



Covid-19
**Are we
asking
the right
questions
about...**

**The nature of
the economic
recovery?**

Introduction

No-one knows what the long-term economic effects of the Covid-19 epidemic will be. The massive disruption attendant on a global lockdown has thrown supply chains into turmoil, pushed tens of millions of the workers into (at least) temporary unemployment, and caused financial markets to gyrate wildly. The future effects are radically uncertain and all but impervious to serious modelling, not least because so little can be known for certain about the evolution of the epidemic itself and how societies will respond, much less how these will impact on the economy in the short, medium and long terms. What is certain is that South Africa's economy will shrink this year relative to last year. In this context, two key concerns for policy-makers, firms and banks is what effect it will have on South Africa's economic output and how quickly will we recover. Estimates of the size of the contraction that we will experience this year range from 4 per cent to 15 per cent of GDP depending on whom you ask and whether you look at their most optimistic or most pessimistic scenarios.

Inspired by some comments made by Prof Paul Romer in a recent webinar¹ on the impact of the coronavirus on the US and how to think about the preconditions for opening the economy after the lockdowns, this report seeks to warn policy-makers not to assume that the economy that emerges after the lockdown will be capable of generating even the rate of growth (inadequate as it was) that South Africa experienced over the past decade. It suggests that the damage done by the epidemic may necessitate very significant economic reforms if South Africa is ever to fully recover.

One way to think about this is to think about what happened after the global financial crisis (GFC).



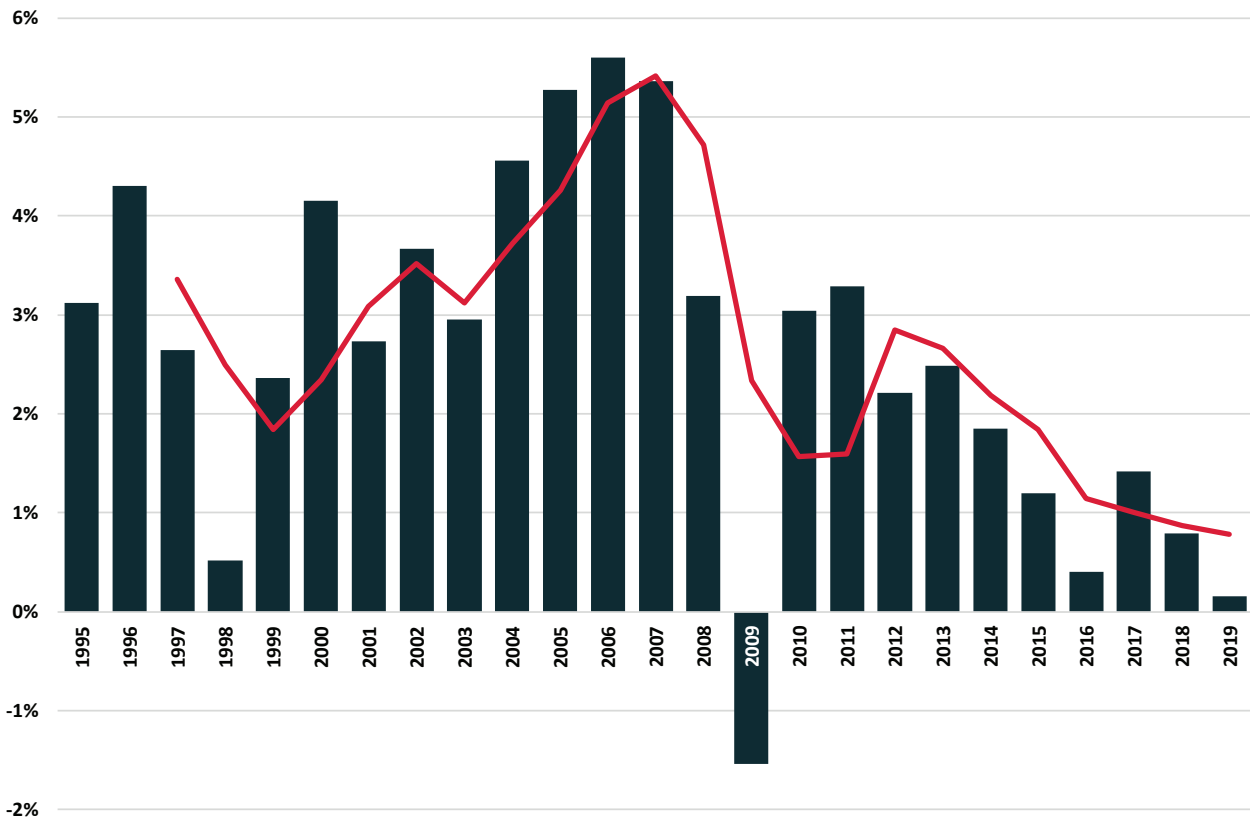
April 2020

During the Covid-19 pandemic, CDE will release a new series of publications titled: 'Are we asking the right questions about...'. These will be short reports that contribute to public discussion about the crisis and how the country is responding.

South Africa's “recovery” after the global financial crisis

Between 1999 (the year after the Asian financial crisis) and 2008 (the year before the GFC), South Africa's economy grew, on average, at just less than 4 per cent per year. That was brought to a crashing halt in 2009, when, as a result of the GFC, the economy contracted by 1.5 per cent. The effect of the GFC was short-lived, however: growth in excess of 3 per cent in 2010 meant that the economy returned to 2008 levels within a year, and another year of growth in excess of 3 per cent in 2011 suggested that we might quickly return to pre-GFC growth rates of 4 per cent a year. But that didn't happen: since 2011, growth rates have fallen almost every year, with the result that in the decade since the GFC, growth has averaged 1.7 per cent a year – a nearly 60 per cent reduction in average annual growth compared to annual growth in the decade before the GFC (Figure 1.)

Figure 1: Annual GDP growth (blue) and three-year moving average (red): 1995 to 2019

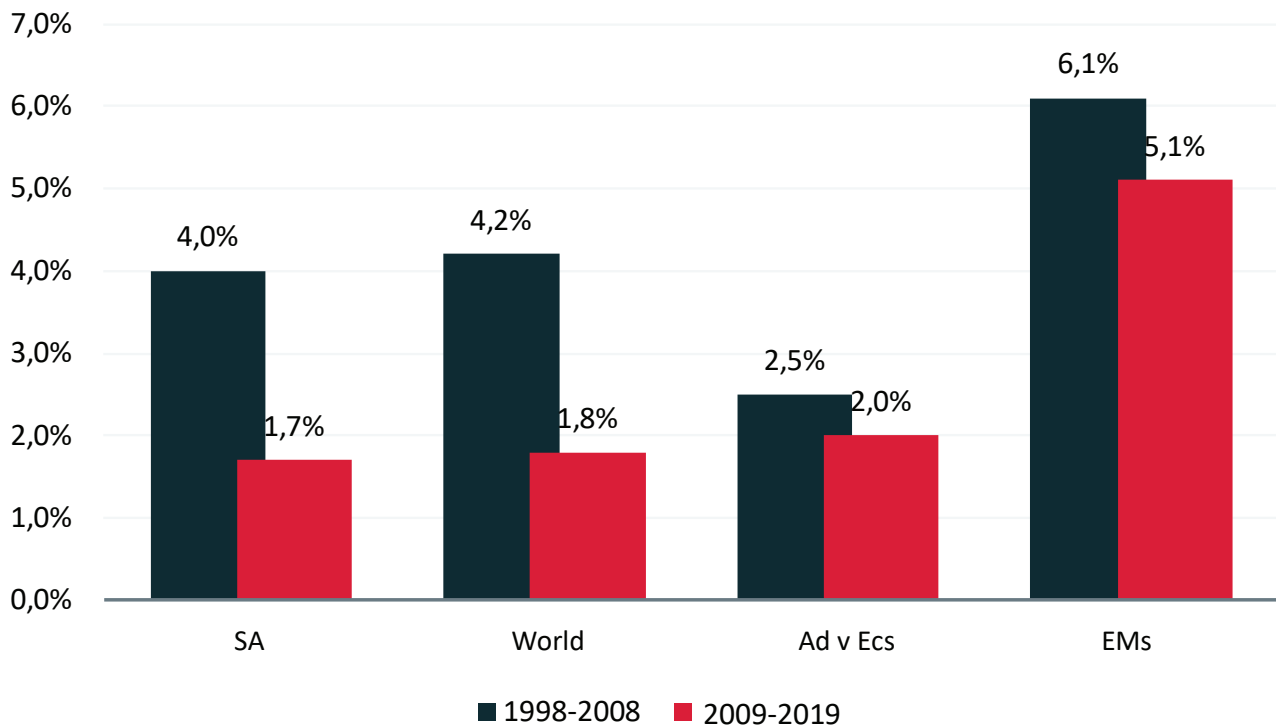


Source: SARB database

The 60 per cent collapse in average annual growth rates (from 4 per cent to 1.7 per cent a year) did not have to happen. Indeed, it did not happen in most of the rest of the world, where growth rates in the decade after the GFC fell by an average of only 12 per cent relative to those of the decade before the GFC (Figure 2) – from 4.2. per cent a year to 3.8 per cent. Even in advanced economies, whose growth rates are generally slower than those of the developing world, growth rates after the GFC, at 2 per cent a year, are only 20 per cent lower than those of a decade earlier.

¹ Available at https://bcf.princeton.edu/event-directory/covid19_04/

Figure 2: Average annual growth rates in the decade before and after the GFC, various regions



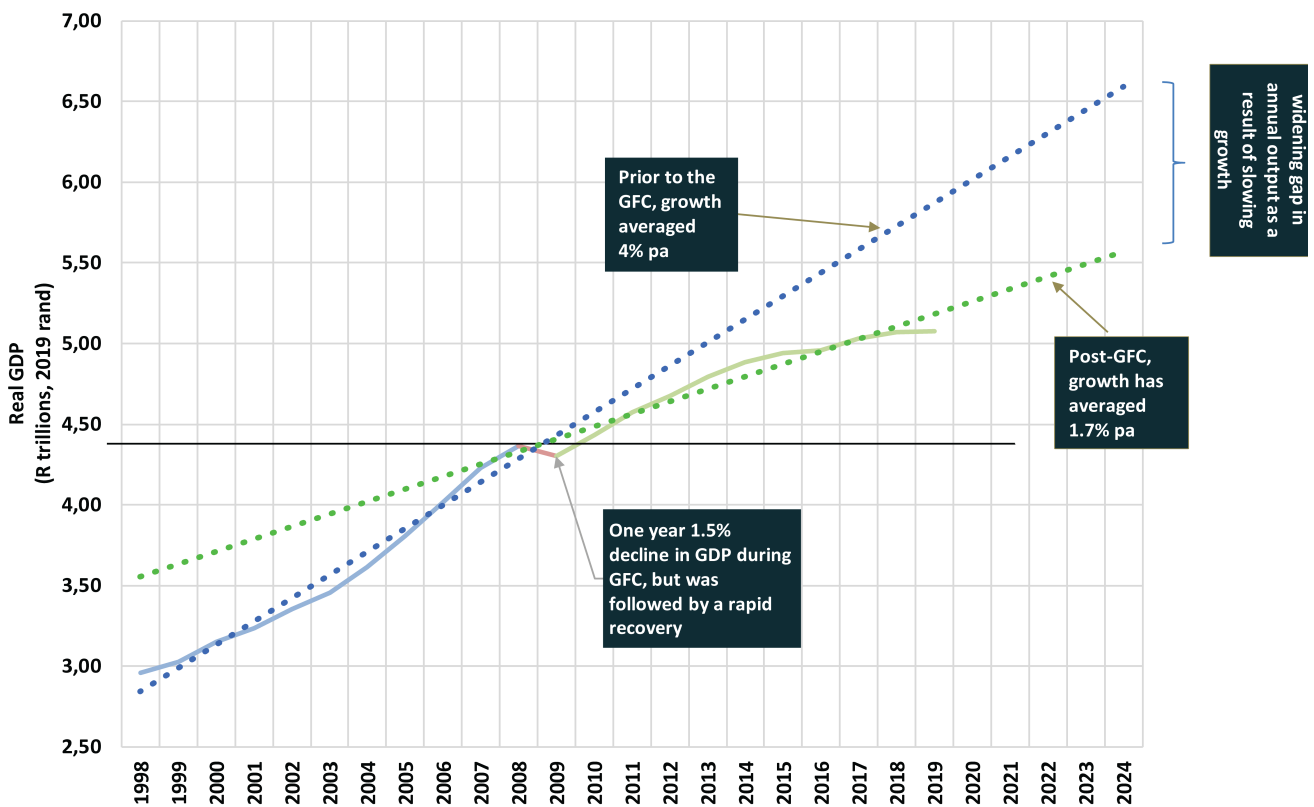
Source: IMF database

The key point here is that how one understands the idea of "recovery" affects the way you might evaluate the impact of a crisis. If you understand recovery to mean returning to the level of GDP achieved immediately prior to the crisis, then South Africa recovered quickly from the GFC. If, however, one defines recovery to mean, "returns to the rate of growth achieved prior to the crisis", then you might say that the world has never recovered. That said, South Africa's failure to recover – as defined by a return to pre-crisis growth rates – is considerably worse than the experience of the rest of the world, where growth rates returned to nearly 90 per cent of the pre-crisis levels, while our growth rate has been about 40 per cent of the pre-crisis level.

One way to think about the cost of this is to think about how much larger the economy would have been had we returned to pre-GFC growth rates. This is shown in Figure 3, which shows that GDP in 2019 would have been about R700 billion larger in 2019 had our trajectory followed the pre-GFC trend, a figure that would have risen to R1 trillion in five years' time.² Effectively, this means that between 2009 and 2020, South Africa missed out on aggregate output valued at around R3.7 trillion in 2019 rands.

² For ease of exposition, Figure 3 assumes growth follows a linear path rather than a more accurate exponential trajectory which would have resulted in larger differentials between the actual course of economic growth relative to one in which growth rates returned to pre-GFC levels.

Figure 3: GDP since 2009, using pre- and post-GFC growth rates

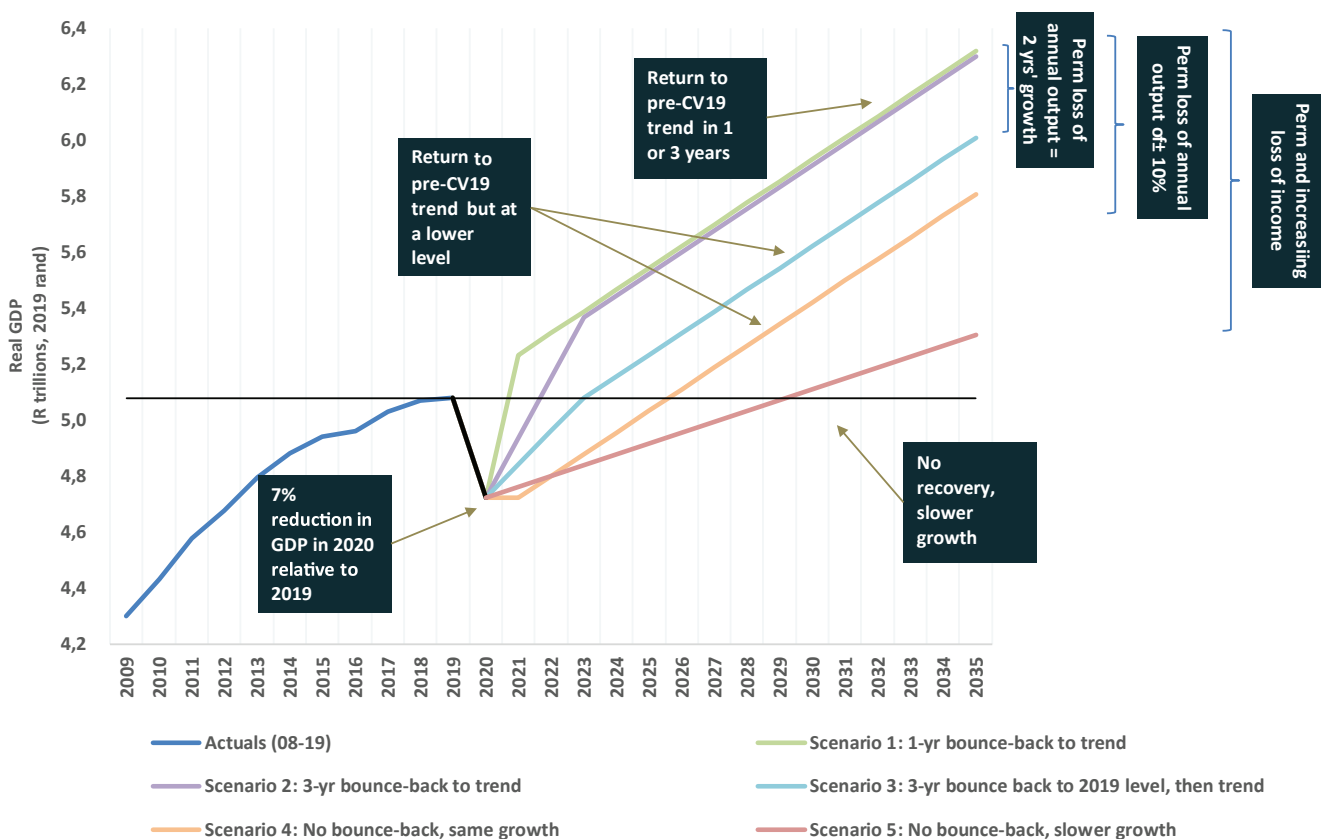


Source: CDE calculations

What does this mean for a post-CV19 recovery?

The implication of the above is that, when we think about what it means to say we have recovered from the Covid-19 crisis, it is not enough just to look at whether and when the economy has returned to its pre-crisis level, but whether and when it returns to the level of GDP it would have achieved had it stayed on its pre-crisis trend. As the experience of the GFC shows, that is by no means a foregone conclusion: even an apparently rapid recovery in the immediate aftermath of the crisis, may be followed by the deceleration of growth such that the trajectory of GDP diverges from the previous trend and can never make up the lost ground. This possibility is reflected in Figure 4 which sets out five distinct scenarios for post-Covid growth.

Figure 4: Alternative trajectories for a post-Covid recovery



Source: CDE calculations

In the first two scenarios, the economy returns to its pre-Covid trajectory (either in one year or over three years of recovery), but in three other scenarios, this does not happen. In the first two scenarios, in other words, there is no permanent shock to GDP, though, of course, there is some lost output during the recovery-to-trend.

In the third scenario, however, a three-year recovery takes the economy back to the level of GDP 2019, after which it grows at the same rate as the pre-Covid trend. There is, in other words a permanent shock to South Africa's income, with output each year lower than it would have been if there had been no Covid-related recession. Scenario four is even bleaker: here there would be a return to pre-Covid growth rates but without a rapid recovery to 2019 GDP levels and only after a two year recession. As a result, the permanent shock to South Africa's income is even larger. But not as large as the one depicted in scenario five, in which post-Covid growth rates are slower than pre-Covid growth, and the permanent shock – measured by the gap between actual GDP and the level of GDP had we stayed on the pre-Covid trajectory – is not only larger, but increases every year.

To be clear, the scenarios depicted here are not predictions. Like everyone else, we think that the cone of uncertainty around the most plausible post-Covid economic trajectories is exceptionally wide. Our intention is not to describe what we think will happen, but simply to note that the degree to which we might say the economy has recovered will depend not just on how quickly output levels return to 2019 levels, but to whether we get back on the same growth trajectory.

Are there reasons to worry that growth will not rebound?

One of the most terrifying aspects of this crisis is the extent to which it threatens to decimate whole industries that employ tens or hundreds of thousands of people. Apart from anything else, disruption of global trade and value chains pose risks to growth to all economies. In addition, it is a reasonable bet that some industries will never wholly recover. It seems likely, for example, that aviation will emerge radically transformed, as will tourism, leisure industries (restaurants, sports events) and some aspects of retailing. This will partly be a consequence of fundamental changes in the way goods and services of these industries are produced and consumed. But it will also be because there is a large probability that many of firms will emerge so weighed down in new debt that they will struggle to survive and grow. In addition, hundreds of thousands of people may already have lost their jobs, and many more might lose them in the next few months. If their unemployment persists for any length of time, there is every reason to worry that skills and capabilities will decay, reducing future productivity. Finally, the large rise in public debt is bound to weigh heavily on our growth prospects, as ever more resources have to be devoted to servicing the costs of that debt.

If any of this turns out to be true, then there is every reason to worry that South Africa would have permanently lost some fraction of its industrial and commercial capabilities. And if that is the case, then there is also reason to worry that average growth over the next decade would be even lower than it has been over the past decade. Importantly, this could be true even if there is a reasonably quick rebound back to GDP levels of 2019, because the effect of this lost capability may take time to show up in the data.

South Africa cannot afford even slower growth

It need hardly be said how terrible an outcome further slowdown in growth would be for South Africa: slow growth after the GFC is the fundamental reason that unemployment and poverty have risen, that our public finances are a mess, and that the country can afford so paltry a response to the current epidemic. A further slowdown would lead to deeper downgrades, and cause irreparable damage to the prospects of long-term prosperity. Indeed, no such prospects would exist.

It is critical, therefore, that our response to the epidemic itself (the nature and length of the lockdown, and the nature of the support provided to firms and households), as well as the conceptualisation of the road to recovery, place the raising of long-term growth rates at the centre of policy makers concerns. It is very likely that the damage done by the epidemic will necessitate very significant economic reforms if South Africa is ever to fully recover.



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