TRADE & INDUSTRIAL POLICY STRATEGIES

TIPS TRACKER

Tracking trends and analysing the COVID-19 pandemic and responses

THE ECONOMY AND THE PANDEMIC

24 AUGUST – 6 SEPTEMBER 2020

KEY FINDINGS

On the pandemic

- The number of new diagnoses of COVID-19, which started to decline rapidly in mid-July, levelled out at an average of just over 2 000 a day in the week to 6 September. In contrast to the move to Levels 4 and 3, however, three weeks after Level 2 started on 18 August reported infections had not risen sharply.
- A review of international data shows that countries with higher reported death rates from COVID-19 can also expect a sharper economic decline. Countries with lower death rates, in contrast, generally also had better economic results. The lowest reported death rates emerged in two kinds of countries: in states that controlled the spread of the pandemic through strong public health measures; and in low-income economies characterised by limited international air links, largely rural populations, and low testing rates.

On the economy

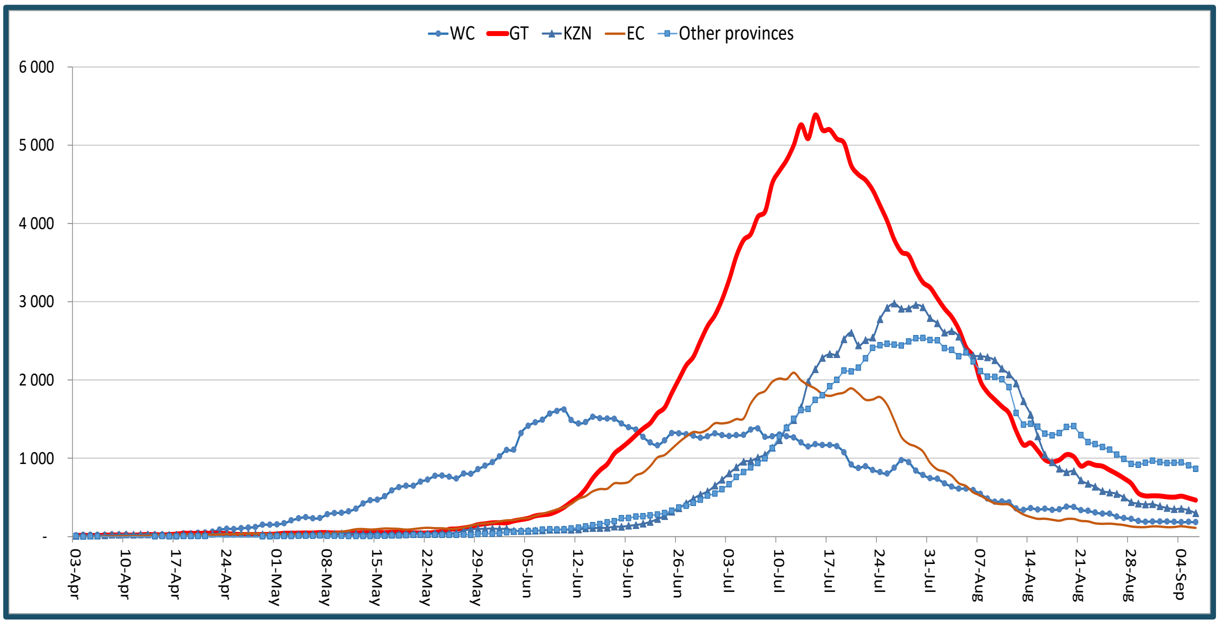
- The move to Level 2 brought an initial increase in economic activity. Overall, the available indicators suggest that economic activity has returned to around 10% below pre-pandemic levels. The Western Cape, however, continues to lag behind.
- The recovery has run up against loadshedding by Eskom. Yet government expects to finalise its emergency acquisition of 2 000 MW of new power from private suppliers only in mid-2022.
- Case studies of steel and tourism underscore that economic recovery will require more than broad government measures to control the pandemic, stimulate demand and fix the electricity supply. In many industries, new business models are required to survive, and that imposes tough choices around write-offs of assets and employment. The particularly stark challenges facing tourism help explain the relatively slow recovery of the Western Cape economy.

THE TIPS TRACKER: THE ECONOMY AND THE PANDEMIC
IS PUBLISHED EVERY TWO WEEKS

TRENDS IN THE PANDEMIC

Since the move to Level 2, the number of COVID-19 diagnoses has stabilised at around 2 000 a day. While reported new cases continued to decline slowly over the past three weeks, they were no longer falling at the fast rate seen since the peak of around 12 000 a day in mid-July. Instead, they have essentially plateaued at levels last seen in early June, around four months into the pandemic.

Graph 1. Reported new cases by province, 3 April to 6 September (seven-day rolling averages)



Source: Calculated from data accessed at www.sacoronavirus.co.za on relevant dates.

South Africa as a whole saw an average of 3,5 new cases per 100 000 residents in the week to 6 September, down from over 20 in mid-July. By international standards, that put it in the yellow zone, with significant but manageable community spread. Only the Northern Cape had over 10 new cases per 100 000 residents, but the number had fallen from almost 50 per 100 000 in the first week of August.

The stabilisation in reported new cases indicated that transmission nationally[1] had risen from a statistical average of around 0,6 per case to 0,9 per case. That is, at the time of the move to Level 2, every two reported cases resulted in just over one additional infection; as of 6 September, reported new infections for every two existing diagnoses had risen, on average, to nearly two. For comparison, in early June, when the number of new diagnoses daily was around the same as it was on 6 September, the transmission rate was 1,6 – that is, every two new cases led to more than three new infections.

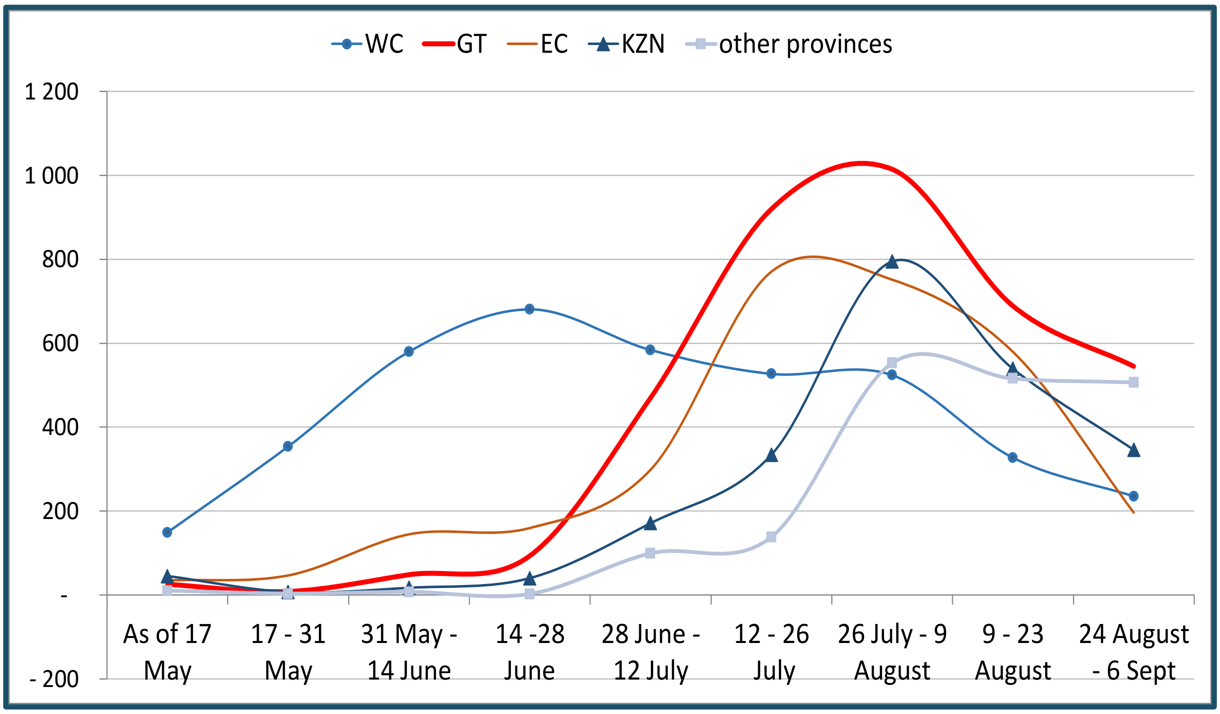
If the rate of transmission does not continue to increase from its current level, the number of new diagnoses will continue to fall, albeit very slowly. Even a small increase in the rate of transmission, however, will bring a renewed surge in cases.

[1] Measured as the ratio of new diagnoses to reported new cases seven days earlier, using rolling seven-day averages.

The share of tests with positive results stabilised at around 11,5% over the two weeks to 6 September. During most of July, in contrast, it hovered around 27%. The World Health Organization considers that the contagion is under control only when the rate falls below 5%.

The number of deaths declined sharply, in line with the fall in new diagnoses a few weeks earlier. In the week to 6 September, 861 deaths from COVID-19 were reported, down from over 2 500 in the third week of August.

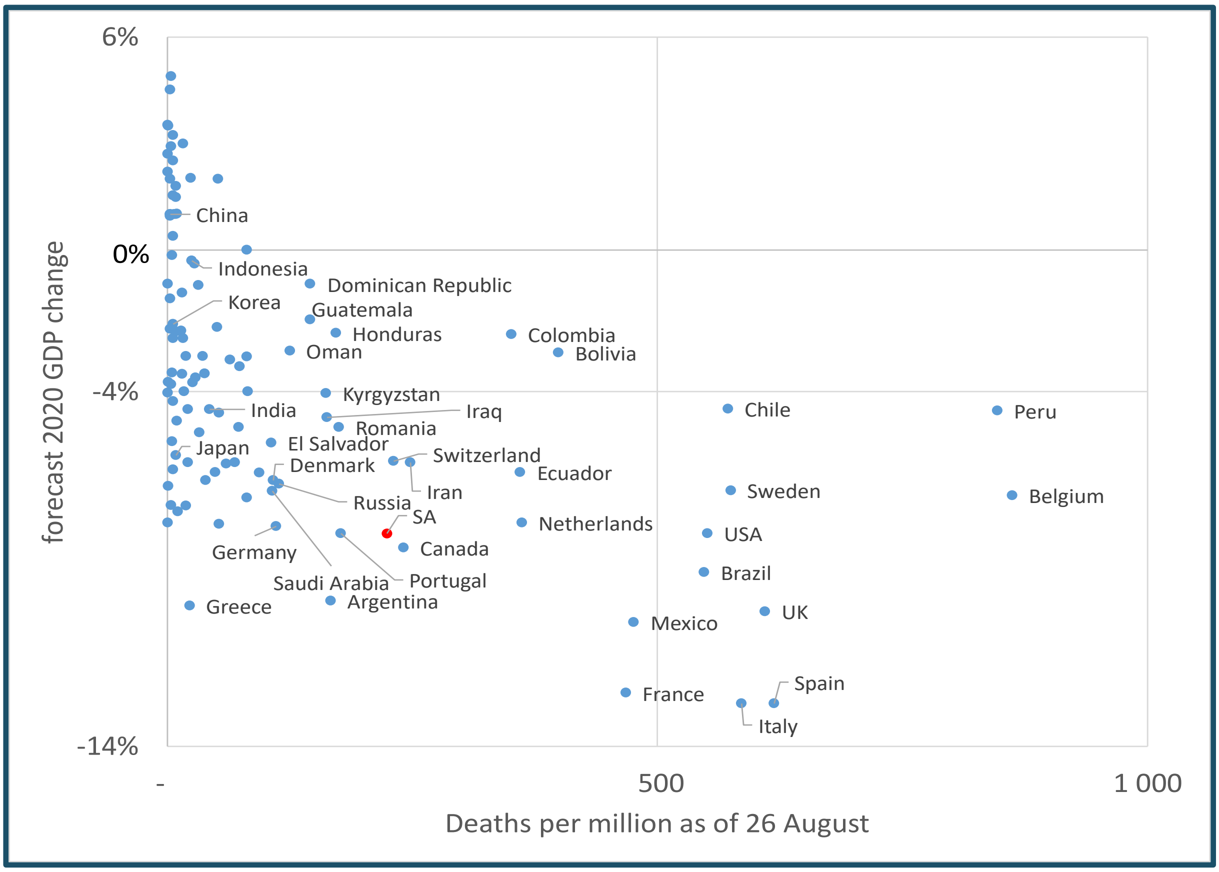
Graph 2. Reported deaths from COVID-19 by province in two-week intervals, 17 May to 6 September



Source: Calculated from data accessed at www.sacoronavirus.co.za on relevant dates.

To date, the much-heralded trade-off between lives and livelihoods has not been borne out by international experience. Instead, the International Monetary Fund (IMF) forecasts that countries with relatively high levels of COVID-19 will also see slower growth for 2020. In contrast, the only countries expected to avoid a sharp downturn have either controlled the virus or avoided the contagion altogether. The high level of transmission in July and August means that South Africa has experienced a relatively high number of deaths per million citizens, despite the comparatively high recovery rate.

Graph 3. Deaths per million and forecast growth rate for 2020



Note: Countries with over five million residents. *Source:* Deaths per million from Worldometer. Reported Cases and Deaths by Country, Territory, or Conveyance. Downloaded on 26 August 2020 from https://www.worldometers.info/coronavirus/#countries. GDP forecasts from the International Monetary Fund, World Economic Outlook, June 2020 Update for larger economies, as provided; for other countries, World Economic Outlook for April 2020. Accessed at www.imf.org in August 2020.

Unfortunately, the countries with high death rates and sharper economic downturns include the United States and most of the European Union (EU), which are key trading partners for South Africa. In contrast, relatively low death rates are reported for two groups of countries. First, a number of high-income Asian and island economies, including China, South Korea, Japan and Vietnam, have managed to control the pandemic through strict public-health measures. Their strategies rely on mask wearing and limits on social (but not economic) activities; contact tracing and isolation of suspected cases; and restrictions on international travel. Second, many low-income economies appear to have avoided the contagion altogether because they never had much air travel and have large rural populations. That said, many of these economies also have limited testing and death registrations, so the cases may be understated.

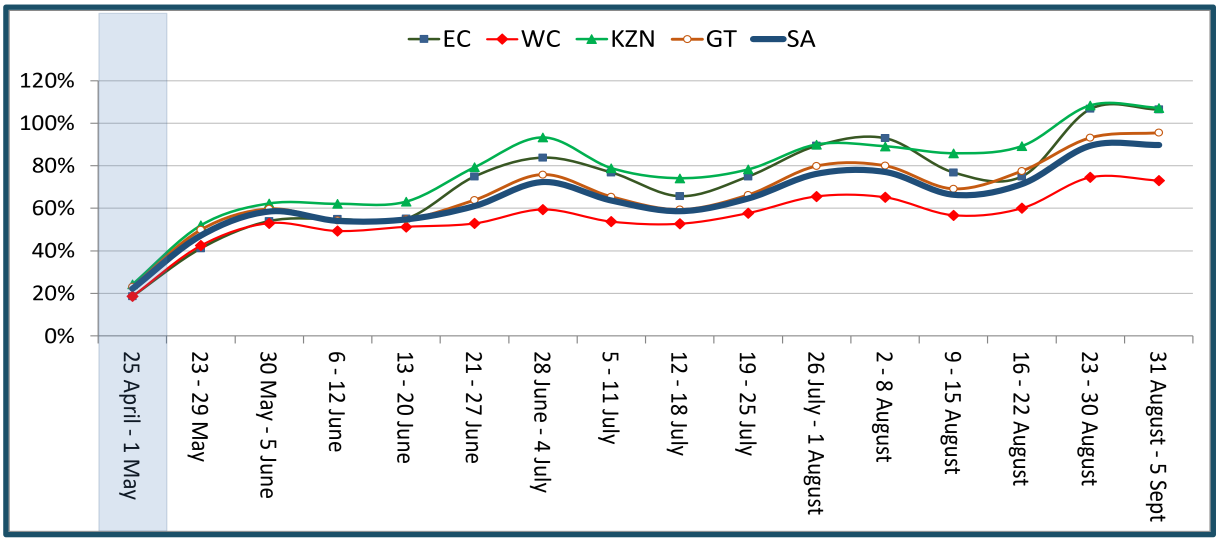
TRENDS IN THE ECONOMY

Overall developments

The economy appears to have enjoyed a fairly substantial boost with the move to Level 2 in the middle of August. The available indicators suggest that it has now levelled out at around 10% lower than in January. The Western Cape continues to lag behind the other provinces, which may be due to the havoc the pandemic has wrought in international and national tourism.

The Yoco index of small business turnover is affected by the wage cycle, with a regular boost at the end of the month. It suggests that in most of the country, the move to Level 2 led to a significant increase in economic activity. In most provinces, its customers have returned to pre-pandemic levels of turnover. In contrast, in the Western Cape turnover remained around 25% below early March.

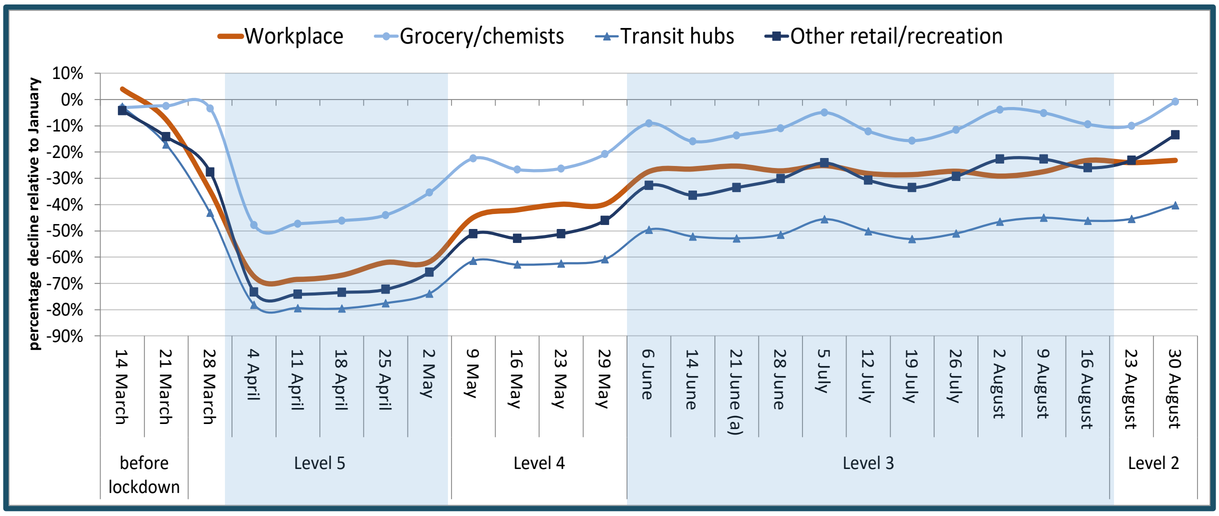
Graph 4. Small business turnover relative to the first two weeks of January, average for week to Saturday through 5 September



Source: Calculated from Yoco Small Business Recovery Monitor. Downloaded at www.yoco.co.za, relevant dates.

A similar picture emerges from figures for travel. Google's report on mobility in South Africa shows that travel to work remained virtually unchanged at around 75% of the January level in the last two weeks of August. In other words, the introduction of Level 2 did not have much impact on the number of commuter trips. In contrast, retail and recreational trips increased around 10% in the week to 30 August, although the figures were affected by payday at the end of the month. As a result, grocery and pharmacy shopping reached levels last seen in January, while other retail and entertainment trips climbed to just 13% below January figures.

Graph 5. Percentage change in travel by type of destination, weekly average from week to 8 March to week to 30 August, compared to January 2020 (a)

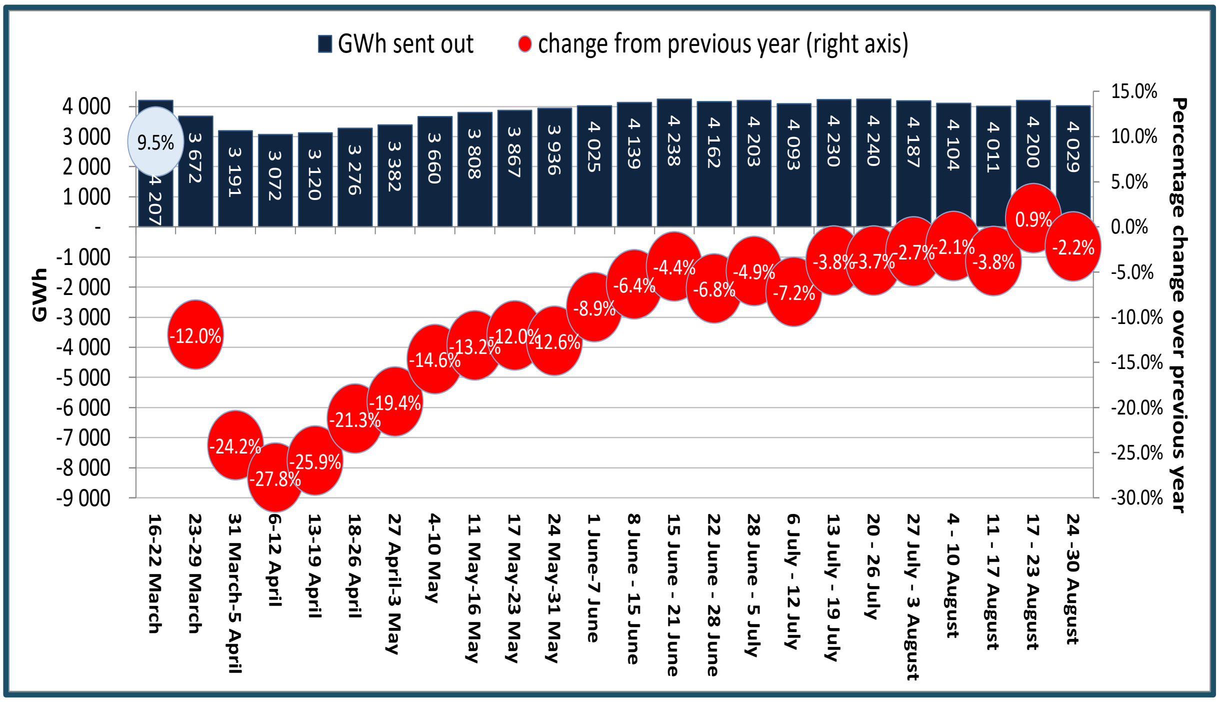


Note: (a) Data for week to 16 August exclude 10 August, which was a holiday, and may not be fully comparable to other weeks. *Source:* Calculated from Google COVID-19 Community Mobility Reports. Accessed at https://www.google.com/covid19/mobility/ on relevant dates.

At provincial level, the Western Cape continued to lag the rest of the country. Trips to work in the Western Cape remained nearly 30% below January levels. In Gauteng, they were around 25% lower than before the pandemic. In other provinces, the shortfall ranged from almost 20% in the Eastern Cape and KwaZulu-Natal to about 5% in Limpopo. The Western Cape also saw the least recovery in terms of shopping, recreation and public transport. Travel in the province for these three purposes remained around 10% below the rest of the country.

As the economy has opened up, loadshedding has again become a binding constraint. Eskom remains unable to maintain and repair its generation capacity and simultaneously meet national demand for electricity. As a result, in the last week of August electricity sent out dropped to 2% below 2019 levels. In the first week of September, loadshedding reached stage 4 for a few days. Eskom expects the situation to stabilise in a year to 18 months. If rationing continues over this period, however, it will hobble recovery from the pandemic.

Graph 6. Electricity sent out in GWh, weekly, 24 March to 30 August, and percentage difference from the same week in 2019



Source: Calculated from Eskom System Adequacy Reports for relevant weeks. Accessed at http://www.eskom.co.za/Whatweredoing/SupplyStatus/Pages/SupplyStatusT.aspx.

In theory, government agreed to facilitate private generation from the end of 2019 so as to give Eskom space to fix its own capacity. In practice, only around 60 MW has been approved to date, in the form of projects generating under 1 MW that are embedded in companies. The Department of Mineral Resources and Energy issued a request for proposals for 2 000 MW of electricity from larger operators on 24 August. It expected to finalise agreements some eight months later, in April 2021. The projects would become operational no later than June 2022, or just under two years from now. Based on an earlier request for information, the Department anticipated investments worth a total of R40 billion.

SECTORAL RECOVERY STRATEGIES

As emergency restrictions on economic activity fall away, it has become increasingly clear that recovery will require new business models as well as national measures to stimulate demand and limit transmission of COVID-19. Over the next few months, this Tracker will explore the challenges facing different industries, starting in this issue with steel and tourism.

In the case of steel, the return to production means it is no longer possible to delay decisions around pricing and profits along the value chain. The outcomes will have profound implications for some of South Africa's largest companies and for manufacturing jobs.

For tourism, the challenge is how to manage the sharp fall especially in overseas demand, which is expected to pick up at the earliest in six months to a year.

The steel value chain

The steel value chain runs from iron-ore mining to the production of basic iron and steel, which is used in a wide array of manufactured products, from structural steel for construction to the auto industry, capital equipment and kitchenware. Even before the pandemic, the competitiveness of steel manufacturing (excluding ferroalloys) was undermined by high input prices combined with the unreliable electricity supply. For a strong recovery from the COVID-19 crisis, these issues must be addressed, which will in itself be highly disruptive.

The steel value chain as a whole accounted for almost 5% of gross domestic product (GDP) in 2019, with iron-ore mining at 1%; basic steel production at 0,5%; and downstream manufacturing adding 2,7%, mostly from auto and machinery production. Downstream steel manufacturers accounted for nearly half of South Africa's exports of manufactures and generated over 300 000 formal jobs, or a third of manufacturing employment. Iron ore and steel production together accounted for an eighth of exports (down from a seventh at the end of the global metals price boom in 2011) and added around 50 000 more jobs.

The COVID-19 crisis brought production and sales crashing across the steel value chain. First quarter exports of iron ore, steel and cars were affected by the global slowdown set off by the disruption of trade with China. Around 90% of iron ore is exported, mostly to China, and it was the most affected in the first quarter, with production volumes falling by over half from January to March. In April, the lockdown led to a far sharper decline. Iron-ore output dropped a further 40%, to around a quarter of its level in January. Machinery and equipment production fell 50% by volume; structural steel and other basic steel products, around 75%; crude steel, over 80%; and auto, almost 90%. In contrast, the rest of manufacturing shrank by around a third in April.

Recovery has been uneven along the value chain, with crude steel and auto lagging behind. By June, the latest available figures, production of machinery and steel products was around 15% below March levels, which was in line with manufacturing as a whole. In contrast, raw steel and transport equipment was still down by over 30%. Iron ore output was only 7% below March levels, but that was still only around half as high as in January.

ArcelorMittal South Africa (AMSA) accounts for the bulk of crude steel production. According to its interim report, In the first half of 2020, its production was half as high as a year earlier, with a loss of R2,6 billion or four times its loss in the first half of 2019. It had already put its Saldanha plant on care and maintenance in the first quarter of 2020, and in the second quarter it shut down two more furnaces at plants in Gauteng. It argued that even though it could legally reopen production, low demand meant it anticipated reaching only 75% of pre-pandemic production levels for the foreseeable future. The biggest fall in demand came from construction, auto and machinery, with agriculture, packaging, home improvements and infrastructure less affected. That said, two fifths of its losses reflected higher financing costs as a result of depreciation, since its debt is largely denominated in foreign currencies.

The crisis in the steel value chain will be aggravated by the relatively early recovery in China, which accounts for just over half of global steel production and virtually all of its growth over the past 20 years. From February to July, China's steel output climbed 25%, while South Africa's dropped 23% and the rest of the world fell 15%. Its share in global steel production jumped from 54% in the first quarter of 2020 to over 60% in the second quarter.

In response to the crisis, the bargaining council for the steel industry agreed on a wage freeze. But the challenges faced by the value chain go far deeper, which is why stakeholders agreed to develop a Master Plan in 2019, facilitated by the Department of Trade, Industry and Competition. The core concern was that value added in iron ore and in crude and structural steel declined from 2014 to 2019, and was essentially flat in the rest of steel manufacturing.

Three fundamental problems led to this outcome.

First, the division of rents from South Africa's small but high quality iron-ore mines has historically benefited upstream ore and steel producers rather than downstream manufacturing. Anglo American's Kumba mining supplies AMSA, which in turn provides most locally produced steel. Until the early 2010s, AMSA had an arrangement to get iron ore from Kumba at a cost-plus price rather than matching the cost of imports. It still, however, sold steel to local manufacturers mostly at the international price. In effect, then, it captured most of the rents from South Africa's small but rich iron ore deposits. Kumba was able to break the contract around 2013, however, at which point it began to charge AMSA first import parity and later export parity prices. That in turn put AMSA's long-term profitability in doubt, but did not moderate the cost of steel for local manufacturers.

In response, AMSA lobbied to hobble imports of cheaper steel. Around 20% of crude steel was imported in the late 2010s, partly to meet demand for specialty products that are not produced locally and partly because it was cheaper as a result of a global steel glut. AMSA succeeded in getting a tariff to prevent dumping, which effectively maintained higher steel prices for downstream producers. In its interim report in mid-2020, AMSA noted that the global steel price had declined 10% in US dollars, but the depreciation of the rand meant that the domestic price remained unchanged.

Second, steel production and fabrication rely on stable, affordable electricity and bulk freight. Eskom's tariffs more than doubled over the past decade in real terms, however, while loadshedding and, for larger customers, on-going rationing of electricity became the norm from around 2015. AMSA estimated that loadshedding, disruption of rail services as a result of cable theft, and above-inflation increases in Eskom and Transnet tariffs accounted for around a tenth of its losses in the first half of 2020.

Finally, AMSA's business model became increasingly tenuous. On the one hand, it depended on large, integrated plants, some of which were founded in the 1920s. These plants could not easily compete with the newer technology that has emerged around smaller, cheaper, cleaner and more flexible mini-mills. On the other hand, the global glut in steel has led AMSA's foreign parent company, ArcelorMittal, to rationalise its international production. This appears to have been a factor in the closure of AMSA's Saldanha plant, as AMSA simultaneously expanded imports from other Arcelor subsidiaries. Downstream manufacturers told Engineering News in mid-August that the combination of lower production from AMSA and tariffs on imports was an obstacle to their recovery as they could not always find the steel to meet new orders.

In sum, recovery from the COVID-19 crisis requires a new business model for South Africa's steel value chain. Policymakers face three difficult choices.

First, they need to ensure that the rents from the highly competitive iron-ore mines benefit downstream manufacturing, which is both the largest and the most dynamic stage in the value chain as a whole. That end could be achieved through a range of measures, from legislation to conditionalities on infrastructure provision (the mines depend on dedicated Transnet lines). Kumba would, however, undertake fierce lobbying and legal challenges to any measures to stop it from capturing the iron-ore rents.

Second, as noted above, fixing the electricity system to ensure an affordable, reliable supply for industry requires restructuring generation, with greater scope for smaller producers to feed into the grid. That would disrupt Eskom's business model, which is built on its monopoly power to extract higher tariffs irrespective of the quality of supply.

Finally, policymakers need to decide on the role of AMSA in the medium to long run. It could in theory be replaced by a group of smaller, more competitive mills. That would, however, effectively mean writing off the huge investments made in Iscor and then AMSA over the past century. Economic progress may require creative destruction, but it is never an easy process for either stakeholders or democratic governments.

Tourism

Globally, the pandemic brought virtually all international travel to a halt, with a sharp decline in domestic travel as well. Moreover, many of the services at the heart of tourism, especially restaurants and entertainment, rely on close social contact indoors, often with drinks, as a core part of their offerings. Even when this kind of activity is legal, many people are reluctant to partake as long as the virus is not strictly controlled. Indeed, the current wave of cases in Europe, which in some cases is larger than the first spike, largely resulted from the decision to reopen tourism for the northern hemisphere's summer season.

The impact of the pandemic on South African tourism can be tracked through hotels and other accommodation. In January and February, occupancy hovered around 50%, and revenues were slightly higher than in 2019. In March, even before the lockdown, the increase in global cases and concerns saw occupancy fall to 30% and revenues to a third of a year earlier. In April and May, during Levels 5 and 4 of the lockdown, occupancy rates plummeted to 1% and revenues approached zero. The latest data are for June, when business travel was allowed under Level 3. Occupancy rates only rose to 4%, however, with revenues at around 10% of the 2019 figures.

Sun International revenues were at 40% of 2019 levels in July, but these were derived largely from its casinos, where revenues rose to 60% of 2019 figures in August. Sun City opened only in September. The company planned to retrench around 2 300 workers, or a quarter of its local staff, in the next few months.

The prospects for tourism reflect the segmentation of the market between domestic, regional and overseas visitors. Around 40% of tourism revenues come from foreign tourists, of whom two thirds are from the Southern African Development Community (SADC) and most of the rest from Europe. Typically, however, high-end, high-profile tourism establishments focus on overseas travellers plus the richest local and regional households.

In the local market, the decline in incomes as the GDP contracts due to the pandemic will certainly see some curtailment in holiday spending. Deep income inequalities mean the top 10% of households consume well over two-thirds of tourism-related services. This group is often older and can stay at home in relative comfort. Still, they may also switch to local holidays both to save money and because most countries still will not accept South African tourists.

Overseas tourism – the most lucrative part of the market – faces steeper challenges. Above all, it requires long-haul flights. Even when international travel to South Africa opens for business, it is not clear how many people will want to spend eight hours or more on a plane to go on holiday. To allay fears, a few long-distance airlines are offering free pandemic insurance, with coverage from diagnosis to funeral (although often only if you book through their own websites). In any case, until COVID-19 is fully under control in South Africa, foreign countries are unlikely to permit their citizens to visit unless they quarantine on return.

Arrivals to South Africa were already down 10% in the first quarter of 2020, before the lockdown effectively ended non-essential international travel. Globally, international travel in August was at around 5% of pre-pandemic levels. The national Tourism Department told Parliament that it expected foreign demand to climb only 25% from April to December. In contrast, it hopes domestic revenues will reach R400 million in December, almost twice as high as in April but still lower than before the pandemic.

Evaluating the implications of the decline in tourism is complicated by the lack of a common definition for the industry, which is not a standalone activity in the Standard Industrial Classification used to consolidate economic statistics. Tourism figures derive from data on travel combined with calculations around travellers' expenditure. In this context, industry associations almost always punt exaggerated figures as a way to lobby for greater support.

Statistics South Africa estimates that tourism contributes just under 3% of the GDP and 4,5% of employment. The industry has, however, seen virtually no growth over the past decade. In constant rand (deflated with CPI), tourism revenues were essentially flat from 2010 to 2017, and then declined. Expenditure by foreign ("in-bound") tourists was hard hit by the 2008/9 downturn and had barely recovered in the late 2010s. Then it declined again following global publicity around "Day Zero" during the 2017 drought in Cape Town.

Tourism has a differentiated impact by region, but it is difficult to track at local level. Clearly it plays a disproportionate role in the economies of the Western Cape and KwaZulu-Natal. It is also crucial, however, for a host of smaller more rural towns, with attractions ranging from game farms to beaches to hiking. The most visible impacts have merged where regions depend on high-spending foreigners. Vinpro told Parliament that revenues just from tourism along the wine route will be down by 65% and employment by 45%, at a cost of between R5 billion and R2,5 billion to businesses there.

As of late July, the national Department of Tourism anticipated a phased response, reflecting the realities that global travel will not recover immediately even if restrictions are lifted. It planned to start with "hyper local" community tourism, followed by growth in broader domestic tourism. International travel would take more time. Its messaging was, however, unavoidably contradictory, as it sought to encourage people to travel and socialise more freely within South Africa, with fewer restrictions on travel, yet at the same time called for strict efforts to prevent COVID-19 through social distancing and masks.

The hard truth is that recovery in tourism and the related services will be far slower than in the rest of the economy, and require profound changes in many of the associated services. As long as the pandemic is not fully under control globally or even nationally, the temptation to fall back on marketing alone will not work. Moreover, the stagnation of the past decade underscores the need for deeper changes in the business model, although stakeholders and policymakers have generally avoided the issues.

Critical decisions include the following.

First, the industry will face sharply lower demand for the next year or two. Policymakers need to decide both how best to preserve capacity and how to ensure a just transition. A risk is that low demand leads to a loss of service providers, which in turn slows the recovery and reduces the attractiveness of tourist destinations. Furthermore, tourism workers are often already poorly paid and insecure. Many live in rural areas with limited options for alternative employment. Simply hoping these realities will go away will ensure an unnecessarily costly, inefficient and unfair unwinding of existing capacity and livelihoods.

Government has provided some support for tourist businesses, but it effectively lasted only through August, without taking into account the longer-term challenges facing the sector. Tourism workers received around R250 million from the UIF's COVID-19 Temporary Employee/Employer Relief Scheme (TERS) programme, but applications closed in mid-August. The national Department of Tourism also provided R200 million to support 3 800 businesses during the lockdown, and set aside an additional R30 million for tour guides. The national and provincial departments of arts and culture have extended R250 million to cultural workers. All of these funds are, however, once-off payments. It is not clear what kind of support will be available for small businesses, workers and their communities if the holiday season around December remains depressed, as currently expected.

Second, preventing the spread of COVID-19 means that unless tourism providers disrupt their business models, many can be safe or profitable, but not both. Maintaining social distancing indoors and enforcing curfews in themselves lead to lower profits. A significant share of customers will not, however, return unless safety measures are visible and effective. In practice, both in South Africa and abroad, tourists have tended to move to self-catering accommodation and outside venues and experiences.

Finally, the shift to local consumers has significant implications for pricing policies. Historically, prices for core tourism services have long been benchmarked against Europe. In particular, accommodation costs more than the equivalent in mass-tourism countries in the EU such as Greece, while the national carrier has priced overseas flights higher than its private (foreign) competitors. Many resorts and hotels were affordable only for the best-off local households even before the pandemic slashed domestic incomes. Ultimately, this pricing model is unsustainable as long as overseas tourism is not an option. The question is whether large formal hotels and game lodges are willing to reduce prices to attract local customers, or prefer to close down.

More broadly, high costs for accommodation and flights have long limited the growth in tourism, at the cost of fast growth and higher levels of job creation. Going forward, government will need to decide if it wants to promote mass tourism, which has greater scope for growth and job creation, or return to promoting mostly high-end travel. The decision may however be pre-empted by increasing limits on long-haul travel because of its contribution to the climate crisis.

TIPS TRACKERS

TIPS Tracker: The economy and the pandemic highlights important trends in the COVID-19 pandemic in South Africa, and how they affect the economy.

TIPS FDI Tracker monitors inward foreign direct investment projects. It reports on new FDI projects, analyses these, and adds them to an ongoing list of investment projects.

TIPS Export Tracker provides updates on export trends and identifies sectors and products that are performing well and those that are lagging.

TIPS Import Tracker provides an overview of import patterns and looks at the causes of surges in imports, and their likely impact on industry.

Trade & Industrial Policy Strategies (TIPS)

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