GROWTH LAB
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Macroeconomic risks after a decade of microeconomic turbulence
South Africa 2007–2020

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Executive Summary

This study analyses the performance of macroeconomic policy in South Africa in 2007–20 and outlines challenges for policy in the coming decade. After remarkable economic growth in 1997-2007, South Africa's progress slowed dramatically in 2009 with the global financial crisis (GFC). Real GDP growth decelerated more than in other emerging markets and mineral exporting peers and never recovered pre-crisis levels. In addition, the budget deficit that provided counter-cyclical support to the economy was never reigned in, leading to a rapidly rising public debt load.

We split post-GFC macro policy into two stylized periods. First, a period of loose fiscal and monetary policy to support the economy in 2007–12 which saw large increases to public expenditures, especially public wages. Second, a period of tighter fiscal and monetary policy from 2012–19 that saw Personal Income Tax (PIT) and Value-Added Tax (VAT) increases, the introduction of an expenditure ceiling, reductions in public investment and higher policy rates to lower inflation. This period also saw important microeconomic developments, like the stiffening of Broad-Based Black Economic Empowerment (B-BBEE) policies in 2013, the introduction of a national minimum wage in 2019, and mounting problems within state-owned enterprises (SOEs), particularly in Eskom and Transnet, which occurred in a highly politicized environment characterized by state capture.

Interviews with experts in government, the private sector, international financial institutions (IFIs) and academia reveal that there is a broad consensus on the drivers of South Africa's woes. Respondents mostly agree that fiscal policy was cyclically appropriate after the GFC but too expansionary as the slowdown continued, with some criticism of the attempted adjustment after 2012. Monetary policy is generally appraised as appropriate and micro policies, especially in labour and SOEs, are broadly characterized as a failure. Consensus on the way forward is limited. Respondents agree that the quality of government expenditures needs to increase and that resources should be reallocated to pro-growth and pro-employment programmes, but there is little agreement on the details. On the revenue side, there is consensus around strengthening South African Revenue Service (SARS) and reducing tax expenditures, but no agreement on which taxes to add or change.

We assess three accounts of South Africa's post-GFC slump: an external story, a macro story, and a microeconomic story. The external story posits that the decline in mineral prices starting in 2011 and the resulting reduction in gross export values and investment can explain South Africa's fiscal deterioration and growth slowdown. However, we find that the direct effect of the decline of mining production values on growth, investment and fiscal outcomes is small. Moreover, the country's overall terms of trade have improved since 2007 and falling export prices have been consistently offset by falling import prices. Considering also 'indirect effects', we conclude that changes in commodity prices can explain at most a quarter of the observed GDP growth slowdown (0.6 p.p. of 2.3 per cent average growth between periods, but much less in alternative estimates) and do not account at all for the deterioration in fiscal accounts.

We then asses various macro stories that link policy to debt accumulation and the growth slowdown. We find that fiscal policy was the largest driver of South Africa's debt build-up (explaining 38 per cent of the increase in the debt-to-GDP ratio between 2007–19). GDP growth, inflation, and budget projection errors

combined explain 25 per cent of the total. Unplanned SOE bailouts account for 16 per cent of the increase. We also find that official real-time estimates consistently overstated the output gap, motivating cyclically inappropriate deficits, which were composed mostly of permanent expenditures, not temporary spending. Regarding the effect of macro policy variables on growth we assess two contrasting views. One claims that fiscal expansion crowded out investment and was responsible for the growth slowdown. The other claims that the efforts at fiscal consolidation were responsible for the slowdown. The almost perfect negative correlation between private and public savings and the deleveraging of households provide supporting evidence of Ricardian effect which shows in the lack of a visible effect on interest rates. Thus, fiscal expansion was altogether irrelevant in terms of economic activity: fiscal expansions led to equivalent contractions in private aggregate demand. Moreover, we provide evidence on small negative fiscal multipliers which also rule out the possibility that the attempts at fiscal consolidation can explain poor growth performance. In short, while fiscal policy did increase debt, it cannot be blamed responsible for poor economic performance neither as a result of its tightness or of its expansion.

The micro story posits that a reduction in aggregate productivity as well as a slowdown in investment driven by microeconomic policies are behind South Africa's growth slowdown and fiscal imbalances. Since around 2011, total factor productivity (TFP) has been declining, particularly in network industries. The utilities sector, which is essentially the electric SOE Eskom, shows extremely negative TFP growth due to a host of idiosyncratic operational, governance, and financial issues. Productivity shocks in network industries have percolated into the rest of the economy through important supply and demand linkages. We find that if non-utilities gross value-added had followed pre-2011 trends, it would have been 8.5 per cent above its actual value by 2015, of which 3 p.p. (or 35 per cent of the slowdown) are explained by the downturn in the utilities sector alone. Beyond network industries, the mining sector exhibits a decline in productivity that cannot be explained by commodity prices. Moreover, increasing economic policy and regulatory uncertainty has also contributed to a reduction in investment and GDP growth. The increase in two standard deviations in a conventional index of policy uncertainty that South Africa exhibited in 2015–19 is associated with a cumulative decrease in 2.6 p.p. in GDP growth in a five-year period. This evidence suggests strong linkages between micro and political developments and growth performance. Beyond the utilities and policy uncertainty stories, other micro stories, related for example to productivity of metropolitan services, could be at potentially at play.

COVID-19 has added a new layer of complexity to South Africa's challenges. The country confronted the crisis with a significantly weakened macro-fiscal position by mandating social distancing, lockdowns and implementing expansionary fiscal and monetary policies. Estimates of future growth indicate that output will remain below the levels expected in 2019 for a significant period of time. At the same time debt ratios jumped upwards as the result of the large deficits during 2020 and 2021. Both developments compound the deteriorating trends we had identified in the pre COVID-19 period. In the coming decade, South Africa will need to re-ignite the drivers of growth and embark on a macro-fiscal path that is credible and sustainable. To that end, economic policy needs without delay to tackle the microeconomic drivers of the country's productivity decline, especially in network industries. The current improvement in terms of trade due to rising mineral prices may temporarily shore up the government's finances and alleviate some imbalances, but will not address deeper production bottlenecks, and should not delay much-needed reforms. In the medium term, South Africa will need to return to primary surpluses, preferably with an expenditure-based adjustment, which has a lower cost output cost due to estimated fiscal multipliers.