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The COVID-19 shock and the revised economic outlook

In brief

- Over the past several months, the COVID-19 pandemic and the emergency health response have brought about a severe global recession.
- Real GDP growth in South Africa is expected to plummet by 7.2 per cent in 2020, primarily due to restrictions on economic activity to contain the spread of the virus.
- Strengthening South Africa's competitiveness in a post-pandemic world will require a new social compact, decisive action to stabilise debt and narrow the budget deficit, and determined implementation of reforms that improve the structure of the economy. In combination, these measures will enable millions of South Africans to participate in building a more productive and prosperous society.

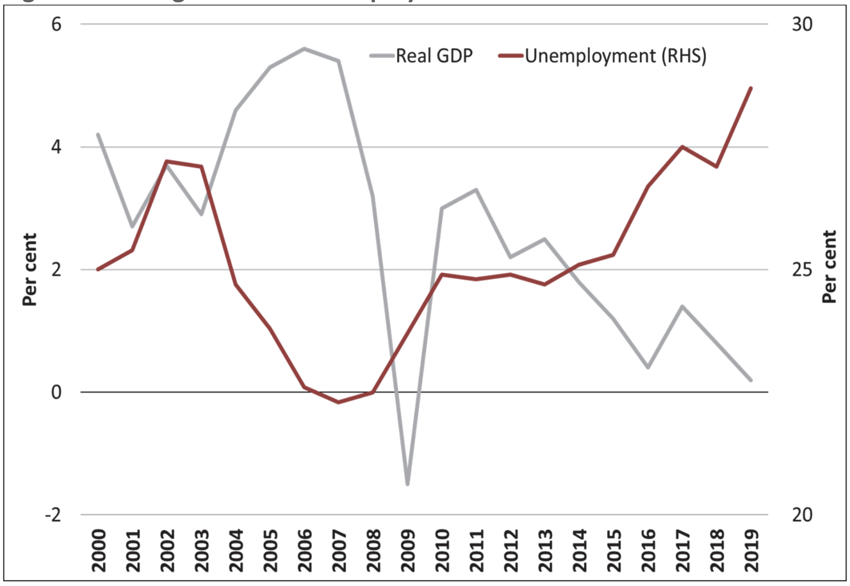
Overview

The global shock prompted by the COVID-19 pandemic, and unprecedented restrictions designed to protect public health, have led to a sharp contraction in the domestic economy. Government interventions have cushioned the impact on workers and businesses, but have not offset the full decline. South Africa's economic growth is forecast to fall by 7.2 per cent in 2020 as a result of the crisis, the March and April 2020 credit rating downgrades, and the compounding effects of weak investor confidence. The economic outlook is highly uncertain.

Yet this crisis also presents an opportunity to enact major reforms. As the President noted in his 21 April address, to break with a pattern of weak growth and overcome structural inequality, the South African economy cannot merely return to where it was before the pandemic. Forging a new economy in a changed global reality will require a social partnership between business, labour, communities and government.

This chapter reviews the economic implications of COVID-19 and government's response, and presents a revised economic outlook for 2020. As set out in Chapters 1 and 4, government will take the necessary measures to stabilise mounting public debt over the medium term. And in the months ahead, it will consult with the private sector, trade unions and civil society on the reforms needed to chart a path to faster, inclusive economic growth. A package of proposed fiscal and economic reforms will be set out in the 2020 *Medium Term Budget Policy Statement* (MTBPS).

Figure 3.1 GDP growth and unemployment



Source: Statistics South Africa

Economic impact and response to pandemic

The global economic contraction brought about by COVID-19 has unfolded with unprecedented speed, hitting developing countries particularly hard. In 2020, according to the World Bank, developing economy output is expected to contract for the first time in at least 60 years.

Global and domestic policy response

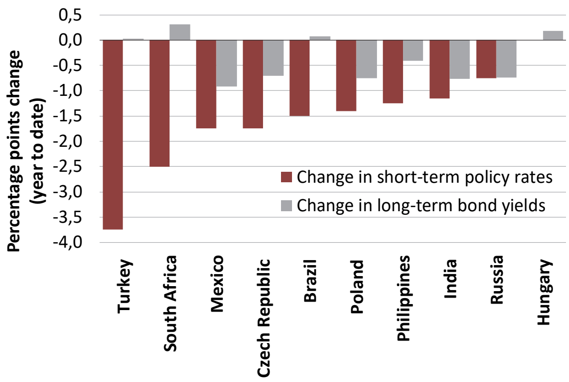
In response to the pandemic, governments worldwide have increased health spending, introduced restrictions on economic activity to limit the spread of the virus, and taken steps to alleviate the effects of lockdowns on households and businesses. Authorities have prioritised income support and wage subsidies for workers, alongside tax relief, lower interest rates and favourable loan schemes to support businesses.

Developing countries face a particular challenge in responding to the protracted effects of the coronavirus. Many governments had borrowed heavily in recent years; as a result, they had little or no fiscal space available as COVID-19 set in. While external financing of approximately US$1 trillion from the International Monetary Fund (IMF) and the World Bank has provided support for countries in need, access to multiple funding sources is critical.

Global financial markets have been severely disrupted, with extreme volatility and capital outflows from developing countries exceeding the peaks reached during the 2008 global financial crisis. Central bank actions have helped to stabilise markets, but volatility remains high.

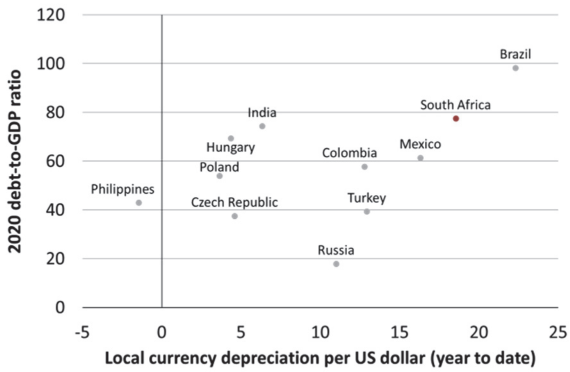
The rand has depreciated by 18.1 per cent against the US dollar since January. In comparison, an index of emerging-market currencies weakened by 4.6 per cent over the same period. South Africa's risk premium – the additional return that investors demand to compensate for higher levels of risk – stood at 5.2 per cent at 15 June 2020, compared with 3.2 per cent at the end of 2019. Bond yields have stabilised due to Reserve Bank purchases of government bonds, but remain higher than before COVID-19. This indicates uncertainty about South Africa's longer-term growth and fiscal position, and means government pays more to borrow money.

Figure 3.2 Developing-country interest rates



Source: Bloomberg

Figure 3.3 Developing-country currencies and debt



Source: IMF (debt-to-GDP forecast, April WEO), IHS Global Insight

To limit the impact of the pandemic on the economy, the Reserve Bank has reduced the repurchase rate to 3.75 per cent, its lowest level since 1973, providing relief to indebted households and businesses. Banking-sector regulations have been eased to encourage lending. Banks have provided R30 billion of relief to customers.

Government's R500 billion fiscal relief package provides significant support to households and businesses. But government's weak fiscal position going into the crisis means that it cannot afford to fully offset the effects of the pandemic.

Steep contraction across all economic sectors

To protect South Africans and prevent the public health system from being overwhelmed, government restricted most economic activity from 26 March to 1 June.

The lockdown has taken a severe toll on an already fragile economy. The limited data available suggests a steep contraction across all sectors over the past three months. Construction, retail and hospitality were particularly hard hit, and retail sales restrictions had significant knock-on effects across the economy. Reduced global demand and border closures, alongside uncertainty about the application of lockdown regulations, further hampered activity.

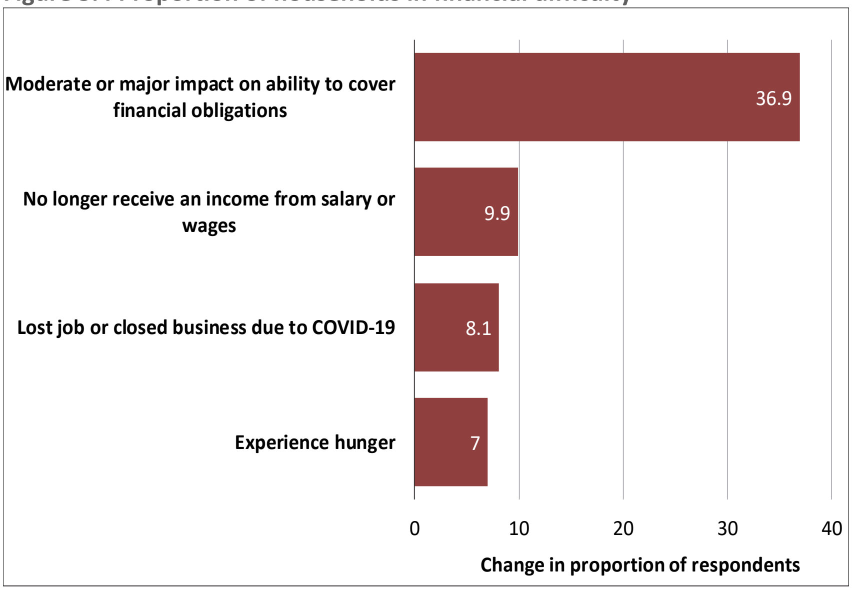
Table 3.1 Impact of pandemic on trading status by sector[1]

Percentage	Trading at full capacity	Trading at partial capacity	Permanently ceased trading	Temporarily ceased trading
Agriculture, hunting, forestry and fishing	11.8	22.4	11.6	54.2
Mining and quarrying	5.6	72.2	–	22.2
Manufacturing	7.5	48.0	6.1	38.4
Electricity, gas and water supply	12.8	43.6	–	43.6
Construction	0.6	18.5	13.7	67.2
Trade	4.6	29.6	5.9	59.9
Transport, storage and communication	7.8	58.9	8.9	24.4
Real estate and other business services	13.8	57.3	4.1	24.8
Community, social and personal services	8.5	32.5	12.0	47.0
Other	6.9	35.3	6.0	51.8

1. Percentage of 2 182 respondents surveyed from 14-30 April 2020
Source: Statistics South Africa

Statistics South Africa (Stats SA) data shows that for the first two weeks of April, nearly 90 per cent of businesses reported below-normal turnover, 48 per cent ceased activity temporarily and 9 per cent permanently closed operations. Business confidence in the second quarter of 2020, as measured by the BER/RMB index, reached its lowest level since the series began in 1975.

Figure 3.4 Proportion of households in financial difficulty*

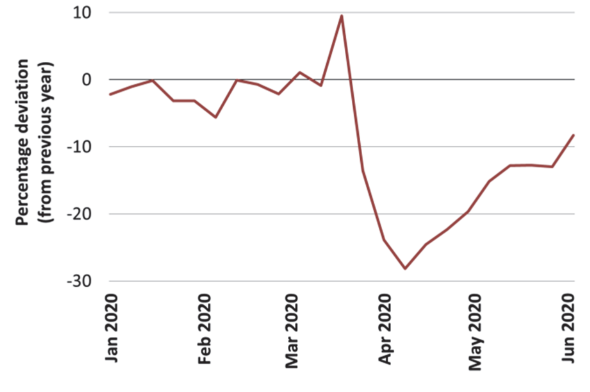


**Percentage of 2 688 respondents surveyed between 29 April and 6 May 2020*
Source: Statistics South Africa

Since March 2020, consumers at all income levels have reduced spending. The crisis is likely to have increased hardship particularly for those in informal or low-skilled jobs. Reduced activity has led to sharp downward pressure on pricing power for the most essential goods.

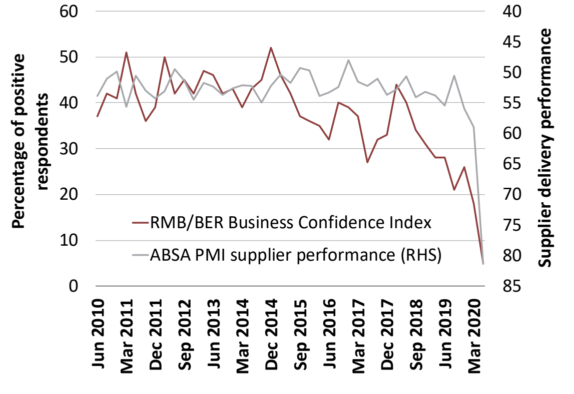
Restrictions are now easing, enabling firms to do business and giving more workers the opportunity to earn a living. There has been a recovery in activity, for example in electricity usage, but levels remain low relative to 2019.

Figure 3.5 Electricity usage



Source: Eskom

Figure 3.6 Business confidence and performance



Source: IHS Global Insight

It is too early to estimate the magnitude of the longer-term effects of the pandemic on business survival and employment. However, the weakness of the economy prior to the onset of COVID-19 suggests elevated risks of business and job destruction under current policies.

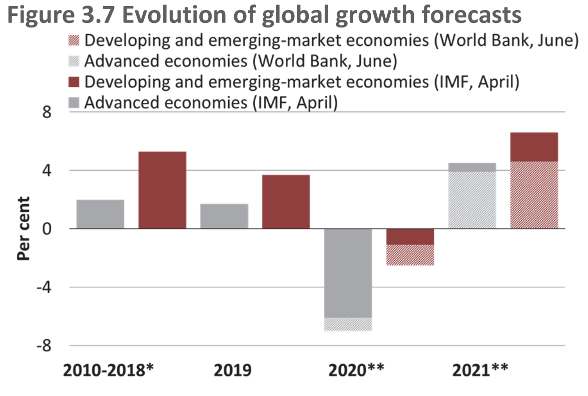
Economic outlook

High levels of uncertainty about the spread of COVID-19, and its containment and treatment, have complicated decision-making for businesses, investors and households the world over. In addition, regular economic surveys have been disrupted and delayed, making policymakers more reliant on smaller, less representative surveys. As a result, estimating the economic impact over the period ahead is exceedingly difficult. While the scenarios outlined in this special adjustments budget are intended to illustrate potential policy outcomes, data and projections may change significantly in the months ahead.

Global outlook

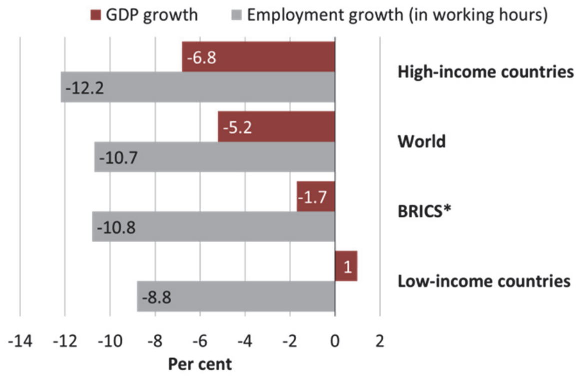
In June, the World Bank forecast a 5.2 per cent contraction in global GDP in 2020. This would mark the deepest global recession since the Second World War, and the broadest collapse in per capita incomes since 1870.

Figure 3.7 Evolution of global growth forecasts



Source: IMF (April 2020), World Bank (June 2020)
**Average **Forecast*

Figure 3.8 Growth and employment in 2020



Source: World Bank (growth), ILO (working hours)
** Brazil, Russia, India, China and South Africa*

Tens of millions of workers have lost their jobs and many more have seen their hours reduced. Trade tensions remain elevated, particularly between the US and China. The IMF's global forecasts, on which the National Treasury bases its projections, are likely to be revised lower later in June 2020.

Weak global growth has resulted in a decline in commodity prices since January, with oil prices down about 40 per cent. An exception has been the gold price, which has risen by 13 per cent, owing to safe-haven demand. As a result of these changes, South Africa's terms of trade are forecast to be positive in 2020, but these gains are expected to dissipate over time.

The domestic economy in 2020

The economy grew by just 0.2 per cent in 2019. As government's fiscal position deteriorated, the ratio of investment to GDP fell to 17.9 per cent, the lowest since 2005, while the unemployment rate reached an 11-year high of 29.1 per cent. The 2020 *Budget Review* forecast growth of 0.9 per cent for 2020. That forecast proved optimistic given the unexpected contraction in the fourth quarter of 2019, which emerged after the Budget was tabled in Parliament but before the onset of COVID-19.

The National Treasury forecasts that the economy will contract by 7.2 per cent in 2020. Business confidence will remain near historic lows, and investment and employment will drop below last year's levels. Household consumption will remain constrained by reduced income – from wages, commissions, bonuses and financial assets – as well as low job growth. Inflation will be contained in the near term due to the collapse in demand, low imported inflation and moderate food price pressures. Weak activity will reduce the current account deficit, which is expected to be fully funded by foreign inflows.

The 2020 outlook may deteriorate further if the global economy continues to weaken, or economic activity is curtailed again to protect public health. A failure to attract sufficient international capital to finance the current account deficit would also constrain growth.

The growth trajectory beyond 2020

South Africa's economic outlook is heavily influenced by global trends. However, it is primarily domestic fiscal policy measures and implementation of economic reforms over the next six to 12 months that will determine the growth trajectory over the next several years. These will be outlined in the 2020 MTBPS.

Critical risks to the economy include continued volatility in global financial markets, sudden interruptions in capital inflows, the reliability of electricity supply, additional commitments to fund financially distressed state-owned companies, low levels of confidence, policy uncertainty and concerns about government's commitment to the independence of the central bank.

In a scenario in which tough fiscal policy and broader economic reforms are not implemented, there would be further prolonged weakness in economic growth, currency depreciation and higher borrowing costs.

To avoid these outcomes, Cabinet has endorsed an active approach that will adjust expenditure to a sustainable level and improve the efficiency of spending. This approach will build confidence and bolster investment as significant economic reforms are implemented. As confidence in the fiscal strategy grows, South Africa's risk premium will decrease and long-term savings will flow into the country. Over the longer term, fiscal policy certainty, the need to rebuild capital stock, and new ways of working will incentivise firms to invest.

Table 3.2 shows a relatively conservative projection of medium-term economic growth, given elevated risks of global and domestic shocks, and low growth and productivity outcomes over the past several years. Concerted implementation of cross-cutting reforms could result in economic growth exceeding these estimates.

Table 3.2 Active scenario outlook

Percentage change	2010-2018[1]	2019	2020	2021	2022	2023
Real GDP growth	1.9	0.2	-7.2	2.6	1.5	1.5
GDP inflation	5.7	4.0	4.0	3.9	4.4	4.6
GDP at current prices (R billion)	3 811.9	5 077.6	4 900.2	5 227.9	5 536.1	5 873.4
CPI inflation	5.3	4.1	3.0	3.9	4.3	4.5

1. Average growth rates
Sources: National Treasury, Reserve Bank and Statistics South Africa

Cross-cutting reforms to boost long-term growth

Over the past decade, South Africa has experienced weak economic growth well below the rate of population growth. COVID-19 has destroyed productive capacity and is changing the global economy. In this context, deeper reforms than previously outlined will be required to meaningfully lift growth over a five-year period.

Raising domestic savings levels and removing the barriers to long-term investments, both domestic and foreign, are key reform objectives. South African firms need greater support to innovate, including moving towards a greener economy, raising productivity and seeking out export markets.

Government envisions a package of economic reforms that will improve productivity, lower costs and reduce demands of state-owned companies on the public purse. These measures include finalising electricity determinations, unbundling Eskom and taking other steps to open up energy markets, modernising ports and rail infrastructure, and licensing spectrum. Additional reforms, in line with *Economic Transformation, Inclusive Growth, and Competitiveness: Towards an Economic Strategy for South Africa* include:

- Lowering the cost of doing business, reducing red tape and improving access to development finance for small, medium and micro enterprises.
- Support for agriculture, tourism and other sectors with high job-creation potential.
- Facilitating regional trade.
- Reducing the skills deficit by attracting skilled immigrants.

- Revamping the skills framework, and undertaking a range of reforms in basic education and the post-schooling environment to improve outcomes for workers – and the firms that can employ them.

To realise the full benefits of these reforms for the economy's growth potential over the long term, implementation should begin now.

Conclusion

After a decade of slow economic growth, the impact of COVID-19 on real income levels is likely to set the South African economy back several years. Urgent action is required to reverse this decline and move towards a future of higher, more inclusive growth.