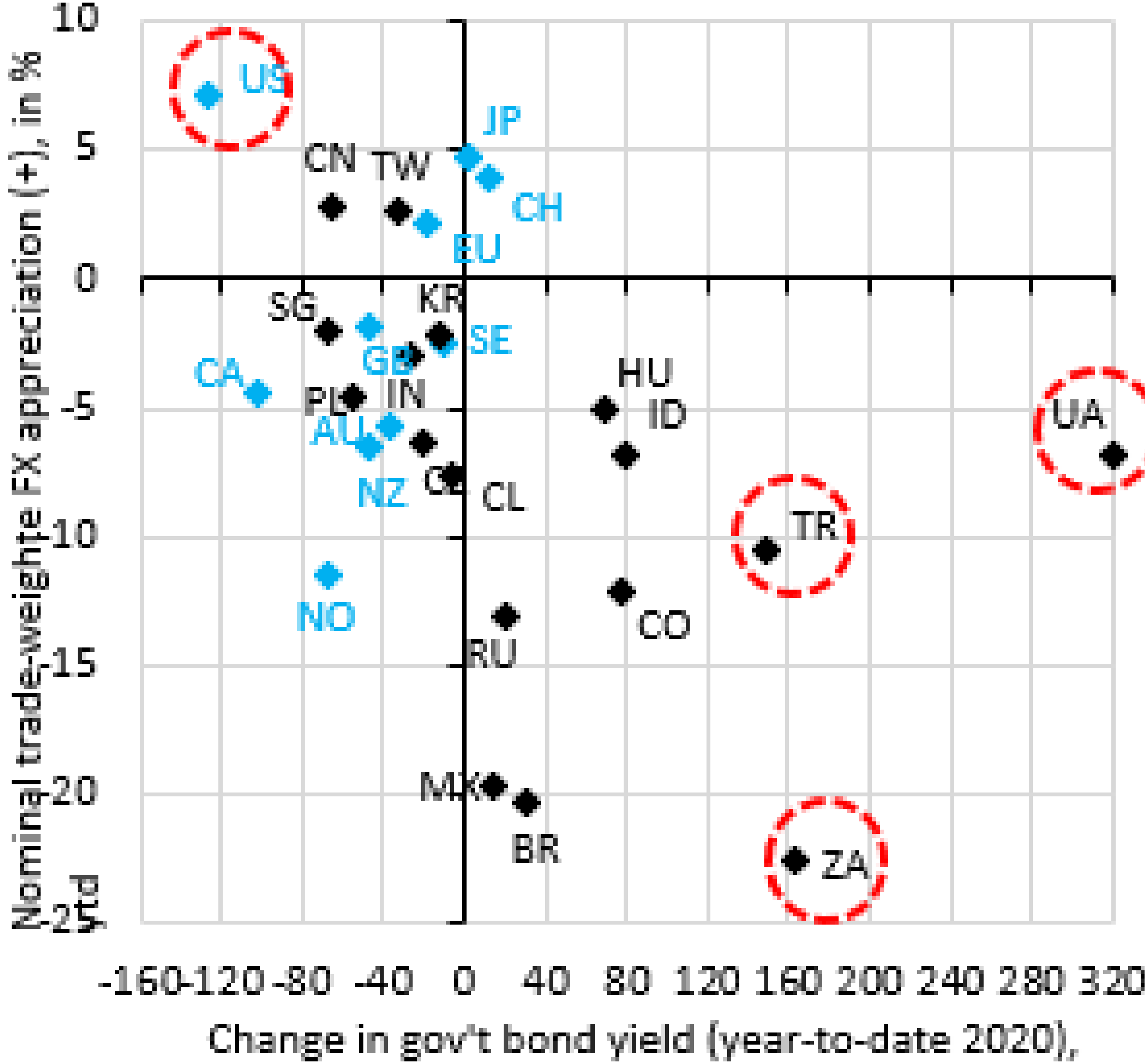
Financing constraint

10-year government bond yield (South Africa and USA)



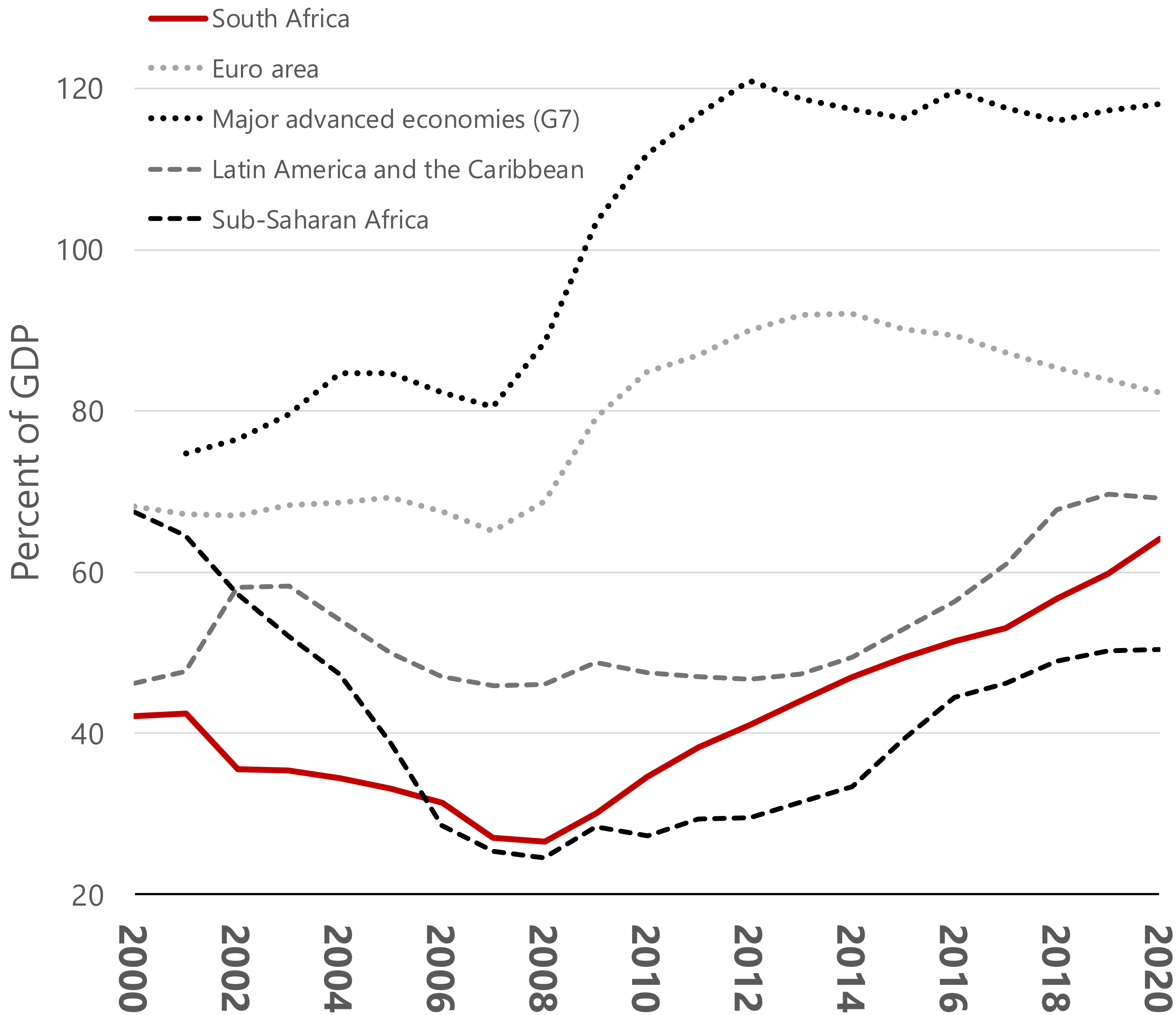
Source Data: South African Reserve Bank

South Africa amongst the worst hit



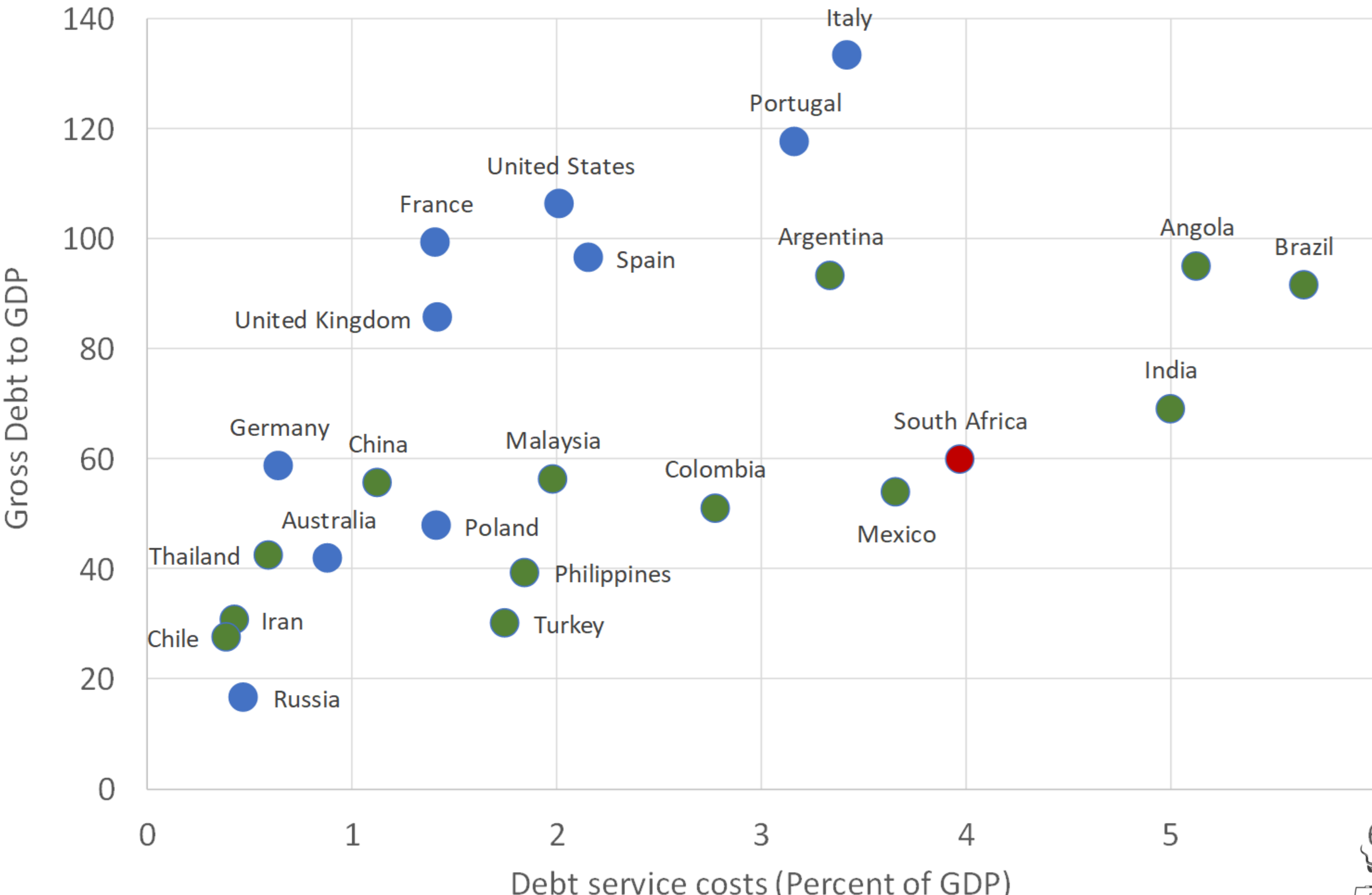
Source: Robin Brooks, Institute for International Finance

Debt before coronavirus: Level vs Path



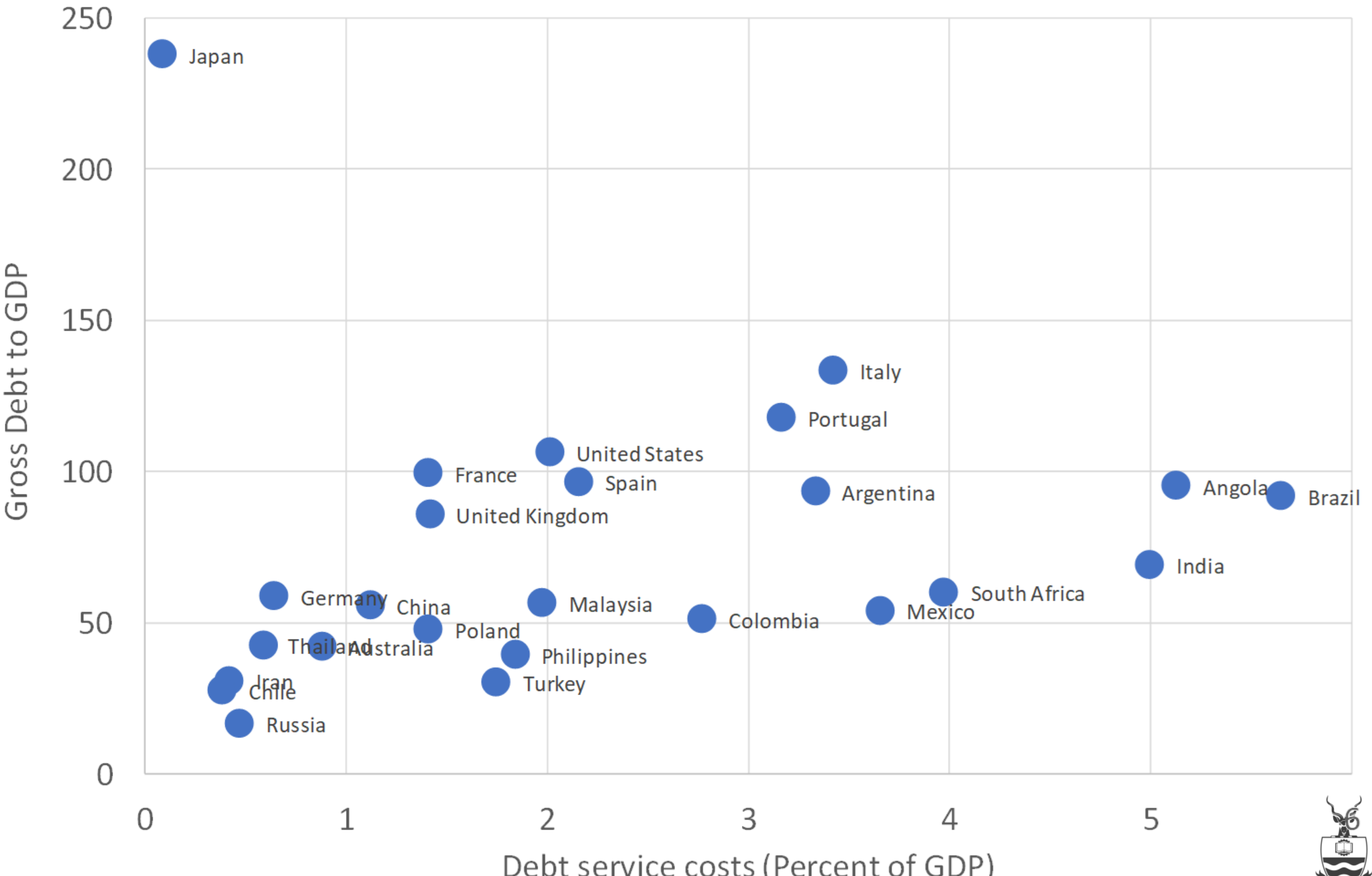
Source Data: IMF World Economic Outlook database

Debt levels, debt burdens and sustainability (2019)



Source Data: Authors calculations based IMF fiscal monitor database

Exceptional Japan



Financing: South Africa's position

- Before coronavirus South Africa's debt trajectory was unsustainable, government had no clear plan to close the deficit
- Most countries face a once-off coronavirus debt shock
- South Africa faces a rapid acceleration of debt trajectory
- Advanced economies will come out with r<g
- There is very little chance of South Africa achieving r<g
  - The burden of debt service will grow substantially and quickly
  - South Africa will face debt distress in the years (and maybe months) ahead
- This year it is not clear that South Africa will be able to finance the budget deficit (even before new spending)

4.

Financing policy issues

Budgets and revenues

- Temporary budget reallocation
  - Skills development levy
  - Postponement of capital projects and other asset-forming spending till next year
  - Draw down on surpluses across consolidated government
  - Contribution holidays (GEPF, GEMS, housing allowance)
- Taxation: Solidarity levy
  - Temporary and modest
  - Surcharge on the back of existing tax instruments
  - Target the most affluent
  - Ringfenced to retire debt incurred for Covid response

Maintaining public access to borrowing

- Easing pressure on the bond market
  - Official foreign creditors essential (and not limited to the IMF)
  - Using cash balances (including sterilization deposits)
  - Fully deploy surplus of the UIF
  - Appropriate use of the GEPF?
  - Risk benchmarks: short and foreign?
- Keeping bond markets open and funding at sustainable rates
  - Avoid disorderly capital flight and domestic asset price collapses
  - Negotiating with the domestic asset base (e.g. solidarity bond)
  - Build on SARB credibility to influence long-term rates?
  - Macro-prudential measures and capital account regulation
- Debating monetisation and compulsory finance

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Thanks