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MACROECONOMIC POLICY RESPONSES TO THE COVID SHOCK AND IMPLICATIONS FOR RECOVERY IN SOUTH AFRICA

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LONG-TERM DEVELOPMENT PERFORMANCE – 2010 to 2019

South Africa is the only major upper-middle income country in Sub-Saharan Africa and constituted 18.6% of the sub-continent's GDP (as measured in USD) in 2020. South Africa's ratio of investment (at 12.4% of GDP) is well below the sub-continental average (22.2%) and any of the case study countries. South Africa is the only case study country with net foreign direct disinvestment. In respect of international trade, South Africa is the most open SSA economy with 30.2% of GDP comprised of tradables (exports and imports). GDP per person is well above the SSA average (Int$ 12 932 vs Int$ 3 926). Extreme poverty stands at 18.7% versus the SSA average of 42%; but inequality is notably higher (0.63 vs 0,49). The structure of South Africa's labour market is markedly different from elsewhere on the sub-continent with 83% of the labour force employed in the formal sector (vs 25%) and 10% in the informal sector (vs 56%). Uniquely, a greater proportion of women are employed formally than men.

01 Growth and Investment

- South Africa experienced structural deceleration of growth into stagnation over this period.
- Rates of investment decelerated into decline since 2016.
- Foreign direct disinvestment has been accelerating and currently stands at -0,1% of GDP.
- In 2010, S&P Global Ratings rated SA's foreign currency sovereign risk at an investment grade of BBB+, in 2012 BBB, 2014 BBB-, in 2017 to BB and in 2020 to BB- (speculative grade).

02 International Trade

- Growth of trade in exports and imports has been more anaemic than that of the domestic economy.
- The deceleration of tradables growth has impacted imports more than exports leading to a decline in the current account deficit to -3% of GDP by 2019.
- Surpluses on the financial account have been insufficient to counter the current account deficits since 2016.
- The ZAR depreciated against the USD by an average -7.85% per annum during this period.

03 Employment and poverty

- There has been no increase in per capita GDP for a decade, and since 2016, they have been declining at -0.7% p.a.
- Levels of extreme and absolute poverty have been rising.
- This is despite rising [female] labour force participation rates and a shift from informal and domestic to formal employment until 2016 whereafter trends reversed.
- Public sector employment has partly compensated rising casualisation of formal private sector employment, and stubbornly high unemployment.

LONG-TERM DEVELOPMENT PERFORMANCE – 2010 to 2019

The relative weight of government revenue and spending as a proportion of South Africa's GDP is well in excess of the Sub-Saharan African average (27.9% vs 15.9% of revenue and 40.1% vs 22.8% of spending in 2020). Furthermore the deficit gap is much wider (-12.3% vs -4.9%). General government gross debt stands at 77.1% of GDP, compared to an SSA average of 57.8%. The capacity of the central and commercial banking system to finance rising government, corporate and household debt is correspondingly greater. The broad money supply (M3) is valued at 82.9% of GDP (vs 38.7% for SSA) and banking assets at 136.5% (vs 76.5%). The South African Reserve Bank (SARB) has been significantly better able than other African central banks in containing growth of the money supply and inflation. South Africa's financial markets are deeper, more diversified and more concerned with capital adequacy ratios (which have been consistently above the minimum 8%) than for other African banks which are more focused on shorter term operational debt and liquidity coverage.

Fiscal affairs

01

- Government revenue growth has been decelerating slower than the economy; whilst spending growth has accelerated over the period.
- Consequently, budget deficits have been rising, in contrast to the SSA average.
- Government revenue composition has shifted from corporate income, property and value added tax to personal income and fuel taxes.
- Government spending has shifted from infrastructure, economic and security services to education and health, with significant increases to social security but particularly to interest repayments.

Monetary affairs

02

- Growth of the money supply has generally kept pace with nominal GDP growth, in contrast to most SSA countries where M3 growth consistently exceeds nominal GDP.
- SARB has therefore managed to contain inflation within its 3-6% target.
- SARB has used traditional instruments of open market operations, reserve requirements and interest / repo rate policy, rather than quantitative easing.
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Financial affairs

03

- As a G20 member, South Africa is signatory to the Basel accords which set minimum capital adequacy and liquidity coverage ratios for commercial banks, especially systemic players.
- Bank capital to assets ratios increased in the five years following the Basel accords but have been drawn down since 2016 in tandem with general economic performance.
- Liquidity reserves to assets, loan to deposit and non-performing loan ratios have all been declining – implying a tightening up of credit markets.

THE COVID SHOCK – 2020-21

Impact on Growth and Investment

- GDP contracted by -7% in 2020, investment by -34% and foreign direct investment by -240% as a result of international trade and travel restrictions and domestic lockdown.
- The most severely impacted industries were respectively construction, transport, tourism, manufacturing, mining, commerce, finance and personal services. Information and communication, public services and agriculture grew in real terms.
- The shock was less severe in the rest of SSA. GDP contracted by -2%, investment by -8% and foreign direct investment by -20%.

Impact on International Trade

- In USD terms, imports contracted by -26.3% and exports by -13.3% enabling an unexpected benefit in the form of a current account surplus of 2.2% of GDP in 2020.
- However, this was more than counteracted by a net outflow from the financial accounts of -2.7% of GDP.
- The ZAR lost -13.9% of its value against the USD during 2020
- For the rest of SSA, exports declined by -16.8% while imports contracted by -13.1% thereby raising current account deficits to -3.7% of GDP.

Impact on Employment and Poverty

- Per capita GDP fell by -8.3% during 2020 (compared to -4.5% for the sub-continent).
- Employment rates dropped from 42.7% of the population in 2019 to 38.5% in 2020.
- Registered unemployment increased from 28.2% of the [formally employed] labour force in 2019 to 29.2% in 2020 and is currently 32.6%.
- Whilst survey data is not yet available, one can anticipate shifts into the informal and domestic sectors.
- The World Bank estimates that extreme [food] poverty will have risen by 9% in 2020.

THE COVID SHOCK – 2020-21

Fiscal Policy Response

- The South African government's fiscal stimulus package resulted in additional spending of 5.3% of GDP in 2020, raising the level to 40.1% of GDP.
- Most of the additional spending (74%) has been redirected into social security spending (notably the Social Distress Relief Grant to the food-poor and the expansion of unemployment insurance), 15% to health, 10% to utility bill deferrals and the rest to MSME support.
- Tax subsidies and deferrals amounted to 1.5% of GDP, whilst a further 0.4% revenue loss can be attributed to economic contraction. Government revenues constituted 27.9% of GDP in 2020.
- The government deficit thereby widened from -5.3% of GDP in 2019 to -12.3% over 2020, more than double the SSA average.

Monetary Policy Response

- The South African government also announced liquidity support measures to the tune of 4.1% of GDP, in the form of loan guarantees directed through the Industrial Development Corporation to be channeled separately to corporates and MSMEs
- To accommodate a total stimulus package of 10% of GDP, the money supply increased by 9.5% over 2020 whilst banking assets as a proportion of GDP rose by 17% of GDP.
- To encourage lending, the SARB dropped the repo rate from 6.5% to 3.5% in 2020. This is lower than the inflation rate of 5.3% and thus negative in real terms. There remains scope for further rate cuts.
- SARB has continued to use open market operations to shift the term structure of national debt rather than adopting a generalized QE approach.

Financial Policy Response

- The Prudential Authority lowered both liquidity coverage and capital adequacy ratios on commercial banks in good standing; and advised against the distribution of dividends and bonuses to senior executives..
- Whilst banks dipped into their liquidity reserves as the non-performing loans ratio jumped from 3.9% to 5.2% of loan value; they also tightened credit by significantly lowering the loan to deposit ratio and increasing capital reserves.
- In respect of the management of national debt, the South African government applied for the IMF's Rapid Financing Instrument (RFI) in July 2020 to the value of 1.4% of GDP. This is a short-term loan intended to stabilize the balance of payments, repayable over the medium-term, and without the need for technical assistance or policy reform.

RELIEF AND RECOVERY FORECAST PERIOD – 2021 to 2026

In its forward projections, the IMF has generally predicted a rapid, short-term recovery for 2021, followed by a medium-term resumption of the [country] structural growth (and development) path over the three-year budgeting horizon to 2024 and the five-year strategic planning horizon to 2026. During the course of this year, it has become apparent that the lifting of international trade and travel restrictions and domestic lockdowns is dependent on the progress of the Covid vaccination rollout. Divergences between advanced (upper-income), emerging (middle-income) and poor (low-income) countries in their recovery paths is most probable. Richer nations can afford and have the capacity to rollout mass vaccination programmes. Further, they can afford to provide debt relief and donor aid to low-income countries, most of which are in SSA. Middle-income countries have neither the domestic fiscal capacity for a prolonged stimulus, nor are the advanced economies able to offer debt relief on the scale required.

01 Growth and Investment

- The IMF's originally predicted 3.1% growth for 2021 decelerating over the medium-term to the structural trend line of 1.3% p,a, Investment is expected to bounce back rapidly for two years and then decelerate whilst raising its share of GDP from 12.4% to 17.1%
- First quarter 2021 results from SARB suggest the GDP prediction has held up so far, but that investment continues to decline rapidly. Hence current growth is consumption-led.
- Following the damages of July's unrest, a 3% contraction of GDP is expected for 2021, implying a medium-term recession to 2023.

02 International Trade

- Imports continue to fall faster than exports although projections supposed imports rising faster than exports.
- Over the short-term, current account surpluses may not be able to counter financial outflows thereby stressing the balance of payments and requiring [further] RFI financing or negotiation of further debt relief.
- After a short-term appreciation in 2021, the IMF predictions suggest ongoing but decelerating depreciation of the ZAR:USD exchange rate.

03 Employment and poverty

- Given assumptions on a medium-term recession until 2023, there is room for debate on the rate of decline in per capita incomes, the increase in [structural] unemployment, the shift into informal and domestic sector employment and the increase in absolute and extreme poverty.
- It is less clear, in the absence of more frequent household surveys, whether income inequality will widen or narrow, whether the gender gap in formal employment will dissipate or widen, and whether labour force participation rates will increase or decline.
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RELIEF AND RECOVERY FORECAST PERIOD – 2021 to 2026

Many low-income SSA countries can, and have, applied to the IMF for progression up the debt relief ladder. Debt relief is granted in the event of balance of payments crises. Specifically, this means less than 3 months of import cover, less than 100% coverage of short-term debt and less than 20% of M2 as a buffer against capital flight. Progress from a Rapid Financing instrument (RFI) through a Rapid Credit Facility (RCF) to an Extended Credit Facility (ECF) implies progressively longer maturities, loan concessionality and policy commitments to (a) poverty relief, (b) government deficit reduction and (c) reaching and sustaining Basel Accord capital adequacy and liquidity coverage ratios. As a middle-income country, South Africa can prepare for a possible extension of such debt relief facilities to middle income countries or take the IMF requirements as a benchmark for financial resilience. As a G20 member, South Africa does not qualify for the Debt Service Suspension Initiative (DSSI) between bilateral creditors.

Fiscal policy implications

- Without the expected bounce-back in investment and economic growth, official projections of a slow recovery of spending supported by a faster rise in revenue to induce a steady deficit reduction may be optimistic.
- A proposed 3% increase in the VAT rate to 18% with which to support a basic income grant might restore a path to deficit reduction (assuming no further stimulus)
- Prioritisation of spending is respectively towards interest (an external constraint), social security (a policy choice), health (an external constraint) and away from education, industrial development, security and infrastructure.

Monetary policy implications

- Through its proposed liquidity support stimulus package, the government is effectively shifting the funding of industrial development (and potentially infrastructure) to development banks by guaranteeing loans.
- The SARB can engage in selective open market operations to nudge credit into development finance instruments, and has the capacity to lower the repo rate further.
- If inflation targeting is to be sustained as predicted, growth in the money supply will need to be restrained through reserve requirements and micro-prudential regulation.

Financial policy implications

- Despite relaxation of Prudential Authority liquidity and capital adequacy requirements, commercial banks have built their capital reserves perhaps in view of a prolonged recession. The PA may have to review its liquidity requirements in the face of non-performing loans.
- If balance of payments crises persist with ongoing capital flight, the government may apply for any further SDR allocations through the Rapid Financing Instrument.
- It remains to be seen whether South Africa can progress to the longer-term Rapid Credit Facilities of the IMF.

01

Debt relief negotiations

Like many SSA countries, South Africa's external debt has been rising faster than its domestic debt burden. As advanced economies wind down their stimulus packages and raise interest rates to curb inflation, destabilising financial account outflows can be expected, South Africa might apply for a further RFI allocation or use its position in the G20 to negotiate extension of RCF and ECF facilities to other middle-income countries.

02

Financial resilience

South Africa's approach to shifting industrial [and infrastructural] development off budget poses risks for SARB in managing national debt. As a G20 member and signatory to the Basel Accords, South Africa has limited leeway over the medium-term to run down its banking sector capital reserves, whereafter the PA may be forced to reimpose its liquidity and capital adequacy requirements.

03

Fiscal inclusivity

Debt negotiations may provide some short- to medium-term relief on interest payments with which to release funds for education and security services. However, priority to social security and health is the best fiscal tool to counter poverty and under-employment. VAT is an income regressive method of revenue raising unless differential rates are applied between basics and luxury goods. The recent G20 agreement on a global minimum corporate income tax may serve to counter capital flight due to tax rate differentials.

04

Green investment

With the possible exception of Nigeria, most SSA economies including South Africa have not given priority to decarbonizing [or circular economy) industrial and infrastructure strategy formulation. A shift towards guaranteeing development finance loans is an opportunity to review an enhanced role of DFIs in incentivizing or risk subsidizing green investments and MSME involvement in economic development.

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