THE REAL ECONOMY BULLETIN

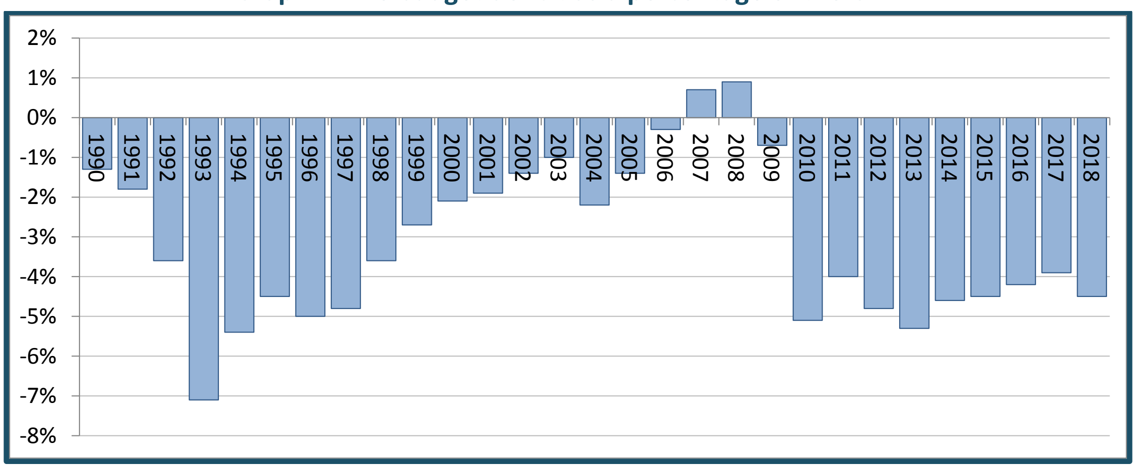
TRENDS, DEVELOPMENTS AND DATA SECOND QUARTER 2018

Briefing Note: Responding to the slowdown

The figures for general government consumption and for public investment point to the pro-cyclical impact of the current fiscal policy, combined with consolidation at the state-owned corporations over the past year. The challenge is to return to a counter-cyclical stance given the limited fiscal space left by the relatively high deficit. Ideally, a stimulus package should be funded through off-budget sources.

In effect, the end of the commodity boom in 2011 meant that the stimulus undertaken in 2008 could not be reduced substantially. As a result, as the following graph shows, the deficit has fallen only slightly from its peak at 5.3% of the GDP in 2013. The failures around tax collection meant that the deficit climbed from just under 4% of the GDP in 2016/7 to 4.5% in 2017/8, largely due to a drop in VAT revenue.

Graph 1. The budget deficit as a percentage of the GDP



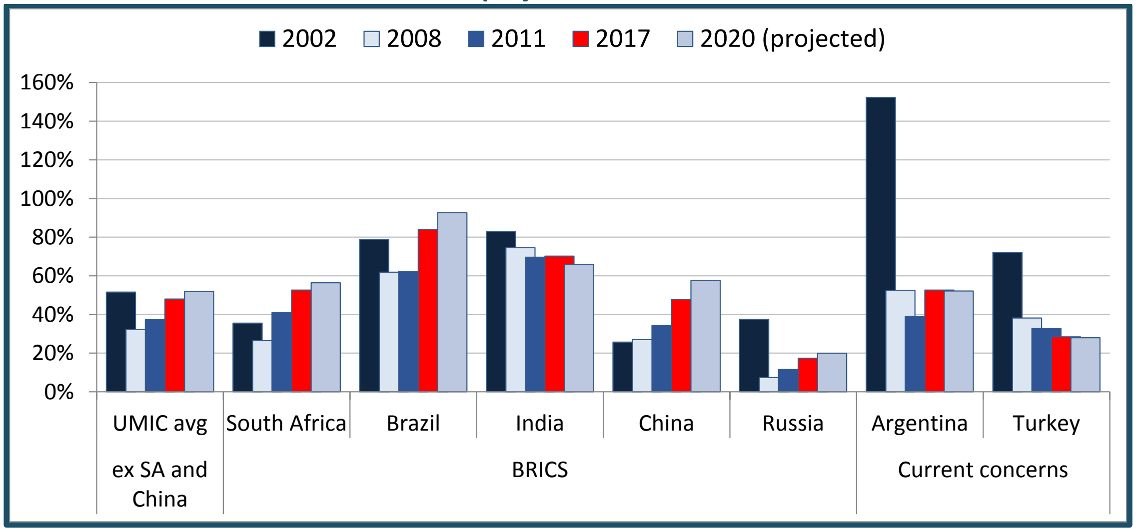
Source: South African Reserve Bank. Interactive dataset. Series on budget deficit as percentage of GDP. Downloaded from www.resbank.co.za in August 2018.

While the deficit is still on the high side, public debt stock in South Africa as a percentage of GDP is essentially at the norm for upper-middle-income economies. As Graph 2 shows, for South Africa the ratio of public debt to GDP remains substantially lower than India and Brazil, and is projected to be slightly lower than China in 2020. Turkey and Argentina (which ranks as a high-income economy) are both currently facing debt crises; they have lower public debt relative to the GDP, but substantially higher private foreign debt than South Africa.

Shifts in the global economy are a further constraint on efforts to finance a stimulus. The increase in interest rates in the US seems likely to encourage an outflow of capital from emerging markets like South

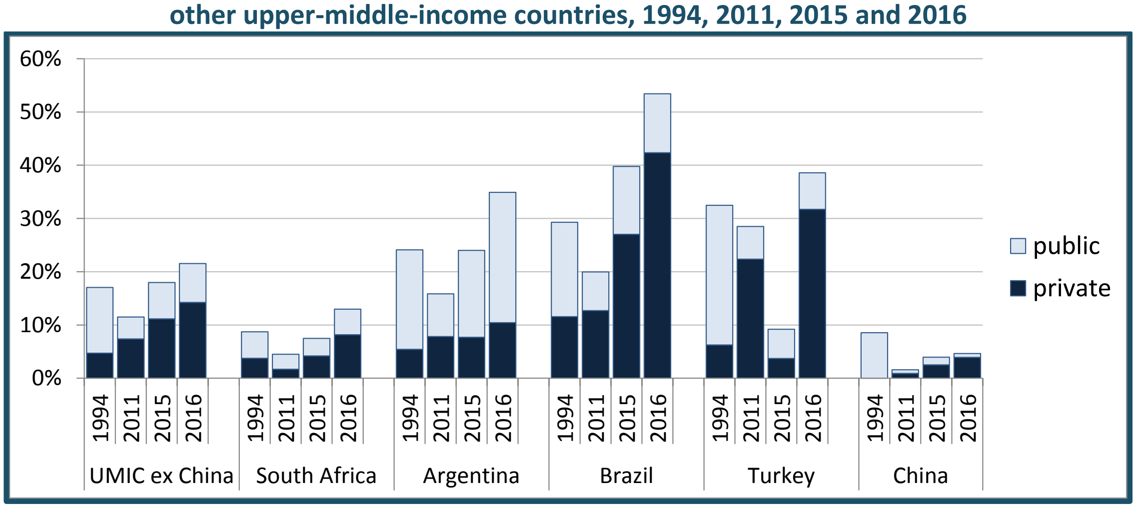
Africa. South Africa's foreign debt is modest compared to other upper-middle-income economies, and much lower than Turkey, Brazil and Argentina, whose troubles have fuelled global concerns about emerging markets. It has, however, risen fairly rapidly in the past few years, in step with peer economies (see Graph 3).

Graph 2. Public debt as a percentage of GDP, 2002, 2008, 2011, 2017 and projected for 2020



Source: Calculated from IMF. World Economic Outlook. April 2018. Interactive dataset. Series on gross public debt as percentage of GDP and GDP for upper-middle-income economies (56 countries reporting).

Graph 3. Debt service payments as percentage of exports for South Africa and other upper-middle-income countries, 1994, 2011, 2015 and 2016



Source: Calculated from World Bank. World Development Indicators. Electronic database. Series on exports and private and public plus publicly guaranteed debt service. Downloaded from www.worldbank.org in September 2018.

South African private foreign debt is relatively low in part because companies have relied instead on portfolio investment through the stock market and on domestic debt. The bulk of government borrowing is also domestic. In contrast to countries that depend heavily on foreign loans, these financing mechanisms mean that while an outflow of funds would lead to further depreciation, it would not directly increase the cost of debt service for local companies.

Given the slowdown in growth combined with a relatively high and prolonged fiscal deficit, South Africa faces two challenges.

First is a need to identify ways to finance a stimulus package sustainably on a large enough scale. Modelling suggests that the stimulus package should be around R60 billion to have a significant impact on growth. Options include a further increase in the deficit; increased off-budget borrowing for capital investment, primarily by state-owned companies; and/or mobilising domestic funds that are currently held in passive investments, particularly in the social security funds and pensions.

Second is a need to develop consensus on the fundamental domestic causes of the economic slowdown since 2014. The noise around the decline in the GDP over the first half of 2018, which is mainly driven by unexplained fluctuations in agricultural output as well as declining state spending, should not distract from the fact that overall performance has been poor over the past five years. An effective response must address the following.

- Concerns around governance and the rule of law. South Africa is still less corrupt than many developing economies, but for decades its strong rule of law and clean government were selling points to investors, both domestic and foreign, as well as to taxpayers. It is therefore more important for South Africa than for other countries to re-establish visibly sound governance. That in turn requires a careful balancing between maintaining the rule of law and bringing about visible improvements in the lives of the majority. It is impossible to sustain good governance in highly inequitable and divided democracies.
- From 2011, producers have had to deal with the simultaneous end of both the global commodity boom and cheap electricity. Their response has been to diversify into other industries to some extent, notably auto exports, food processing and clothing – but also to downsize the metals industry, which has long been a pillar of the economy. There is a need for a much clearer and better defined strategy on how to address this challenge while simultaneously dealing with the structural economic factors that have entrenched high joblessness, not as a cyclical problem, but as an enduring feature of the economy.

Finally, the volatility in reported growth figures for agriculture should be analysed more carefully. They have a disproportionate impact on GDP numbers, which in turn affects investor and voter confidence. But there is no obvious economic reason for the current fluctuations in growth in the sector.