ECONOMIC POLICY IN EMERGING COUNTRIES – SOUTH AFRICA AND THAILAND

ABSTRACT

Analyses on the independent issues such as the suitability of inflation targeting in emerging markets, the role of fiscal policy in stabilizing the economy. The effect of debt accumulation on macroeconomic stability, how participation on international capital market constraints national economic policies, and how monetary and fiscal policy can be coordinated.

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Question 1 - Monetary Policy Target and Instruments

How monetary policy might control private sector expectations

Central Banks from different economies have different primary roles, in the case of emerging economies, price stability is a predominant goal. This holds for SARB as well. Over the period of the covid pandemic, in the short run, global economies found their actual output deviating from their potential output with it being largely negative. What fed into this was low aggregate demand, as a result of, large parts of the economy being shut down. Consequently, households and firms' expectations were quite negative in that the economy started experiencing deflation, unemployment rates escalated, financial markets were under distress and all of these indicators were a recipe for declining real GDP output. As the governor suggested, the agents of the economy found their consumption and investment patters changing to adjust to the current (at the time) economic conditions. The role of economic agents is crucial, in that, their initial behaviour causes a significant spillover effect on the economic outcomes just previously mentioned in more like a domino style. The circular flow model is one that adequately explains how with restricted household and firm participation, product and factor markets impact becomes negligible to a certain extent. Using the advantage of hindsight with respect to the GFC. One of the much more accepted paths to take when dealing with liquidity shortages on a national scale is to implement Quantitative Easing (QE). This was once again done during the pandemic

This became the one of the official Monetary Policy (MP) response actions. According to the Governor, a combination of dropping interest rates and stimulating the economy by taking up QE, was the best way to respond to a otherwise sluggish economy. Between 2017 and the first quarter of 2020 the repo rate was averaging 6.7 percent which then dropped to as low as 3.5 percent by the second quarter of 2020. The combination of these two policy responses by the SARB has filtered through five transmission channels namely; interest, credit, asset, exchange rate and the expectations channel. However, the most uncertain channel is the expectations channel as this solely lies on how citizens interpret the SARBs MP stance. Since the role of SARB lies with inflation targeting by achieving price stability, the constant communication of what the SARBs target range is for inflation is what assists in anchoring private sector expectations. Nevertheless, this effort - swift policy action from SARB - was aimed at adjusting the consumption and investment patterns mentioned earlier which ultimately affect production an inflation. Unfortunately, in the case of South Africa, MP did not have much of an impact on bringing down the unemployment rates in any meaningful way. The Governor stated how, "the solutions to our unemployment problem lie well outside the realm of monetary policy". In essence, structural inefficiencies limit the amount of contribution MP can provide. What should be noted is that the SARB can achieve their mandate even if it comes at the cost growth but more fittingly sustainable economic growth. What shields SARB in achieving their mandate is the South African (1996) outlines in Section 224(1) which states that the mandate is "to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic". Shocks are temporal by nature, how long they last are always the uncertain factor which is hard to account for. However, the shock being temporary implies that it will not last for a long time. Thus, expansionary MP will revert to restrictive MP and stimulating the economy through QE programs will revert to tapering, all in line with controlling private sector expectations on the path of unemployment, inflation and real GDP growth.

Give and discuss two examples of news around the world showing the importance (or not) of monetary policy credibility and independence

The best country that illustrates importance of MP credibility and independence is the ideology of Turkey president Recep Tayyip Erdogan. He believed that interest rates should be reduced when inflation is rising instead of raising interest rates in the wake of rising inflation rates. Mixing politics and economics then to exert more negative spillover on the macroeconomic and financial stability of an economy. The approach Turkey and their president Erdogan embarked on since 2019 explain why fundamentals matter. The call of contractionary economic theory from president Erdogan has resulted in the country losing confidence in the eyes of international investors. What usually fuels dependence of the Central Bank of a nation and the ruling party is altruism (self-interest) in funding election campaigns through increasing government spending for alternative motives. This can also lead to the Central Bank being used to run a hot money printer machine which keeps printing to keep political motives at ease. As soon as the credibility was thrown under the bus, we saw the Turkish currency depreciate up to 18.78 to the dollar in January 2023 from 5.37 to the dollar in January 2019 (Federal Reserve Bank of St. Louis, n.d.). This act of altruistic behaviour from the ruling party has demonstrated how crucial Economic bank independence can be for a nation's macroeconomic and financial stability.

On the other hand, one of many significant events that put credibility of MP into question are events where the output gap was badly measured. The SARB Governor mentions how post GFC and post the covid pandemic, emerging markets specifically have struggled in adequately capturing or measuring the output gap. This is the case study scenario of what happened post the global oil shocks in the in the 1970s. Lack of information by Central Banks on the state of the economy, resulted in, policymakers judging that actual output was below potential - they assumed that the economy was heading a recession. Over the short run, the potential output was in fact growing slower than the actual output and not faster than it. The response from them was incorrectly administering expansionary MP (lowering interest rate to stimulate the economy). In fact, The Fed contributed to higher inflation in the economy and the credibility was put into question by institutions worldwide. Hence, later the 1970s was known as the period of the Great Inflation. Thus, time inconsistency in policy action does tend to throw credibility under the bus.

Question 2 - Fiscal Monetary Policy Interdependence

Fiscal policy (FP) revolves around government spending, that is, usage of taxation and increasing public debt to facilitate various functional or economical classifications. Outlining the exact relationship between borrowing or public debt and the real GDP output can prove to be challenging; however, excessive borrowing can be said to have a negative correlation. A rise in borrowings in the short run will foresee a reduction in real GDP output in the long run. This is owing to inflation or rather how sticky inflation is in the short run. Hence, when it comes to borrowing, the golden rule is to borrow only for capital expenditure; although, politicians and government officials tend to misallocate funds which distort the real value citizens receive in the long run. This is even more true in countries with weak institutions. Consequently, the FP response to cover budget deficits is to raise taxes sometime in the future. This is in line with the Ricardian equivalence which emphasizes how economic agents tend to anticipate a rise in taxes, in order, for government to repay public debt. The underlying point is that irrespective of the path government chooses to finance expenditure, price stability will be put under pressure. Subsequently, expected inflation rises. This raises flags for the Central Bank as primarily their goal, with focus on emerging economies, revolves around maintaining price stability and containing inflation within predefined bounds or target range. Fiscal policy influences monetary policy, in that, the Central Bank is called in action by them consequently having to raise interest rates. Additionally, the implication of the consequence poses a threat of a reduction in real GDP output over in the long run. Fiscal policy only proposes economic growth which is in favour of Keynesianism; on the other hand, MP proposes ‘sustainable’ economic growth more favoured by

Neoliberalism (Polillo and Guillen, 2005). The biggest separator between the two is that FP is not bounded by inflation targeting; whereas, MP is bounded by inflation targeting.

The truth about FP in its most honest approach, is it seeks to bridge the gap in society of standard of living. The implication here is that governments will borrow or try increasing revenue by raising taxes in order to reinvest into the economy by solving problems such as an alarming unemployment rate, failing state owned enterprises, energy utility issues. Ultimately the goal is to better service delivery of public goods and services to the citizens of the nation while simultaneously increasing the standard of living. The driving force behind much governmental decisions is not financial stability of the economy in the short to medium term. Politicians being restricted to a four-year period means in order to have the highest impact with the end goal of being reinstated for a second tenure would imply implementing policies that focus more on achieving distributional stability. In a country such as South Africa with the highest income inequality Gini-coefficient of 0.63. The tradeoff involved in embarking on an aggressive FP path would be indirectly intervening with the path of the Central Bank. The way the Reserve Bank analyzes the scenarios at play is that the financial stability of the economy is being undermined by such political objectives. In hindsight, given the structural impairments prevalent in the economy, for instance loadshedding and high transportation costs as suggested by the Governor, the bridge of income distribution stability that FP tries to build is being burnt by MP. Thus, FP only allows MP to stamp an even more firm foot of authority in their own stance and efforts at achieving their goals over the long run, as current governments only end up tying the hands of future governments.

Discuss how the South African government can stabilize FP while maintaining the independence and credibility of MP.

Stabilization of FP revolves mainly around fiscal discipline; whereby, there is a limit to how much inflationary shocks government can cause for the economy. Dependence of Government on Central Banks allows for cases where politicians periodically interfere with the Central Banks mandate and momentarily boost output in the economy (Polillo and Guillen, 2005). The converse which becomes the soundest option advocates for independence, in that, MP restricts any unjustifiable borrowing to the government as well as administering a strict goal of targeting inflation. There should be barriers to entry of any kind of political interference strictly over monetary policy. The correlation in the Phillips curve does back up the idea that governments tend to suffer from time-inconsistency problems/issues, again owing to structural deficiencies prevalent mainly in emerging economies. Short run output with hopes of stabilizing employment, for instance, is much more detrimental to the economy in the long run as inflation is only a tax on the poor. Thus, South Africa should borrow less from the likes of the IMF and the World Bank as the cost of debt comes at an opportunity cost of reinvesting that servicing cost into education, skills development, bettering state institutions and so forth.

Alternatively, Government through FP could look at creating an environment for local business to compete on an international level. Increasing the competitiveness on a global scale could see government administering policies such as reducing the cost of capital for production inputs and incentivizing borrowing. This allows firms to have a slightly more room for reinvesting capital into their own businesses or else borrow to increase capacity which in essence allows them to compete on a global scale. FP policy would shift focus onto creating an environment that incentivizes FDI by maintaining MP independence which, as a result, assuring foreign investors that the value of their investment will endure in the long run. As a result, South African government borrows less from the likes of the IMF and the World Bank. Polillo and Guillen (2005) suggest that the Central Bank's independence increases with increased exposure to international trade and foreign investments.

Hindsight can work towards South Africa’s advantage. The Washington consensus approach to FP, should allow government to focus on specific sectors to gain confidence in stabilizing FP while maintaining the independence and credibility of monetary policy. This was what sparked South Africa to drive in considerably good investment growth in Finance, Insurance and Real Estate in the early 2000s.

Question 3 - Analysis of Emerging Market Economy

Introduction

We intend on analyzing various economic indicators to gain a deeper understanding of Thailand, an emerging economy. The goal is to examine the Monetary and Fiscal policy framework of Thailand. This will be approached using time series analysis from 2018 to 2021, with the data coming from the World Development Indicators and IMF over the last few years and to advise on the risks going forward. What will feed into this report is, firstly, understanding the specific economic indicators - public debt, inflation, and economic growth. Secondly, we aim to uncover the challenges to macroeconomic stability facing Thailand. Lastly, we will hit a home run by grasping the level of independence and credibility of the Central Bank.

1. Public debt dynamics in Thailand

Prior to the covid pandemic the stock of gross debt had been steadily increasing. Central banks worldwide have not truly stopped printing money since the wake of the GFC. The dynamics of Thailand particularly are interesting given how the economy is structured. As at 2018 the stock of gross debt as a percentage of GDP was 41.8 percent and increased to 59.91 percent by October 2022, accumulating by 18.42 percent over this window. Zooming into what drove debt accumulation, the largest contributor[1] was domestic debt which implies one of two things. Firstly, government issued bonds to citizens which allow for government to accumulate debt with long-term maturing dates. Secondly, higher primary budget deficits would have created a need for financing this shortfall by government borrowing funds from the Central Bank. This became more aggressive from January 2020 to January 2021 - owing to the covid pandemic. However, high government debt weakens the credibility of the government's capacity to cushion the banking system (Kose et al., 2022). Although, higher transparency within government assists with managing expectations.

Concerns do arise over rising public debt to GDP ratio in Thailand, more so when expenditure is rising quicker than revenues. Maturing dates on debts are approaching. Efforts aimed at reducing the impact on

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[1] Domestic output to GDP = $\frac{4095014.06}{6441357.86} \times 100 = 63.57\%$ (as a percentage of GDP)

the Ficus include fiscal consolidation. The risks of a higher debt burden will force government to revert to fiscal consolidation through increasing tax rates or expenditure cuts in certain sectors of the economy. The last scenario at risk is government privatizing state entities. This free's up debt obligations; whereby, government is no longer bailing out SOEs in the long term which stabilizes debt to a steady state. Nevertheless, embarking on such a route can be detrimental on the economy given that strong institutions and regulation reforms are not in place (Kose et al., 2022).

2. Inflation in Thailand

Thailand has been on a relatively stable steady state inflation rate from 1.1 percent in quarter one of 2018 to 1.2 percent in quarter one of 2021. The Bank of Thailand (BoT) has indicated that the biggest drivers of low inflation are low housing prices, education fees, and public transportation which are 23, 6 and 24 percent in weighting respectively (Bangkok Post Business, 2017). Supply side factors such as relatively smooth oil prices over the period of interest have contributed to cost push inflation factors shock not having a significant impact on the local consumer price index. On the other hand, weak demand overall in the economy has also led to historically low-price expectations for the nation. Another factor owing to relatively low inflation is due to BoT adopting a flexible inflation rate framework. There are other drivers of inflation outside what the MPC can control, hence improving the measures aimed at picking up real inflation movements could be useful in the BoT avoiding time inconsistency in policy action problems.

3. Economic growth in Thailand

Real GDP growth has averaged 0.57 percent over the period 2018 to 2021. This actual GDP growth per annum has been on a downward trend since 2018, with covid only exacerbating this effect in the year 2020. It is worthwhile to note that the biggest contributor to GDP for this economy is tourism, in effect, the demand for tourism has been reducing over the period as well. Thailand is not realizing the full potential of their resources with the output gap being recorded as low as -4.2 percent in 2020 and -4.1 in 2021 (IMF, 2023). This indicates that recovery might be sluggish in essentially getting to a point where actual equals potential output. Projections by the BoT are only signaling this to happen in 2024 with recovery to pre pandemic levels only in 2025/2026. It is hard not to see recovery in the tourism sector as global demand starts picking up again but the risks of slow recovery involve other shocks to the economy such as the oil price shocks, as a result of, escalations in the Russia-Ukraine which cause input prices in the cost of production to be quite expensive.

4. The level of independence and credibility of the Central Bank and the challenges to macroeconomic stability facing the country.

The flexibility of inflation targeting as well as constant consultation with the Minister of Finance has seen well-coordinated policy implementation over the last decade. This has created much more transparency within the BoT, in that, inflation expectations are smoother and within the target range. The coordination has also been welcomed globally by trade partners and those involved in the foreign direct investment transactions with Thailand. Given the well over 100 percent trade openness of this emerging economy this has seen higher credibility, conditional on decent financial stability of Thailand's national accounts (Direkudomsak, 2016). Temporal shocks dissipate quickly in Thailand’s economy, owing to how well the BoT tailored the monetary framework to tame price stability and assist citizens in not being exposed inconsiderably to price instability and rather high inflation expectations. However, the challenges to macro stability as suggested by the IMF (2023), are a resurgence of the pandemic, exchange rate depreciation from advanced economies tightening their MPs much faster. In my opinion, there should be an awareness of a debt crises which could loom large given how domestic debt has almost doubled from about 4 billion in 2018 to 7.7 billion Baht in 2021. This could pose financial stability risks. Thus, this wildcard should be closely monitored.

Conclusion

Thailand have found themselves on trend of reducing real GDP output growth since 2018. Over this time period it has been highlighted how a large negative output gap has been a tradeoff to lower growth; where government has resorted to increasing the share of public debt by 18.6 to support lower demand. Overlaying the covid pandemic and the Russia-Ukraine war has only exacerbated the inflation, economic growth, and public debt, all in only a negative manner. Hence, addressing structural shortfalls (aging labour force, political instability, labour shortages in sectors other than tourism) which were already birthed pre-pandemic will only help Thailand return to steady state. Over and above, more measures should aim at further contributing to turning the negatives into positives; otherwise, over the short to the medium term (2026) we can only Thailand to return to pre-pandemic levels and perhaps continue their downward trend until neighboring countries diverge to them. The BoT unfortunately irrespective of how good their framework is, are limited on massively contributing to higher and sustainable economic growth if structural problems are not adequately reformed.

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