THE REAL ECONOMY BULLETIN
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Briefing Note:
The unbalanced economy: a cause for concern

Since the first quarter of 2015, the South African economy has experienced its worst period of growth since the transition to democracy (aside from the global financial crisis in 2009). The economy has been dipping in and out of negative growth on a fairly consistent basis over the past three years.

Slow growth is a cause for concern by policymakers and impacts on the ability of the state to deliver basic services and support industrialisation. To shore up the economy, the national budget has increasingly been going into deficit with the commitment by the government that the deficit would be scaled back once the economy picked up. Using deficit finance to sustain economic growth during periods of downturn combined with strong public sector programmes is an important measure to keep the economy from heading into a downward spiral, keeping jobs intact and preventing the poor from going into desperate poverty.

South Africa's international creditors and investors have started to push back on the budget deficit, and recent public announcements show the government is taking those views very seriously. The risk is that South Africa moves from much needed government "cost containment" measures into budget cuts and full austerity. The easiest place to start cutting is always on capital projects. That would impact on the construction sector, which has already seen three quarters of decline.

Most practical economists agree that austerity would be pro-cyclical and would reinforce the downward trajectory of the economy. Throwing more people into the ranks of the unemployed would likely result in social upheaval that the country cannot afford.

While the slow growth is a cause for concern for policymakers, it is less so for the financial sector. In the past quarter the JSE has reached its highest ever levels. It is a serious bull market and people are earning good returns.

The question is whether this is an asset bubble that will inevitably implode. Given low growth in the economy, the economic fundamentals are clearly not the underlying cause of the stock market appreciation. It appears that we are seeing a delinking of the financial sector from the real economy, due in large part to global financial flows managed by huge institutional investors. The growth on the JSE comes from a global upward trend in stock markets generally – South Africa is just following the international trend.

The answers to the contradiction between fiscal pressures, slow growth and high prices on the JSE are not immediately visible. Keynes would argue that we cannot split the financial sector from the rest of the economy, as firms borrow on the market and are present in the market through their balance sheet and investments.

As we saw in the 2008 financial crises and resulting depression, a financial sector implosion has far-reaching implications for the rest of the economy. In South Africa we lost a million jobs and pushed many people below the poverty line.

A core challenge is that South Africa's stock market capitalisation to GDP is abnormally high at over 300% (the average is 61% for Upper Middle Income Countries, which are South Africa's global peers). There are clearly risks to the financial sector with the current capitalisation of the JSE and a downgrade may see offshore funds being withdrawn. In contrast, the rest of the financial sector has been prudently managed with good governance and normal rates of private credit extension relative to the size of the economy. Arguably, indeed, the economy would benefit from larger and more affordable credit flows to industry.

There is an urgent need for the government and private sector to respond to this unbalanced state. The two immediate priorities are:

- Rapidly addressing high unemployment. In the short run, given the scale of what is required this can only be achieved through public employment programmes. The Community Work Programme is one such initiative that has already reached hundreds of thousands of unemployed people in over 200 sites across the country.
- Supporting significant growth in the real economy, which would require well targeted and run government programmes undertaken in partnership with the private sector. Like other developing countries, South Africa needs to implement a significant Credit Guarantee scheme targeted at manufacturing firms. Such a scheme would crowd in private sector finance and stimulate investment; administration of the scheme by the Industrial Development Corporation (IDC) would give banks and industrial firms a measure of confidence in the approach. Other areas include strengthening incentive support and partnering with structures such as the Manufacturing Circle to address unused capacity and unlock new investment.

Addressing both priorities would in turn restore confidence in the South African economy and policymakers. The options for financing such interventions include reprioritising existing budgets, using off-budget resources or borrowing more. Reprioritising budgets, ensuring state resources are used effectively and for their intended purpose is something that governments should always strive for and there are ongoing efforts on this. Off-budget resources could come through selling non-core state assets; drawing on the Unemployment Insurance Fund (UIF) surplus with agreement from social partners; or requesting the pension funds to do more to finance new productive and infrastructure projects. Regulation 28 allows pension funds to use up to 10% of funds for non-listed investments, and less than 5% has been used in this way. Pension funds have a vested interest in ensuring balance in the economy and protecting the trillions invested in the stock market.

Can South Africa borrow more? Developing countries are often advised to follow the orthodox Washington Consensus approach of roughly 3% of deficit financing and to keep government debt down. Currently, South Africa's deficit is at 5,3%. Borrowing more is a risk for developing countries as they may run into a foreign exchange crisis if they offshore deficit finance beyond a certain amount.

This issue is less of a risk for South Africa given the capital account inflows directed to the stock market, but a sudden withdrawal of funds from the market in the event of a downgrade would have a significant impact on foreign exchange, among other consequences.

South Africa has an unusual level of financialisation for a developing country. The possibilities exist for both the public and private sector to use those resources to grow the real economy (and manufacturing in particular) and address high unemployment to bring balance back into the economy and mitigate the risk of unbridled asset price inflation.