In search of a new growth path for South Africa

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The international crisis reflects fundamental structural imbalances in the world economy. In particular, growth in Asia relied on the global North, especially the United States, to buy imports of manufactured goods that were effectively paid for by mounting international debts. If that pattern of growth cannot be revived, robust international growth will only return when the dominant economies find a new growth path.

For South Africa, the initial impact of the global crisis, from the end of 2008, was a sharp decline in exports, especially from mining, as well as a fall in foreign capital inflows to the stock and bond markets. For the majority of South Africans, the results were lower employment, lower incomes and higher joblessness. Formal sector employers cut back on hours, while informal hawkers – about half the informal sector – faced shrinking markets. Declining government revenues placed a strain on the state's ability to deliver services, especially in municipalities.

The state has sought to minimise the impact of the crisis through a combination of counter-cyclical fiscal policies linked especially to:

- maintenance of infrastructure investment
- increased local procurement
- support for funding for companies in distress
- labour-market interventions to minimise retrenchment in the formal sector.

It has signed a framework agreement with organised business and labour to take these initiatives forward. By mid-2009, however, the sharp fall in state revenues and the high cost of borrowing for Eskom and Transnet made it increasingly difficult to sustain the counter-cyclical stance.

The international downturn indicates the need to revisit assumptions about South Africa's options for long-term, sustainable and equitable growth.

Rapid economic expansion through the mid-2000s largely depended on high prices for commodity exports plus foreign capital inflows into the stock and bond markets to fund new investment. If global growth remains slow for the next few years, at least, that model may no longer be viable. In that case, the challenge will be to identify areas that can both grow and create employment on a large scale by meeting domestic and regional needs – notably through the agricultural value chain, light industry, public and private services and construction.

GLOBAL STRUCTURAL CRISIS

From the late 1980s, the world economy has grown relatively steadily, despite occasional cyclical downturns[1]. From around 2000, growth fuelled a boom in commodity prices. That benefitted South Africa, which remains dependent on mining-based exports. But the international economy grew increasingly reliant on unsustainable borrowing by the US, which was the dominant source of demand for traded consumer durables.

The Kuznets concept of long cycles is useful in analysing this extended period of economic expansion. Essentially, his long-cycle approach suggests that capitalist economies experience structural adjustments every 15 to 20 years[2]. From this perspective, broadly speaking, the long-growth cycle from the late 1980s to 2008 resulted from the opening up of the former socialist regions in Eastern Europe and Asia to capitalist investment and trade. The new opportunities both fostered and benefitted from advances in logistics that facilitated long-distance trade in goods and services.

Increasingly, however, China and other Asian countries saw exports of manufactures (and services, in the case of India) as a way to stimulate growth. But the global North, especially the US, could not maintain exports to pay for its imports. The US essentially borrowed from the Asian countries, led by China, to maintain consumption. In the mid-2000s, the US deficit on current account ranged around 5 percent of its GDP, or over US$700 billion. Most Asian countries had surpluses on their current accounts, which were invested largely in various kinds of US securities. This recycling process underpinned lower interest rates and soaring stock markets in the global North.

There were contrasting trends in the US and China. The share of the US in the global economy climbed through the 1990s, peaking at 32 percent in 2001, but then dropped to 23.5 percent in 2008. The share of China in the world economy climbed from 1.7 percent in 1990 to 7.3 percent in 2008.

These trends had a profound impact on the US economy, which in turn led quite directly to the financial crisis of 2008. The US lost productive jobs and capacity for much of the past ten years, but maintained its status through ownership of production, military power, technological leadership and its position as "consumer of last resort". The financial sector expanded at an extraordinary rate.

As the US grew less competitive in consumer manufacturing, companies moved into the financial sector. Deregulation boosted short-run profits but added to systemic risk. Profits from the financial sector climbed from an average of 25 percent of all domestic US profits in the 1990s to 35 percent in 2008. US companies also relied increasingly on profits from outside the US which rose from 18 percent of all US corporate profits in the 1990s to 27 percent in 2008.

Since interest rates remained low, middle-class Americans borrowed against their houses, relying on home loans and the stock market to maintain their living standards. The overextension of US consumer debt proved the weak link in the chain. It led to widespread defaults and ultimately a broad financial crash across Europe and the US. The average US household saw 25 percent of the value of its assets disappear, resulting in a sharp fall in demand. Major financial institutions in the US and Europe had to write off billions in bonds. As the banks became more risk averse, the flow of credit even to viable producers shut down. The result was a severe recession across the global North. The IMF expected the GDP of the "advanced economies" to drop by almost 4 percent in 2009 (IMF 2009a).

The rapid drop in consumer demand in the global North meant that China and other East Asian countries experienced a sharp fall in export sales, even though their financial institutions were mostly not directly affected. As a result, growth also slowed across Asia and China lost millions of jobs in export industries.

> The international downturn indicates the need to revisit assumptions about South Africa's options for long-term, sustainable and equitable growth.

The structural roots of the crisis make it difficult to predict medium-term outcomes. It seems virtually impossible for the US to return to the overheated consumption of the 2000s. That means that the Asian economies can only grow if they can expand domestic and regional markets. Strong stimulus packages in both countries have been linked to proposals for a new growth path – in the US, based on revival of technological leadership and infrastructure expenditure; in China, rooted in both infrastructure renewal and subsidies for consumer durables.

Still, it seems unlikely that the world economy will grow strongly for several years before the new structure of growth takes off. That reality constrains South Africa's policy choices.

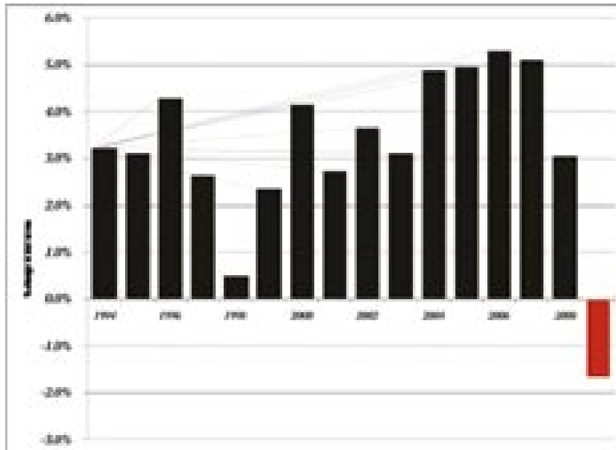
IMPACT ON SOUTH AFRICA

The structure of the South African economy left it particularly vulnerable to the global downturn. Despite significant reductions in poverty and unemployment in the 2000s, it was still characterised by unusually low levels of employment and deep social inequalities. However, through the mid-

2000s South Africa grew increasingly dependent on mining-based exports and short-term capital inflows into stock and bond markets. Both these economic pillars were hard hit by the global downturn.

The following table shows the latest available data on the GDP. It demonstrates that South Africa both benefitted from the relatively rapid global growth of the mid 2000s and experienced a decline following on the international downturn in early 2009.

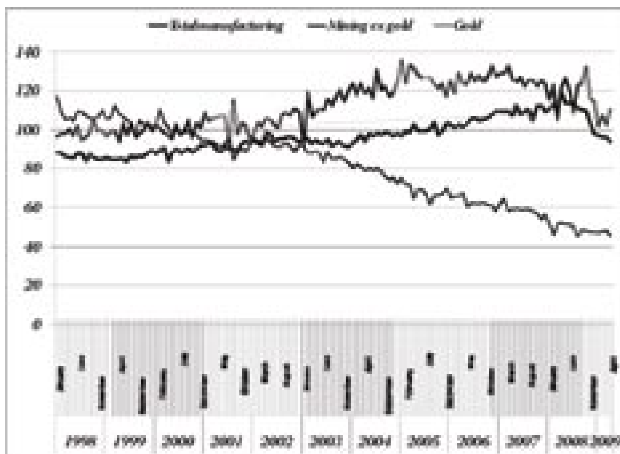
GDP growth, 1995 to first quarter 2009



Note: Growth for first quarter 2009 compared to third quarter 2008, seasonally adjusted.
Source: StatsSA. GDP data. Downloaded from www.statssa.gov.za in May 2009.

Mining and manufacturing saw particularly sharp drops in output.

Volume of production for manufacturing and mining (2000 = 100)

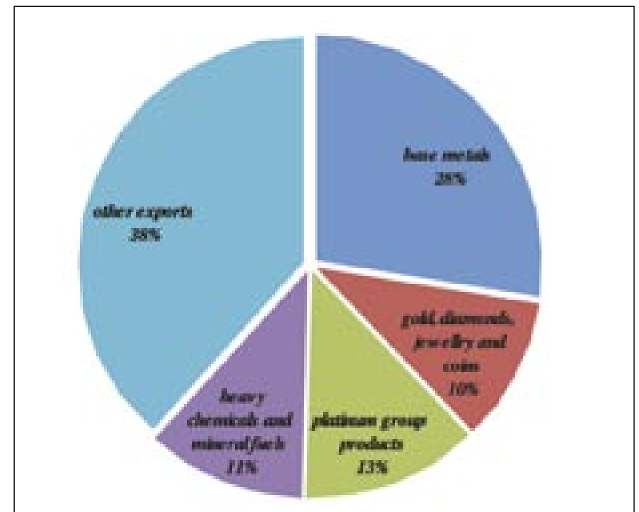


Source: Data downloaded from StatsSA downloadable database, economics series, www.statssa.gov.za, June 2009

The decline in mining reflected the serious drop in the prices of minerals and coal. While gold recovered fairly rapidly, in mid-2009 other commodities remained well below their peaks. Coal export prices dropped by over a third in 2009 (IMF 2009b).

For South Africa, the weakness of mineral markets was particularly worrying. High metals prices had reinforced dependence on mining-based exports in the mid-2000s. The mining value chain, including coal-based heavy chemicals, accounted for almost two thirds of total exports in 2008.

Exports by major commodity, 2008



Source: Calculated from Quantec data on exports, HS 6-digit data, downloaded from www.quantec.co.za in July 2009.

The economic decline from late 2008 to mid-2009 had a serious impact on employment.

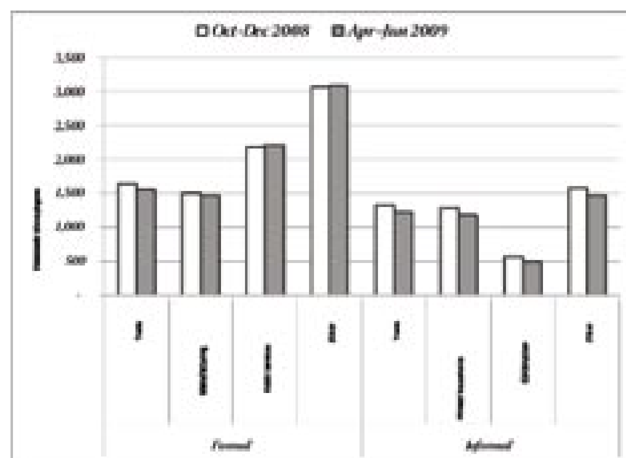
In the formal sector, the number of jobs dropped by 61 000 from the last quarter of 2008 to the second quarter of 2009. Most job losses were in retail and manufacturing (apparently largely in refineries and foundries), while both public and private services showed modest job growth. Many formal workers who kept their jobs faced cuts in working hours and consequently in take-home pay, leading to increased debt.

> As of mid-July 2009, the government had not adopted a consistent policy to ensure departments did more to find local producers.

The informal sector was hit even harder: it lost 404 000 income earners, or 8.5 percent of the total. Half the losses were split between self-employed hawkers and domestic workers. This shrinkage probably resulted quite directly from lower incomes in the formal sector. Another 15 percent of job losses took place in informal construction as the housing sector stagnated.

Young people were also badly affected. Employment for workers under 30 years old shrank by almost 7 percent, about twice as fast as job losses for older people.

Employment in the fourth quarter of 2008 and the second quarter of 2009



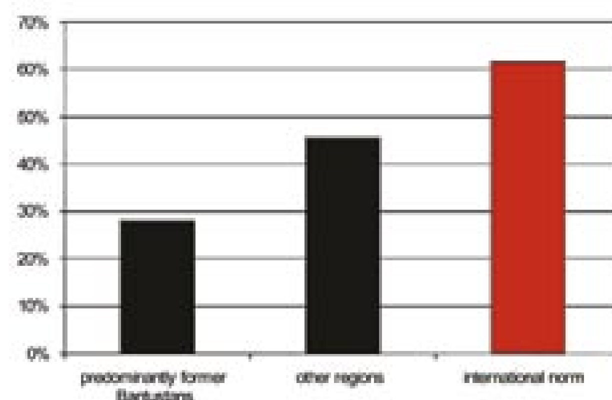
Note: Not seasonally adjusted.
Source: Calculated from StatsSA. 2009, Quarterly Labour Force Survey, Quarters 1 and 2. Downloaded from www.statssa.gov.za in July 2009.

Job losses were particularly damaging in South Africa because of low employment levels, which persisted despite the relatively rapid employment growth of the mid-2000s. Globally, around 60 percent of working-age adults have some kind of paid employment. In South Africa, the figure was under 50 percent, with only around one-third of working-age people in the former bantustan regions having paid employment.

In the mid-2000s, the absorption rate improved as a result of rapid employment growth. Formal employment expanded by 20 percent, or over 2 million, between September 2002 and the third quarter of 2008 (Stats SA, 2003 and 2008). Most new jobs emerged in the retail, construction and public and private services sectors. As a result, the absorption rate climbed from 39 percent in 2002 to 45 percent in mid-2008. In the second quarter of 2009, as job losses mounted, it fell back to 43 percent.

The fact that most employment losses occurred among self-employed informal workers meant that the Unemployment Insurance Fund (UIF) did relatively little to mitigate the impact. The UIF provided between one and two thirds of pay for covered employees, including some domestic workers.

Share of working-age adults with paid employment (absorption rate), 2007

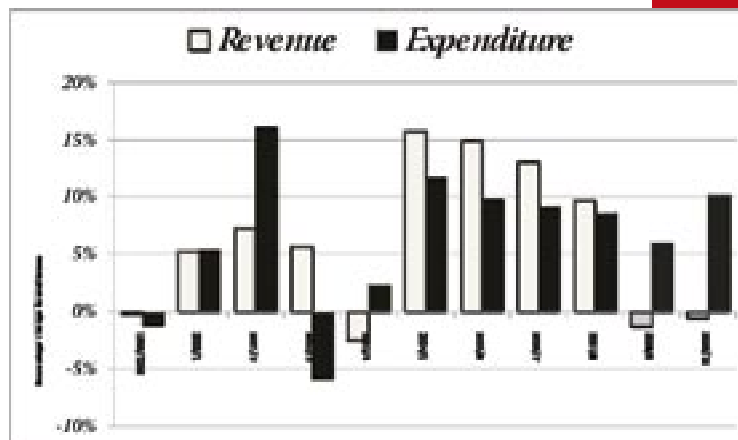


Source: Calculated from StatsSA, Labour Force Survey, March 2007. Database on CD-ROM.

But hawkers and other self-employed people, as well as most part-time and casual workers, could not join the UIF.

The crisis also cut deeply into government revenues. In the 2009/10 budget, the Treasury predicted that the state's income would decline by 1.3 percent. In the event, it seemed likely that the decline would be at least twice as steep, although the final outcome for 2009/10 remains uncertain (Gordhan, 2009). This fall came after eight years of rapid growth in both government spending and revenues.

Government revenue and expenditure, 1999 to 2009



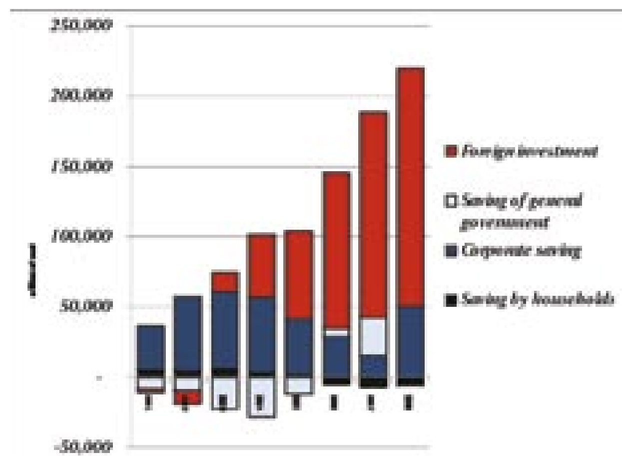
Note: Actual to 2008, budget and MTEF forecast thereafter.
Source: Calculated from National Treasury Medium-Term Budget Statement 2008 and Budget Review 2009, Pretoria. Deflated using CPI.

A particular concern arose around municipal revenues. As incomes and economic activity declined, service payments came under great pressure, although (as of mid-July 2009) there were no studies to indicate the overall impact. Unlike the national government, however, most municipalities were unable to borrow to cover the shortfall. The main risk was that they would cut back on maintenance of municipal infrastructure – roads, electricity and water, in particular

– even though most of these systems already needed recapitalisation.

Finally, South Africa seemed particularly vulnerable to fluctuations in international capital flows. During the global upswing, when international liquidity was high, new investment relied increasingly on inflows into the equity and bond markets.

Financing of new investment, 2001 to 2008



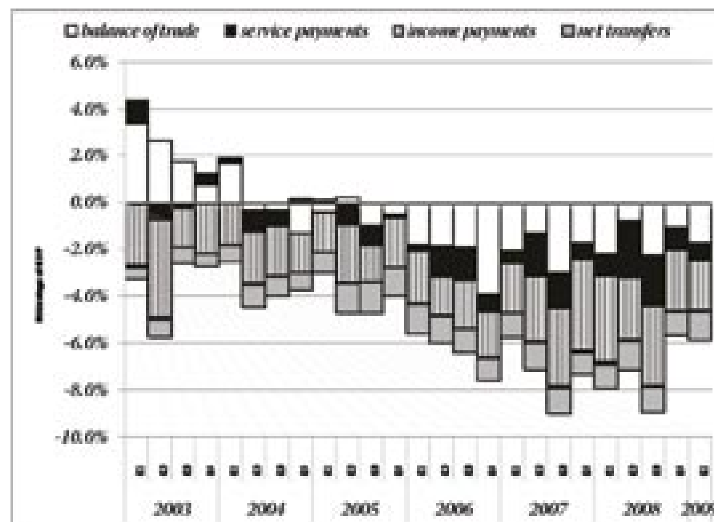
Source: Calculated from SARB, Quarterly Bulletin, First Quarter 2009, p.S-124.

The spike in short-run capital inflows in the mid-2000s had a major impact on the structure of growth. They strengthened the rand, which in turn constrained growth in manufacturing while fostering a deficit on the balance of trade. The stronger rand contributed to lower inflation, which encouraged lower interest rates and soaring borrowing. As a result, domestic savings by households and companies declined. In addition, the country paid for the capital inflows through high dividend and interest payments to foreigners, with outflows of capital for this purpose averaging over 3.5 percent of the GDP in 2007/8 (calculated from SARB, 2009 p. S-79 ff).

Taken together, these factors meant South Africa had an unusually high deficit on current account in the mid-2000s, at around 5 percent of the GDP. Capital inflows declined somewhat with the international crisis, but remained reasonably strong. The rand only depreciated by around 20 percent in the first half of 2009. If a further crisis led to a reduction in short-run foreign investment, however, South Africa seemed likely to face painful adjustments mediated through a further weakening in the rand, making imports substantially more expensive.

In sum, the international crisis affected South Africa directly through reduced demand for our exports, which in turn had a multiplier effect that led to major job losses at home. At the same time, it reduced government's fiscal space, making a counter-cyclical policy harder to sustain, and pointed up the economy's vulnerability to fluctuations in international capital flows.

Elements in the balance on current account, 2003 to first quarter 2009



Source: Calculated from SARB, Quarterly Bulletin, First Quarter 2009, p. S-79 ff

NATIONAL RESPONSE

Through the National Economic Development and Labour Council (NEDLAC), the government reached agreement with organised business and labour in the "Framework for South Africa's Response to the International Economic Crisis". This represented an important effort to ensure a rapid collective reaction to mitigate the effects of the crisis. It also included an historic commitment from all the parties to prioritise protecting employment and, in the longer run, expanding it.

In this context, the government undertook some important interventions.

Counter-cyclical policies

The state agreed to a counter-cyclical fiscal and monetary policy. In line with this commitment, the government budgeted for a 3.8 percent deficit, after two years of modest surpluses. Lower revenues as a result of the economic downturn could lead to a substantially higher deficit for 2009/10, possibly around 6 percent.

Public investment

As part of its counter-cyclical package, the government planned to proceed with public investment based on existing plans. Initiated in 2005, these foresaw very significant investment by government departments, and even more by Transnet and Eskom. The main challenge became ensuring adequate funding in light of lower tax revenues and more expensive international funding. The Framework Agreement called on both development finance institutions – the Industrial Development Corporation (IDC) and the

Development Bank of Southern Africa (DBSA) – and private partners to investigate ways to ensure more affordable funding, especially for the parastatal build programmes.

Local procurement

The multiplier effect of state spending depends largely on the extent of local procurement. The government committed itself to encourage both departments and state-owned enterprises to buy local, as long as this did not impose an excessive cost on the budget or the quality of services. Some progress was made, particularly by Eskom, in engaging with local producers, starting when the build programme was initiated around 2005–06. As of mid-July 2009, however, the government had not adopted a consistent policy to ensure departments did more to find local producers. In the long run, using procurement to support national capacity development requires the introduction of new systems to ensure that potential local suppliers learn about government needs in time to gear up for efficient production.

Support for businesses and sectors

The government encouraged the IDC to develop a facility to support distressed companies. The facility aimed to provide funding to enterprises that would be sustainable if not for the sudden drop in demand and the tightening of financial markets as a result of the downturn. The main challenges were:

- high levels of demand relative to the IDC's funds
- the tendency of enterprises to apply only when they were in a deep crisis
- the inherent difficulty of distinguishing between sustainable and unsustainable enterprises.

Various government departments engaged with sectors that seemed likely to face a drop in demand. The department of trade and industry held extensive meetings with the auto, clothing and capital-goods industries, which were the only sectors that admitted to severe impacts from the downturn. They agreed in principle on measures to reduce illegal imports, assist with investment and other incentives, and explore ways to reduce production costs. Experience suggests, however, that this type of sectoral programme takes at least six months to a year to implement.

> A crucial innovation is the provision of subsidies to NGOs and communities to organise public employment schemes.

Support for retrenched workers

The department of labour developed several programmes to limit retrenchments and reduce their impact. It worked with employers and the Commission for Conciliation, Medication and Arbitration (CCMA) to ensure that parties explored alternatives to retrenchment. It engaged the Sectoral Education and Training Authorities (SETAs) to develop "training layoffs," where workers who would otherwise be retrenched would undergo training, with a stipend, for at least several months.

Public employment schemes

The government committed to a rapid expansion in public employment schemes through the Expanded Public Works Programme (EPWP) Phase II. A crucial innovation was the provision of subsidies to NGOs and communities to organise public employment schemes. The immediate challenge was to set up efficient funding channels. More fundamentally, the scheme required a shift in the EPWP's emphasis, from its long-standing focus on providing high-quality government services in a labour-intensive fashion to one that prioritises social cohesion and provides some income for the unemployed – even if that meant funding new kinds of projects, such as cultural programmes and community recycling.

Social grants

Finally, the government has committed to maintaining existing social programmes, including social grants for relief of distress. If revenues fell as far as some anticipated through 2009, however, the Treasury would be tempted to increase social grants less than inflation in 2010/11.

Challenges and obstacles

The Framework Agreement – and especially the implementation of a counter-cyclical fiscal policy – laid an important foundation for minimising the effects of the international downturn. But it faced some difficult challenges.

The main obstacle lay in translating the principles in the framework agreement into practical programmes. The main blockages emerged from bureaucratic inertia – across the state – and the time required for engagement at NEDLAC on programme details.

In addition, funding proved very problematic. The Treasury had to manage the risk of a sharper than expected decline in revenues. The state-owned enterprises had to find new sources of funding in order to maintain their investment programmes, even as their revenues dropped.

SOME LONG-TERM IMPLICATIONS

The restructuring of the international economy poses important questions about the long-run development

strategy. Above all, if consumer demand remains relatively depressed in the US, the prospects for exports of consumer durables and foreign funding seem substantially bleaker. Instead, economic diversification would have to look more to local and regional markets, and be funded more by the mobilisation of local resources than international markets.

In the mid-2000s, South Africa was still a classic mining-based economy in many ways. Although mining contributed only about 10 percent of the GDP and employment, it still accounted for over half of exports. Typically, this type of economy booms when commodity prices soar, but experiences little diversification into new industries. Moreover, the benefits of growth tend to be relatively concentrated, so inequalities remain pronounced. When commodity prices slump, the economy then faces a sharp downturn, particularly in imports and state revenues (which in turn limits both economic and social programmes).

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The way in which both mineral prices and international demand for consumer durables will develop in the next five to ten years thus becomes a central question. The challenge is to define what kinds of employment-creating industries could grow in these circumstances. In the event, the production of basic goods for the poor, services, construction and agricultural goods seem able both to compete and to find domestic and regional markets. These industries would, however, require consistent state support through provision of appropriate and affordable infrastructure and skills as well as measures to stimulate regional growth.

Shifting to this kind of growth path would require significant institutional changes within the state. There is little capacity in government to encourage growth in services and agriculture and in industries geared to domestic and regional markets. Moreover, the government has not published policies on how it can engage with the region in ways that would support economic growth and diversification.

Finally, an effective diversification strategy requires a stronger effort to mobilise domestic funding and production of inputs in order to avoid excessive dependence on unstable, short-term international capital inflows and to maintain a competitive value for the rand.

NOTES

1. Unless otherwise noted, the data for countries other than South Africa is from the IMF *World Economic Outlook* database and the *World Bank Development Indicators* database, both downloaded in July 2009.
2. The explanations given for long cycles in the literature tend to be quite specific. The concept is employed here only to suggest that it is useful to analyse long-term growth cycles as opposed to the shorter term business cycle. See Solomou, 2008.

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