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COVID-19 and the South African Economy: Synthesis and Policy Brief

Discussion Document 02

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Matthew Stern | Chris Loewald

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We provide the opportunity for contribution from all relevant perspectives, and therefore these papers do not represent a position by ERSA, its associates, or funders on the identified issues.

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Matthew Simmonds

Director

COVID-19 and the South African Economy: Synthesis and Policy Brief

This discussion document is drawn from a previous research project, The Covid Project, conducted in collaboration with the International Food Policy Research Institute (IFPRI), the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) and Economic Research Southern Africa on post Covid-19 growth policies.
For more information on these research papers belonging to this project, please see our website at:
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1. Background

In the third quarter of 2021 South Africa's official unemployment rate reached 34.9%. This is a staggering statistic which reflects an unsustainable reality. More than 4.5 million South Africans under 35 are unemployed, and around 300 000 more youth are expected to enter the labour market every year[1]. This unemployment crisis represents the greatest disappointment of the democratic era. Despite the dramatic political and social transformation that has taken place over the last few decades; South Africa has failed to create sufficient economic opportunities for the post-1994 generation. It is also unsurprising. from 2010 to 2020, South Africa's real economic growth rate has failed to keep pace with the country's population, and GDP per capita has fallen by 36% in US$ terms over this period. The country is getting poorer and its people are evidently more desperate.

The COVID-19 pandemic therefore found a South African economy that was already vulnerable and weak. The resulting impact on society and the economy has been dramatic. To assess the likely trajectory of the country over the next few years and to outline the available options to restore and accelerate economic growth, the South African Reserve Bank, IFRPI and ERSA (with funding from GIZ) commissioned a series of independent research papers. This work was initiated in late 2020 and concluded in 2021. The papers focus on current trends and developments in the areas of labour markets, trade, monetary policy and the environment and present a number of alternative growth and policy scenarios. Whereas these papers were intended to address

[1] StatsSA, QLFS, Quarter 3: 2021

the immediate implications of COVID-19; they all inevitably point to the longer-term deterioration of the South African economy.

The causes of South Africa's poor economic and employment performance are generally understood, often repeated, and are largely structural in nature. These include a deficient education system, that is unable to produce the skills needed for a modern workplace; ageing and badly maintained transport and electricity infrastructure, that is unable provide industry with consistent inputs at a reasonable cost; and the spatial legacy of Apartheid, which effectively locks so many South Africans out of the formal economy. Whereas efforts are in place to improve the education system, invest in new infrastructure and provide housing and social support to the poor, progress has been mixed and it will take significantly more resources and time to lift these constraints.

The papers published under this project consider some of the short-term policy options that are immediately available to Government. Here too South Africa's performance is mixed. Over the last twenty years, the introduction of inflation-targeting has served to provide greater stability and certainty to all economic actors, and has been accompanied by a gradual depreciation of the real effective exchange rate. The resulting improvement in price competitiveness has, however, not translated into significantly more trade or jobs. Similarly, South Africa has failed to take advantage of rapid changes in energy technology and demand and favourable climatic conditions to ramp up the production of renewables. The analysis presented in the papers suggests that policy developments have not kept pace with changes in the domestic and international environment and are further constraining South Africa's ability to compete.

As South Africa looks to navigate itself out of a COVID-induced recession and to restore economic growth and create new jobs, a more active and informed policy response is needed. As a small, open and exposed economy, the policy options available to South Africa are somewhat limited. The uncertain global environment, coupled with an increasingly fragile domestic fiscal situation, has further reduced this policy space. On the other hand, the country's lived experience over the last decade clearly demonstrates that the existing policy framework is not working fast enough. Different and more purposeful policy reforms are needed to alter the trajectory of the slow-growing South African economy.

The papers published under this project highlight some of the most obvious areas in which policy change should be immediately considered. In this overview, we first outline some notable trends and developments in the South African economy, including the recent impact of COVID-19. We then review the contribution of selected government policies to the country's economic performance and consider alternative approaches that may serve to generate faster and sustainable growth. The chapter concludes with some specific recommendations for immediate policy reform.

2. South Africa's recent economic performance

Whereas the focus of the papers are different, together they provide a comprehensive review of the past performance of the South African economy, and the likely trajectory of its post-COVID recovery. Overall, the papers paint a picture of lost opportunities – in terms of growth, employment, trade and the environment – and this slippage has left the economy and society more susceptible to external shocks, including the COVID pandemic. It will also make recovery longer and more unbalanced.

Figure 1 shows the average real growth rate for all countries in the MSCI Emerging Market Index from 2008 to 2019. Over this period, South Africa recorded average real growth of just 1.6%; slower than all other countries with the exception of Brazil, Russia and Argentina. According to Loate et al, this disappointing growth performance has been driven by a decline in the potential output of the economy and very low levels of investment.

South Africa has also fallen behind its peers from an international trading perspective. Figure 2 demonstrates that South Africa's export growth rate fell sharply over the last decade; and that the country's exports have increased at a much slower rate that other middle-income and Sub-Saharan comparators. As a result, South Africa's share of world exports has fallen from 0,6% to 0,4% between 1990 and 2019. This shift alone has shaved as much as US$50 billion off the country's GDP.

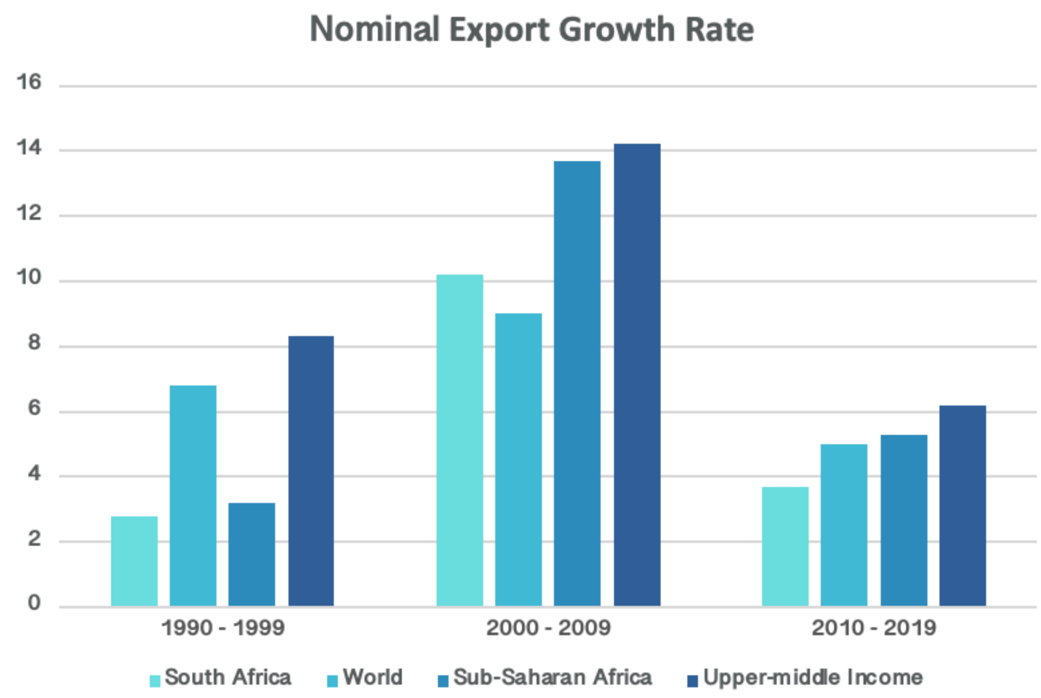
Slower economic growth and the relative decline of South Africa's export sector has severely limited the country's capacity to create and sustain formal labour market opportunities (Loewald et al). The situation in South Africa is exasperated by a comparatively low labour utilisation gap. This is confirmed in figure 3. According to Loewald et al, South Africa would need about twice the economic growth as Turkey, the next worst performer, in order to achieve the same labour utilisation outcome.

Finally, despite the notable progress made by South Africa in lowering the energy intensity of production, Gwatidzo et al point out that the country has underperformed when compared to other BRICS countries. Figure 4 reveals that despite a significant head start - in 1990, Co2 emissions per unit of GDP in South Africa were below Brazil, Russia, India and China – South Africa is now the least energy efficient of the group. This is largely due to the country's ongoing dependence on coal for most of its energy supply.

The onset of the COVID-10 pandemic severely worsened most of these trends. As reported by Arndt et al, economic growth contracted by 7.0% in 2020 and unemployment, poverty and inequality increased. Gross fixed capital formation fell to 15% of GDP in the fourth quarter of 2020, equalling the historical low recorded in 2002, and formal employment was around 5% lower than the 2019 average (Arndt et al).

The economic recovery experienced to date has been uneven and fragile (Arndt et al). Whereas production in most sectors is close to 2019 levels, construction related activity and employment has weakened further. Moreover, and despite increased government support and buoyant household spending, there is evidence that child hunger has increased (Van der Berg, Patel, and Bridgman, 2020, in Arndt et al) and poor households remain particularly vulnerable.

The Government has responded through the provision of emergency relief and is considering additional policy instruments, such as a basic income grant, to address the immediate consequences of pervasive inequality. However, the country's recent economic experience suggests that wider policy reforms are needed to reverse the steady deterioration in growth, exports, employment and access to critical and clean inputs, such as energy, that have undermined the country's longer-term development potential.



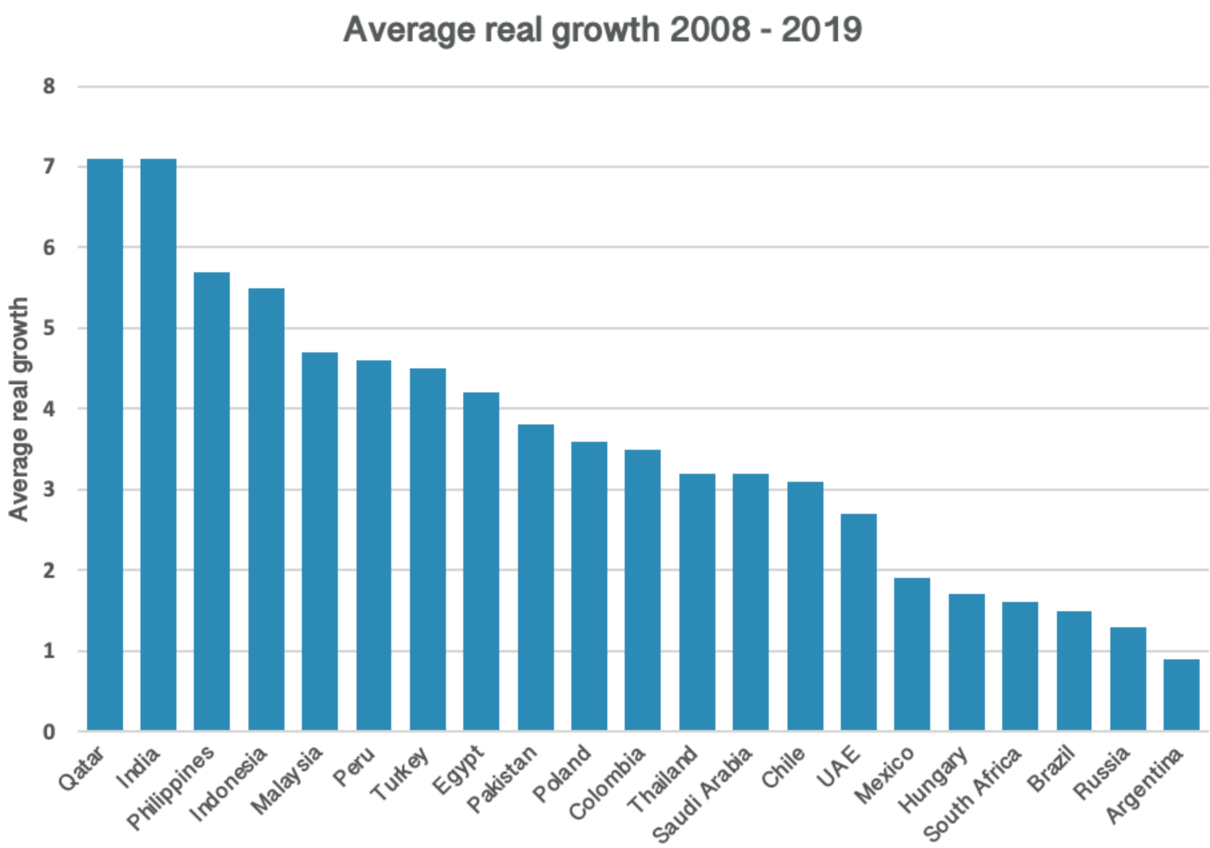


Figure 1: Average real growth (2009-2019) – MSCI Emerging Markets Index (IMF WEO Database 2020, in Loate et al)

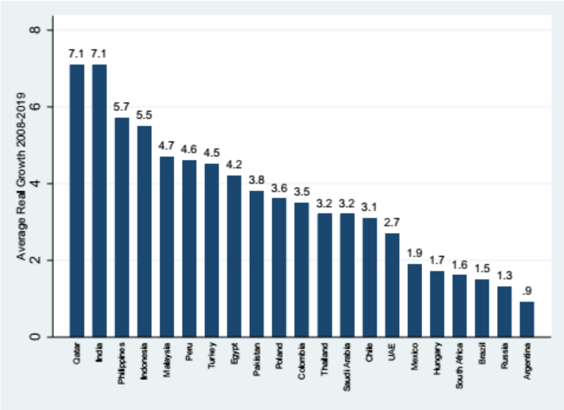


Figure 2: Nominal export growth rate (World Bank 2020, in Stern and Ramkolowan)

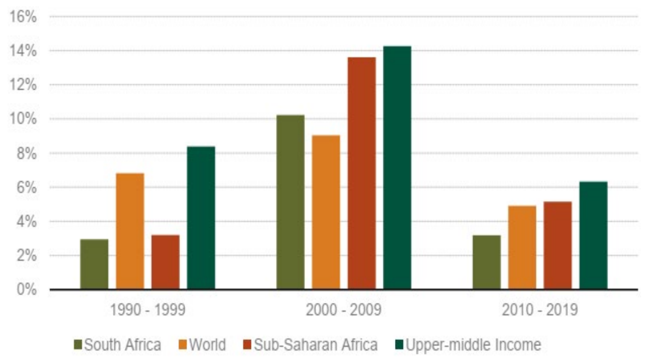


Figure 3: Average GDP growth and labour utilisation (OECD Economic Outlook Database 2019, in Loewald et al)

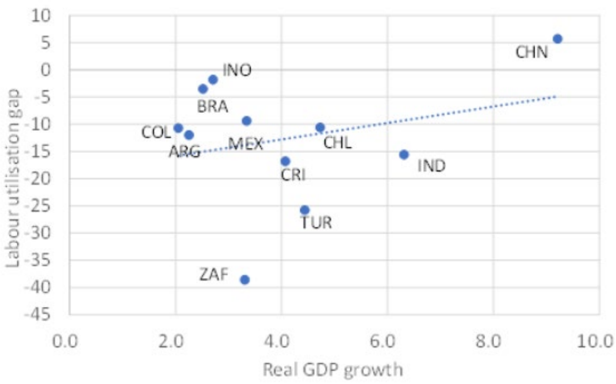
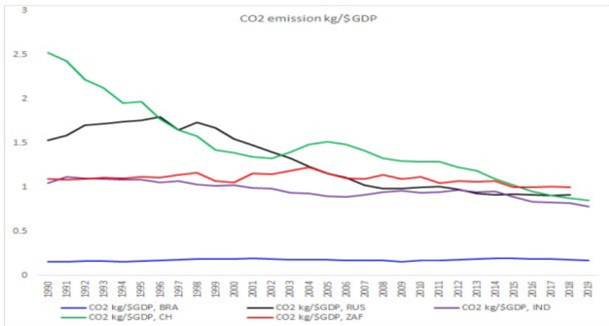


Figure 4: CO2 emissions per unit of GDP, South Africa vs the BRICS countries (World Bank WDI and IEA databases, in Gwatidzo et al)



3. South Africa's recent policy performance

The papers emphasise the critical role of Government in defining economic policy in general, and supporting exports, job creation and sustainable development in particular. They also acknowledge the active efforts that have been made by the State to ensure price stability and to facilitate industrial development. However, the evidence strongly suggests that the current policy framework is not working well enough, and the authors point to multiple areas where urgent reforms are needed and possible.

Loate et al consider the relationship between monetary policy and economic growth. They find that monetary policy has not been pro-cyclical during the inflation-targeting period – to the contrary, the evidence is clear that South Africa maintained an expansionary monetary stance for much of the economic slowdown – at least until 2016. Whereas the policy rate was increased in 2016 to counter rising inflationary pressures, these increases did not last long and the SARB has made greater use of active communication tools to control private sector expectations in recent years. Moreover, since the adoption of inflation targeting, the average real interest rate has been no higher than it was in previous regimes. They also demonstrate the clear but negative relationship between inflation and per capita GDP growth in South Africa. Lower inflation has supported rather than restricted economic development.

On the other hand, Loate et al raise a number of concerns related to South Africa's fiscal situation, which was had deteriorated persistently for most of the last decade, but worsened significantly in the aftermath of the COVID-19 shock. Government debt is expected to exceed 100% of GDP by 2024-2025. Their analysis of South Africa's debt expansion over the last five years shows that it has contributed to a sharp increase in the country's risk premium and long-term interest rates, with follow-through and negative effects on manufacturing output and capital flows.

Loewald et al identify numerous factors that explain why the South African economy has not generated the required growth to absorb its unemployed, or to make growth more labour intensive. This includes the overall industrial structure, which is characterised by low levels of competition and higher barriers to entry; skills shortages; and weak public employment services. They also point to South Africa's relatively rigid labour market regime. Specifically, the country's extended collective bargaining system has contributed to wages that are too high to clear the labour market, while long and costly firing procedures discourage small firms from taking on new employees.

Likewise, the structure of the South African economy and the deteriorating international competitiveness of the underlying business environment has weakened the country's export performance. South Africa's external trade remains dependent on a relatively narrow basket of exports to large but mature export markets. Stern and

Ramkolowan raise concerns that the country's cautious approach to regional and international trade negotiations, the high cost of logistics, and preferences afforded to local companies, increase the incentive to produce for the protected domestic market over exploring new export opportunities.

South Africa's stated policy response to climate change has been more encouraging. According to Gwatidzo et al, the Government has committed to transform the country into a low-carbon and climate resilient economy, and the Integrated Resource Plan of 2010 articulates the need to add almost 18 000 MW of renewably energy to the grids by 2030. The implementation of these plans has however been patchy, and the Government appears reluctant to move forward on an accelerated transition. This is ascribed by Gwatidzo et al to political economy factors, including the interests of trade unions, the coal mining sector and the vast market power of Eskom.

Finally, the papers touch on the unintended consequences of the country's necessary and ambitious transformation policies, on other economic outcomes. Specifically, Loewald et al note that the regulatory compliance costs associated with BEE may impede labour utilisation, especially amongst small and medium-sized firms. It may also reduce competition and overall economic activity. Likewise, Stern and Ramkolowan describe how BEE may impact adversely on international investment in some sectors and makes the use of foreign skills and technology more challenging.

4. Alternative policy options

The South African Government is acutely aware of the need to raise growth, exports and employment and has recently pledged to reduce carbon emissions more aggressively at the 2021 United Nations Climate Change Conference. Moreover, multiple policies, plans and programmes are already in place. However, the research presented in this book suggests that in many instances, these interventions have served to aggravate rather than ease existing constraints. The papers also put forward number of alternative policy proposals.

Firstly, to increase competition and the international scale and competitiveness of South African firms, stronger incentives need to be put in place to encourage businesses to invest, innovate and export; and inappropriate incentives need to be removed. This requires an overhaul of South Africa's current approach to trade and industrial policy, which is overly concerned with promoting local content and protecting the country's existing manufacturing capabilities, rather than enabling industry (including services firms) to explore new and more sizable opportunities abroad. South Africa will not create the jobs needed to address its gaping unemployment crisis by selling to itself.

Secondly, to ensure that this export-led expansion is sufficiently labour intensive, multiple labour market reforms will be needed to lower the risk and costs associated with the hiring of relatively unskilled workers. Here, the Government's attention needs to shift considerably away from protecting the employed at the expense of those that have no income. Specifically, Loewald et al propose the use of tax credits to support the employment of graduates, lowering firing costs by linking employment protection to employment tenure, and a major expansion of public employment (job brokerage) services.

Thirdly, in recognition of the reality that many of the skills needed to grow into new sectors and compete internationally are in short-supply in South Africa, and that improvements to the education system will take time, a more active and aggressive immigration policy is needed. The economic simulations undertaken by Channing et al demonstrate that a much more open immigration regime for highly skilled and experienced labour has a particularly strong potential to stimulate growth, create jobs and reduce inequality at scale, at lost cost to government, and at low risk.

Fourthly, to enable skilled migrants to find appropriate employment and to fast-track the creation of new jobs and enterprises, the interaction between South Africa's economic transformation and economic growth objectives requires further consideration. Changing the ownership and employment profile of South Africa's domestic industrial structure is a social and economic imperative, but so too is the need for increased international knowledge, technology, investment and competition. To the extent that these priorities conflict, low-cost and effective compromises will need to be found.

Fifthly, to facilitate the growth of the green economy and to speed-up the country's transition away from coal, the Government must ramp up investment in renewable energy production while moving decisively to remove barriers to green industrialisation. Existing industrial incentives should also be reviewed to encourage firms to adopt cleaner and more energy efficient technologies. Given the extreme energy shortfall in the country, Gwatidzo et al point out that there is no trade-off between renewables and coal in the short-term, and that most of the large coal plants will reach the end of their lifespan relatively soon. There is therefore no apparent misalignment between South Africa's green, economic and employment objectives.

Sixthly, recognising that some of these reforms will take time to impact meaningfully on growth and employment, and may even lead to short-term dislocations, the provision of additional or continued income support for the very poor is a desirable objective. The modelling scenarios presented by Channing et al confirm that the financial support provided to poor households throughout the COVID pandemic has been an appropriate counter to the public health measures in place. However, there is little space for the Government to continue with this support, without running into serious fiscal and structural constraints. Once South Africans return to near normal economic activity, the Government will need to taper-off its COVID-19 support programme and focus its efforts on addressing the underlying growth constraints noted in this chapter.

Finally, ensuring that the SARB remains singularly focused on maintaining price stability is critical in protecting the domestic economy from international shocks and uncertainty. According to Loate et al, any relaxation in monetary policy that increases inflation expectations, will have a rapid effect on nominal wages without any significant boost to firm-level profitability and investment. The net impact on economic growth and jobs is likely to be negative. They also argue strongly against furnishing the SARB with any kind of developmental role. Not only is this unnecessary – they find no evidence that the credit market is a major constraint to industrial development – it would also risk damaging the international credibility of this important institution.

5. Conclusion and recommendations

In many respects, the research that is presented as part of this project reinforces what is already known about the South African economy. Over the last decade, the country's growth rate has failed to keep pace with the rest of the world and its expanding population, and this has resulted in increased unemployment and inequality. South Africa has also fallen behind in world trade and has failed to take advantage of its unique climatic conditions to address energy shortages and transition rapidly into the production of green goods.

The main departure is to note that many of these challenges stem from inappropriate or inadequate policy choices. South Africa's disappointing export performance is partly a consequence of trade and industrial policies that punt domestic interests and industrialisation over deep regional integration and international competitiveness; the country's slow uptake of renewables reflects a reluctance to depart from a history of coal-fired electricity generation; and the low labour absorption rate is strongly impacted by labour market policies that effectively limit new entrants, and heighten the risk and costs of employment. Moreover, a conservative approach to immigration and an administratively complex transformation agenda, constrain access to new skills and international investment.

These policy hurdles add to South Africa's already deep structural constraints to growth. Correcting South Africa's infrastructure, education and spatial imbalances will take time and plans are in place to address the underlying causes. But without a short-term boost to growth, it will be difficult to secure the resources needed to fund these longer- term initiatives, and the unemployment rate will continue to tick upwards. The existing data tells us that the Government needs to act quickly to move us out of our current social and economic malaise, and our recent history tells us that the existing policy framework is not up to this task.

Most of the policy recommendations outlined in these papers can be implemented quickly and at reasonable cost. They are also not out of line with the Government's own economic thinking, as revealed in the National Treasury paper: "Economic transformation, inclusive growth, and competitiveness: Towards an Economic Strategy for South Africa". This nascent strategy proposes that South Africa should modernise network industries (including in the energy sector); lower barriers to entry for small businesses; prioritise labour-intensive growth, most notably in agriculture and services; and implement a more focused and flexible industrial and trade policy, including a stronger focus on export competitiveness and regional integration.

Based on the evidence presented here, this reform agenda should immediately be extended to include:

- The unrestrained roll-out of renewable energy production, absent from unnecessary and potentially costly conditions, and led by private sector interests and capabilities. The Government should focus its own efforts on delivering the Just Energy Partnership which has been structured to transition Eskom (and therefore the country) away from coal.
- Greater ambition and active leadership in the conclusion and implementation of regional and continent-wide trade agreements, including a more open approach to the use of preferences and rules of origin, and the development of informed positions that reflect the country's actual economic interests in services, e-commerce and other new trade issues.
- Direct labour market reforms to lower the costs of hiring and firing, especially for smaller businesses, and increased investment in wage subsidies and other active labour market interventions for the large and growing number of unemployed young South Africans.
- A more urgent and deliberate approach to the relaxation of immigration restrictions, especially on skilled and regional workers and their families, in order to encourage foreign firms and talent to locate, invest and remain in South Africa.
- Targeted land reform initiatives that focus on shifting production away from bulk commodities and into the intensive production of higher value crops, such as fruit and vegetables, on high potential land. This would enable the better management of South Africa's scarce water resources and could create substantial better paying jobs.

- An independent assessment of the possible and unintended consequences of South Africa's local content and Black Economic Empowerment policies on employment, competition, trade and investment; with view to developing new and administratively light mechanisms to enable small and foreign firms to contribute towards the country's broader transformation and development objectives.

To ensure that these reforms are implemented fully and effectively – will also require a change to the policy making process. Currently, it would seem that Government Departments are given an open mandate to define their own policy agenda, with insufficient coordination and a lack of consistency between programmes and instruments. Loate et al, for example, illustrate how monetary policy has had to counteract an overly accommodative fiscal stance; Loewald et al and Stern and Ramkolowan point to an apparent tension between the country's transformation and competition objectives; and Gwatidzo et al describe the lack of attention to the green economy in the design of industrial policy.

The economic departments of Government need to work in tandem to achieve a common policy outcome. This will require strong leadership from the centre and a willingness from others to look beyond short-term sector and insider interests, and to consider the economy-wide net impacts of the proposed policy reforms. Moreover, to move South Africa forward along a different and faster growth path will not only require determination and coordination across Government, but will inevitably require a corresponding shake-up within business and labour. It is for this reason that Loewald et al talk about the need for a high-level social accord through which all parties agree to commit and compromise for the greater good of the unemployed.

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