“Post-truth”, “alternative facts” & “Fakenomics”

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A. Introduction

My career as an economist has taken me to three very different environments. So, I thought it would be helpful in this address to reflect on what my time in a government policy agency, in business, and most recently in higher education, has taught me about the practice of economic policy formulation and the value of economic research.

In all three of these spaces I have been called upon to produce economic evaluations of possible policy choices. For much of my career these were relatively isolated issues but there was a time when I was close to national policy debates, and I consider myself very fortunate that a large part of my business career coincided with South Africa's transition to democracy. This transition required not just reaching a democratic political settlement, but also the search for a new economic path, and policies that would address the gross inequalities and injustices of our divisive and hurtful apartheid past. I was exposed to these fascinating exchanges through my own work, but mainly in support of senior business leaders.

While there were large ideological differences, pre-1994 relations between business and the ANC and its labour alliance partner Cosatu were mostly quite cordial. There is little doubt that relations between business and the ANC government have soured since 1994. Governing is always a difficult challenge and the fact that so much of the last 23 years has been characterised by the slow pace of economic transformation, disappointingly low growth, limited job creation and poor service delivery has resulted in mutual finger-pointing.

This has impacted on policy discourse which has become fractured and bitter at times, leaving one to question what role we economists play or should play in a worrying ideological divide.

My first point is that South African academic economists should play a much greater role in policy discourse than is currently the case. When trying to put together the vast jigsaw puzzle that is this Conference programme, I was struck by how important and relevant so many of the papers presented here are for understanding and addressing our economic, educational and social problems. But too few of these findings will ever find their way outside rarefied academic circles. We need as the Economic Society, and as the Universities or the government departments most of us represent, to play more active and more public roles to inform and promote debate about our country's economic future and possible alternatives.

On-line resources like The Conversation are creating new channels to share our work, but much more needs to be done to encourage academics to participate openly in the critical debates currently underway across South Africa. In part, this requires government and business to realise that valuable research resources lie within our universities. Possibly we need to incentivise academics differently, either by how we judge research within universities, or by providing more resources such as through ERSA.

Academics must make themselves better known, not just to their peers, but also to government, research institutes and the public. More of our universities should follow the example of Stellenbosch where Servaas van der Berg, Nick Spaull and their colleagues have built an enviable reputation in educational research informed by economic principles. Nor should it come as a surprise when academics produce comprehensive reports on current controversies, such as the Betrayal of the Promise report by Prof Mark Swilling and a team that included several economists.

Ideally, there should be greater career movement between the public and private sectors and academia. Even a small step, such as seeking to spend our sabbaticals in government departments or the private sector, to sharpen our own understanding of the practical realities of public policy making and implementation would be valuable. Too much of what we teach and write about seems stuck in idealised understandings of what it is that government and firms actually do, and time out in the real world would be a useful antidote.

Secondly, in raising our public participation, we need also to recognise the importance that is often attached to our findings. While we may appreciate the fragile foundations of our models and the tenuous nature of our conclusions, this is not always recognised by non-economists. Graphs, equations and statistics are often given far greater weight than they merit. We are all aware of Keynes' (1936: 383-384) warning that

> "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else."

Keynes then went on to argue, optimistically, that new ideas would eventually triumph over vested interests. What I want to focus on today is less optimistic than Keynes; namely, the danger of allowing "vested interests" or ideology to triumph not <u>over</u> facts and logic but to become accepted <u>as</u> facts and logic. It is not just in politics that we are faced with a "post-truth" world where "alternative facts" are given equal weight to the facts themselves.

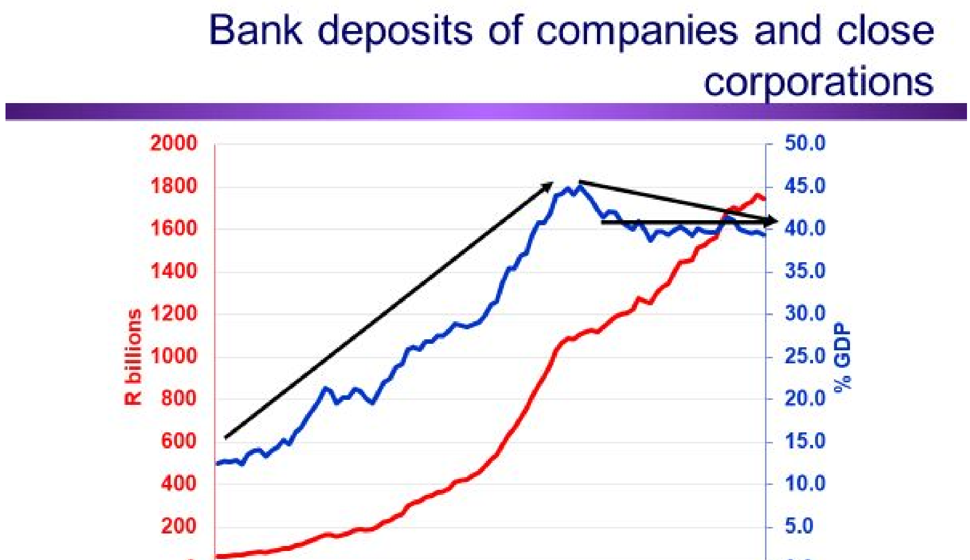
We face, too often, "Fakenomics" of which there are many examples that over-ride legitimate debate on all sides of the political spectrum. I want to focus on two recent examples. Unsurprisingly, given my background, both challenge the role of business in our economy.

The first example is the claim that South African companies are currently sitting on large amounts of "idle cash" which they "refuse to invest". The second is that SA companies, especially mining companies, have engaged in illegal capital flight on a colossal scale. In each case, business is accused of hamstringing the economy. Understandably, both claims have further soured already strained government-business relations as, if true, they undermine efforts to grow the economy and reduce poverty, inequality and unemployment.

But if they are false, they unnecessarily divert attention from the need to develop more effective policies, and to do so together, drawing on the strengths and commitment of different stakeholders. In the flurry of such allegations, however, government is encouraged to believe the fault lies not in faulty policies but in the actions of an unpatriotic and dishonest business sector.

I will try to show evidence that calls into question the basis for each of these claims. Moreover, that there are grounds for believing that economic analysis is being used to "confirm" what are largely pre-set positions. Normative positions and ideological agendas are masquerading as impartial analysis.

Note that I am not saying that there are no SA companies with large amounts of cash on their balance sheets. Nor am I saying that there is no illegal capital flight. What I hope to show, however, is that neither can possibly occur on the scale that is claimed and popularly repeated. Also, that the methodology used to support such claims, is fatally flawed.



B. Are SA companies sitting on large amounts of cash?

The claim that South African companies are sitting on large piles of "idle cash" which they "refuse" to invest has its origins in the early 1990s, when business was said to be on an "investment strike". In neoclassical economics, it is a principle that firms invest whenever profits exceed the cost of capital. Now instead it is claimed there are plentiful profitable investment opportunities in South Africa in which business "refuses" to invest.

This claim was given new weight in the period prior to 2008 when the bank deposits of SA companies started to rise rapidly. Evidence of this was published in the Reserve Bank Quarterly Bulletin which showed that the category bank deposits of "other companies and close corporations" rose dramatically in Rand terms from R60 billion in 1994 to R1.7 trillion in 2017. As a percentage of GDP, bank deposits rose from 12% to 40%. The rise was most notable until 2008 when deposits reached 45% of GDP. They then fell to 40% of GDP and seem to have stabilised at this level.

These deposits, it is claimed, represent profits that have been retained by businesses, and are now held in cash that is deliberately left to lie idle. Even commentators favourable to business have bought into the notion of such idle deposits. However, they suggest business wants to invest, but policy and political uncertainty make this impossible. The fault then, in the counter-claim, is government's.

Mike Brown (2017) the CEO of Nedbank recently reminded us that bank deposits are not in fact "idle". He notes that no profit-maximising bank would pay depositors interest for money to stay in their vaults. This is what happens only in the movies where Harry Potter's treasure in the vaults of Gringotts Bank is guarded by goblin bankers. In real life, however, such deposits do not lie in vaults but are on-lent through the banking system to be used by households, private developers and government. They are not "idle" in the way popularly portrayed.

But the real explanation of all this actually lies in our undergraduate macroeconomic textbooks. It is to be found in what we teach our students what money is and how it is created. We teach our students that "money" is coins, notes and bank deposits. When we apply this to the rise in corporate bank deposits it is clear that the claim that corporates retaining profits has resulted in rising bank deposits is necessarily wrong.

When a firm sells widgets to its customers, bank deposits change hands, but remain at the same magnitude overall. Logic shows us that even if companies choose to retain earnings instead of paying out profits as dividends to their shareholders, all that happens is that *the ownership of bank deposits changes*. The quantum of deposits is not affected.

Consider an example where a hypothetical company sells goods to a customer for R100. As a result of this transaction, the bank deposit of its customer falls by R100 and the company's bank deposits rise by R100. The company then pays, say, R90 to its suppliers, workers, tax to government and dividends to shareholders. It retains R10 in undistributed earnings. After all these transactions, its bank deposits have risen by R10 and the combined bank deposits of its customers, workers, suppliers, government and its shareholders fell by R10. Overall bank deposits are unchanged.

Yet it is these retained profits that are portrayed as the "idle cash" supposedly reflected in rising corporate bank deposits. This cannot be true. Bank deposits cannot grow because a company retains profits. They simply shift from other bank deposits into the deposits of the company that retains earnings.

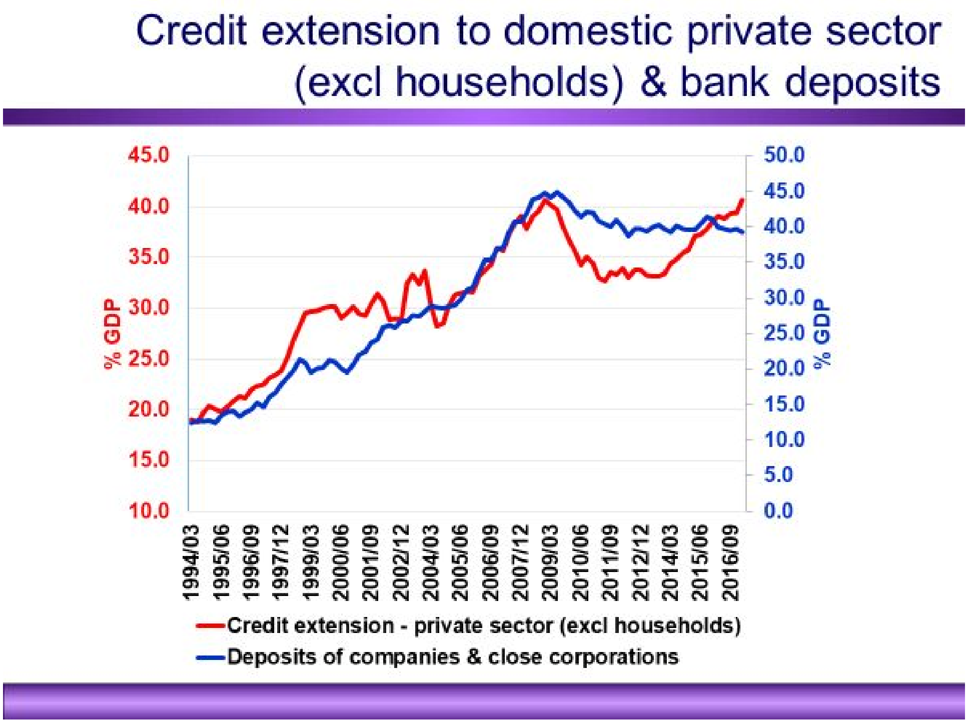
Economic theory explains how new bank deposits are actually created. Some textbooks continue to treat money as *exogenous*. Money supply in terms of this theory expands/contracts when the central bank buys/sells bonds from/to households. The change in the overall money supply is then a multiple of this transaction, the size of which is determined by the central bank's minimum reserve ratio.

But we know that this view of money supply is actually a description of the *central bank*'s open market operations. It is not how commercial bank deposits, and therefore how "money" as we understand it in technical terms, is created or reduced in the "real" world.

The model of *endogenous* money supply is what therefore now appears in most textbooks. It explains that by definition bank deposits are created when a commercial bank grants a loan to a customer. This act of granting a loan creates a deposit in the customer's account that enables the customer to acquire whatever it is they wish to use the loan for. This means the money supply (or stock) has increased. For the bank, it has created both a liability (the deposit) and an asset (the loan) on its balance sheet. The bank must square up all its accounts to meet the minimum reserve requirement of the central bank. If necessary the bank borrows the reserves needed, for which it is charged the repo rate.

The rise in bank deposits until 2008 shown in the Reserve Bank Quarterly Bulletin therefore had its origin not in the fact that companies were hoarding cash, *but that they were borrowing. And they were borrowing in order to invest.*

The rise in company borrowing – derived from the Reserve Bank's credit extended to the domestic private sector, excluding households – is shown alongside bank deposits in this diagram. Credit extension, too, rises significantly as a share of GDP. As theory predicts, the rise in bank deposits was caused by companies borrowing – and not by them saving.



The rise in borrowing coincides with the rise in private sector fixed investment until 2008 and the fall thereafter. It is unclear why borrowing in recent times has risen even as investment fell but I'm sure our colleagues from the SARB can explain it.

It is therefore – as theory predicts - increased corporate borrowings and investment which increased the bank deposits on which so much attention has focused, not accumulated profits.

Finally, the model of money creation tells us that the quantum of bank deposits falls only if borrowers repay their debt (i.e. bank credit extension falls), or the central bank conducts contractionary monetary policy (sells bonds to households or the non-bank sector) or the central bank sells foreign currency from its reserves.

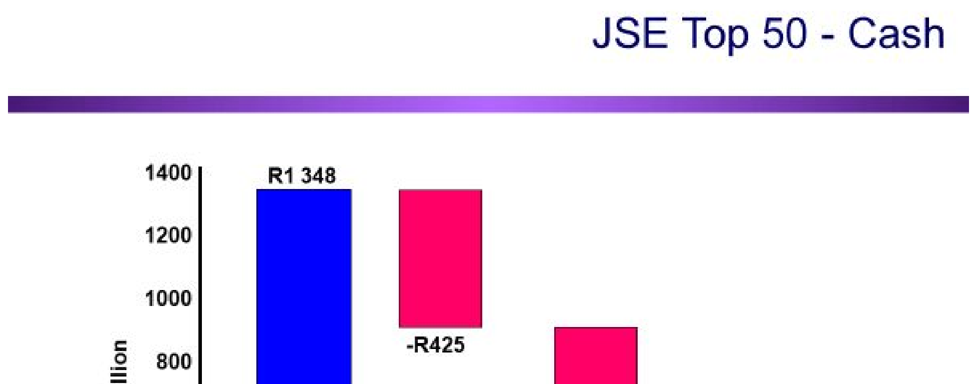
This means that even if companies with positive bank deposits choose to invest these balances – i.e. the supposed "investment strike' comes to an end - the total amount of bank deposits will not fall. Deposits will simply shift from the investing company to its suppliers in the manner just described. The total of bank deposits will be unchanged by investment that is funded from "cash". Ironically, it is likely that when company investment rises, bank deposits will actually increase – because some of that investment will be funded by borrowing, which will create new bank deposits.

The above logic does not prove or disprove claims that at least some individual companies are currently sitting on large amounts of cash (bank deposits). But it does show that, net of debt, cash holdings for the corporate sector as a whole have not increased in the way that is claimed.

One way of determining which individual companies *are sitting on cash* is to examine the balance sheets of listed companies. A number of studies have done this for the largest companies on the JSE.

Such an examination needs to be done carefully.

A study currently being done by a Rhodes Honours student (Stuart, 2017) looks at *cash declared on the balance sheets* of the JSE's 50 largest companies. It finds that collectively in 2016 they held R1.3 trillion in cash – an amount equal to 76% of the R1.7 trillion which Reserve Bank data show as the total bank deposits of all SA companies and close corporations.



But before concluding we have found the "culprits", we need to examine the companies comprising the JSE's Top 50. Many are not really South African companies at all (eg BAT, AB Inbev, Glencore, Richemont), or are dual-listed (Anglo American, BHP-Billiton, Old Mutual, Mondi, and Steinhoff) that have most of their operations abroad. Cash on the balance sheets of these companies – some R425 billion - is probably not in South Africa at all and therefore cannot be part of the claimed rise in bank deposits.

An even larger part of the cash of the Top 50 is held by banks as part of their liquidity requirements, rather than "idle cash". Collectively our 6 largest banks have cash of R581 billion – 43% of the total for the 50 largest companies. If we exclude the offshore companies and the banks we are left with R342 billion. Adjusting for nominal GDP growth this is not such a dramatic increase from past levels.

Some of this is also offshore (MTN for example has cash of R27 billion, much of which is trapped in Nigeria). While this is certainly a lot of money, it is hardly the mountain of cash which is claimed in the media.

Just as critical is the fact that these top 50 companies in 2016 with R1.3 trillion in cash also had R4.6 trillion in debt! Fortunately most of that is in the offshore companies!

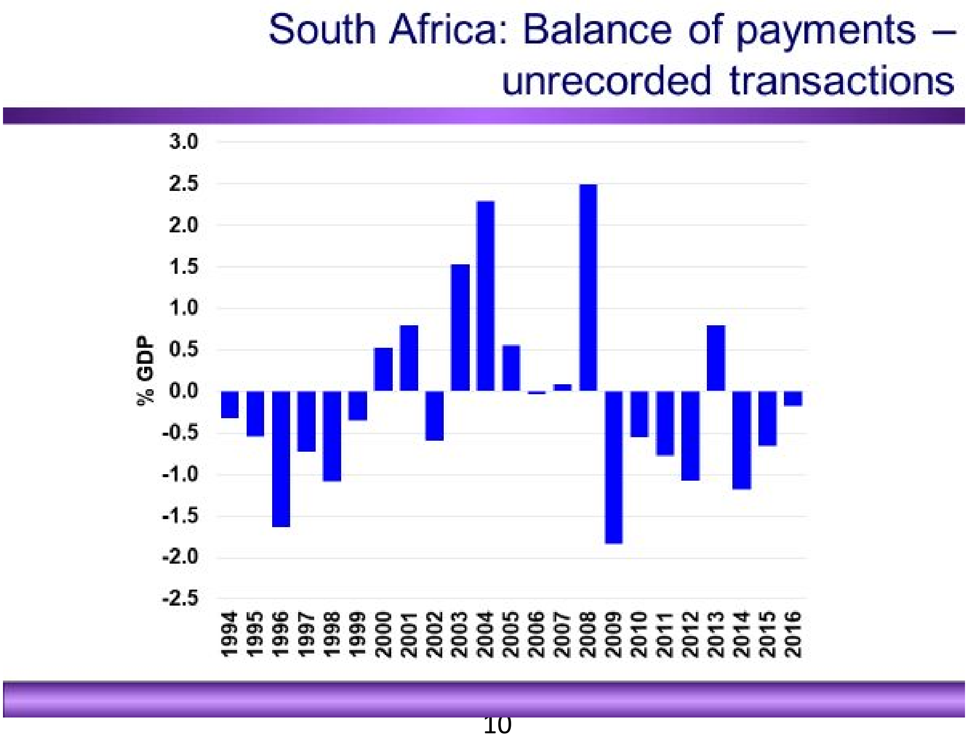
What I hope all these billions and trillions have shown you, is we have to be very careful to look at the complete balance sheet of companies rather than a single item such as cash. We need to include our accounting colleagues in our research to understand what balance sheets actually mean rather than what we as economists think they mean. For example, “reserves” on a balance sheet do not mean cash assets in the way economists would expect. Sweeping conclusions without substantiating evidence from a range of sources are very dangerous.

C. <u>Are SA companies responsible for large-scale capital flight?</u>

I want to turn now to the other claim that SA companies have been responsible for large amounts of illegal capital flight.

The various reasons for capital flight are well established in the literature. Companies or individuals may wish to shift their earnings to where taxes are lower. This is not necessarily illegal. However, when they wish to evade exchange controls or hide earnings from the authorities, it is.

Measuring such illegal flows, as with anything illicit, is difficult. Economists have attempted to do so mainly in two ways. The first ascribes the “unrecorded transactions” in the balance of payments to illegal activities which cannot be measured by the authorities. This is problematic. Firstly, given the scale of forex transactions (over $22 billion per day in SA), it is an heroic assumption that all legal activities are accurately reflected in official balance of payments statistics, so any errors must be illegal transactions and not just simple recording errors.



Secondly, as reflected here for South Africa, the "unrecorded transactions" are sometimes negative and sometimes positive. Can we really believe that illegal capital flight in one year is followed by illegal capital inflows the next? Surely, our method is faulty?

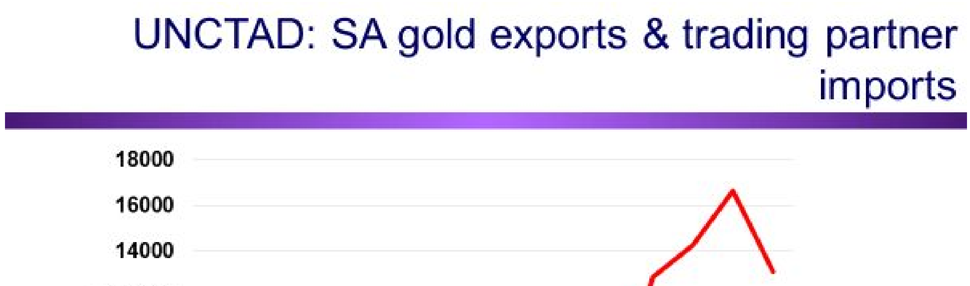
An alternative approach, suggested by Bhagwati (1964), is to try to capture illegal flows by comparing export statistics from the country of origin with the reported imports of that country's overseas trading partners. If these differ by more than can be accounted for by transport costs, the difference is said to reflect underinvoicing by exporters and overinvoicing by importers. By understating the true value of their exports, misinvoicing is a form of tax and forex controls evasion. It allows importers to access often scarce foreign exchange and to transfer proceeds abroad.

Probably the most high-profile use of this approach was the 2014 AU Report on Illicit Financial Flows from Africa, chaired by President Mbeki. This estimated that Africa loses about USD 60 billion a year from illicit capital flight.

More recently in June 2016 UNCTAD published "Trade Misinvoicing in Primary Commodities in Developing Countries: The cases of Chile, Cote d'Ivoire, Nigeria, South Africa and Zambia". This report used the UN Comtrade database to compare reported exports by destination with reported imports by major trading partners over the period 2000-14. It allowed a 10% margin for the cost of transporting commodities to be included in import values.

In the case of SA, the Report claimed that misinvoicing had resulted in illegal outflows of USD102.8 billion (expressed in constant 2014 US dollars) just from trade in the 3 mining commodities which the report examined. This was made up of misinvoicing of USD78.2 billion for gold, US24 billion for "silver and platinum" and USD 620 million for iron ore. The negative implications of over 100 billion USD in outflows for SA's balance of payments and economic performance are obvious.

Could this really have been so? In answering this question, I want to focus on just the biggest item, the claimed USD78.2 billion in *gold* underinvoicing.



USD78.2 billion is 67% of the value of reported gold imports by SA's trading partners. UNCTAD (2016: 31) concludes from this that South Africa's

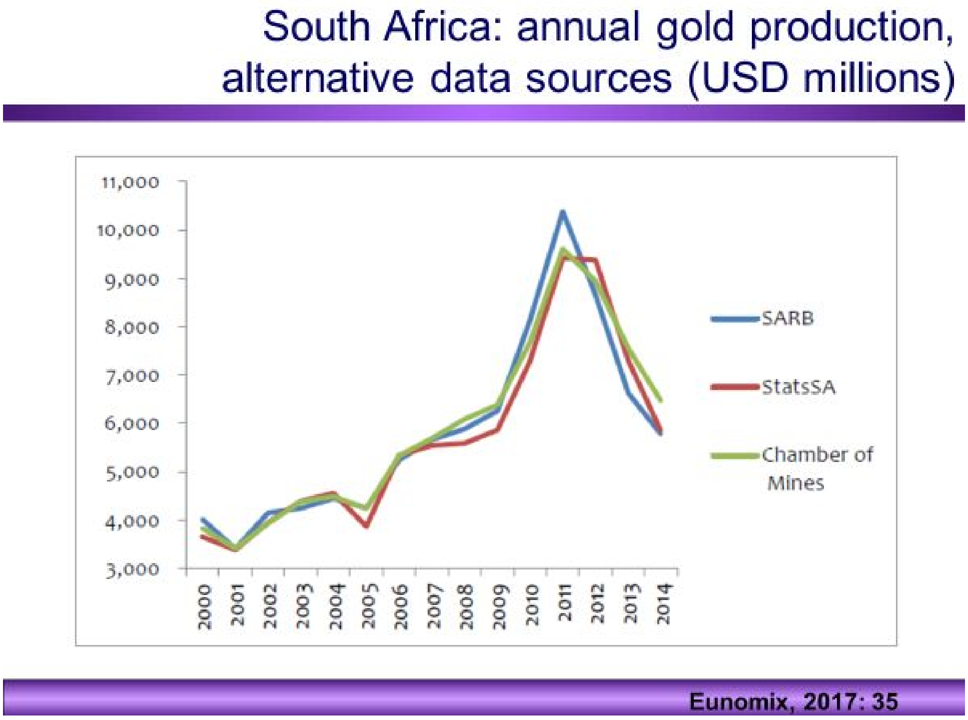
> "official statistics report very little gold exports while substantial amounts appear in its leading trading partners' records. This does not appear to be a simple matter of undervaluation of the quantities of gold exported, but rather a case of pure smuggling of gold out of the country."

In case we misunderstand the term "smuggling" it defines it for us as (UNCTAD, 2016: 28) "cases where imported or exported goods are not recorded *at all at entry into or exit out* of the country." Later (UNCTAD, 2016: 32) it asks: "The question is whether or not illegal gold trade is taking place disguised behind legal trade of other products."

These are astonishing claims. Can they possibly be true? Let's consider the implications.

If SA gold miners hid 67% of their earnings behind understated export income and smuggled production, they must have paid their workers, suppliers of inputs, taxes and dividends out of just 33% of their total income. This means their profit margins were greater than 67% of earnings, making them amongst the most profitable of businesses in the world. Gold miners should have been queuing up to mine in SA. This was clearly not the case.

And while the physical gold allegedly either illegally left SA or with false statements of export value, what happened to the funds from the sale of all this gold overseas at full value? All our gold companies are local and would have to declare all earnings, local and foreign, as part of their annual financial statements. Not to do so would mean management is stealing billions of dollars *from their own shareholders*.



But we need not go that far. We can look for corroborating evidence in other data. StatsSA reports SA gold exports monthly and the Reserve Bank records their value as a line item in our quarterly balance of payments. The Chamber of Mines reports volumes of gold production, the value of which can be easily estimated using the average gold price for the period, as fixed twice daily in London and reported globally.

The Chamber of Mines commissioned the consultancy Eunomix (2017) to respond to UNCTAD's claim. I was involved in drafting the response. Eunomix (2017) compared these alternative sources with the claimed imports of SA's trading partners. The discrepancy now falls to USD19.5 billion - or $9.8 billion if one allows for the 10% transport costs used in UNCTAD's methodology.

This remaining discrepancy is easily explained if one considers that SA refines gold at the Rand Refinery for the whole of Africa. Today that represents almost half the Rand Refinery's output. SA correctly does not count this refined gold from the rest of Africa as our exports. But it is quite possible that importers sometimes fail to make that distinction in recording the true origin of gold purchases.

The reasons UNCTAD's export figures are so much lower than other official SA sources is that SA – in line with international reporting standards - did not record gold exports by destination. Most gold exports were lumped together as "unclassified". The UN Comtrade database's data of exports by country therefore ignores most of SA's gold exports.

This error – and other perceived problems with the Report's methodology - were quickly pointed out to UNCTAD by StatsSA and a number of commentators. UNCTAD's response in a December 2016 revised report was to leave all its other claims unchanged but to revise down its claimed underinvoicing of SA gold exports to $57 billion, but for only the period 2000-10. This revision was based upon dti data for exports of what is described as "non-monetary gold". These "non-monetary" exports were compared to reported imports by trading partners which were assumed also to be "non-monetary" gold. The difference, UNCTAD (2016) continued to claim is "*prima facie* indication of export misinvoicing".

In sticking rigidly to its methodology, UNCTAD continued to ignore all other sources of gold export data readily available in SA. It refused also to accept that the reported imports of SA's trading partners must surely include both "non-monetary" and "monetary gold". If this were not so, the monetary gold would have to be recorded as imports elsewhere – but they are not. Importantly, for UNCTAD's distinction between "monetary" and "non-monetary" gold to be true, SA's physical gold production would have to be double what is actually the case.

Eunomix (2017: 39) concludes: "The reality is that the UNCTAD study is double-counting by arguing that South Africa's "monetary gold exports" are not the same thing as the trading partners' "non-monetary gold". In addition, some non-South African gold processed on behalf of other African countries at the Rand Refinery is being captured in trading partner data."

D. Implications and conclusions

What can we conclude from all this? Firstly, research is an essential part of the "academic project" and it is what we as economists should be doing more of. Many of you have done amazing research with the papers you have presented over the past few days and can feel justifiably proud of your efforts. You have asked the difficult questions and followed the interesting threads in our discipline and shared what you have learnt with others. Many papers will be published in journals and receive wider readership.

But it needs to be more than that. We need to frame our arguments in ways that are accessible and helpful to a wider audience – especially policy makers. Economics is sometimes called "the dismal science", possibly because we often hide our work behind complicated formulae and obscure jargon. The methodology need not change, but for the results to shine through they must be put "out there" in ways that make sense to others.

The two claims I have presented have tried to do the opposite – they have hidden behind their methodologies to produce findings that others are expected to take at face value. This is neither good economics or good science. And I have further tried to argue, it is damaging for sound policy making and meaningful debate.

What I have tried to show is that there are lots of different ways to identify any possible errors – big or small – in our findings *before* going to print. As economists, we must actively seek ways to test our findings against other data to ensure it is accurate and true.

It means we need to be much more careful about seeking verification for our findings only from like-minded individuals – those working in the same area as ourselves. The UNCTAD report, for example, cites a number of reports that use its methodology. This is little help if all suffer from the same errors. Or if the method works better for some types of goods but is hopeless for others.

When looking for co-authors, referees, external examiners and assessors of our work we should be more open to looking for others than just those with the academic credentials. If we are writing about things that are bread and butter in real life for experienced professionals, we should seek their guidance and value their judgement. We may do the modelling, but they can tell us if our results make sense.

Finally, we must be mindful always of the maxim that if something cannot possibly be true…… then it isn't.

We must also recognise the limits of both our experience and discipline. To quote Keynes, "'economists should be humble, like dentists'".

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