Can infrastructure spend offset consumer slump?

BALANCING THE DEFICIT

Margaret Chitiga-Mabugu and Ramos Mabugu

IN THE PAST, South Africa has maintained prudent macroeconomic policies that helped shield it from the negative effects of economic recession during the financial crisis of 2008.

Economic growth in South Africa is largely driven by consumption, which has slowed since the economic contraction of 2009. Gross domestic product (GDP) is growing slower than expected, at a projected 2.7 percent this year, 3.5 percent in 2014 and 3.8 percent in 2015. The slower growth means less revenue for the government, whose main revenue sources are taxes, while ameliorating the negative consequences of the global economic crisis has required more expenditure from it.

Since 2008/09, the social assistance budget has been increasing by an average of 11 percent a year. The housing and amenities budget has increased by more than 16 percent a year since 2008. In his Budget speech this year, Finance Minister Pravin Gordhan said social assistance spending was set to increase to R120 billion in 2014.

When there is low or negative growth, government spending can and is normally used to boost countries' economies.

Figure 1 plots South African government spending growth versus growth in GDP. During the 2008 recession, these two variables moved in opposite directions.

It is thus not surprising that the fiscal balance, which was in surplus in 2007, fell into a deficit by 2009/10 and has not recovered, as shown in Figure 2. The deficit worsened as it fell further from minus 4.2 percent of GDP in 2011 to minus 4.9 percent in 2012. The mismatch between revenue and expenditure has meant that the burden of debt has increased. As the deficit increases, so does the cost of financing it, and so does the interest on payments, as shown in Figure 3.

The issue that concerns rating agencies is that the pace at which South Africa's public debt to GDP ratio is rising, is in contrast with the average trend for other emerging markets where the trend is decreasing. As a result, the state had the option of either cutting expenditure or increasing tax rates, or alternatively, allowing the budget deficit to rise sharply and in so doing countenance an increase in the public debt to GDP ratio. The government chose the latter, fearing that reducing expenditure or increasing tax rates would further damage economic growth.

The question we ask is why the recovery has been so slow several years after the crisis. The reasons are varied. According to a recent International Monetary Fund report, three factors are at play, namely, shocks, policies and institutions.

Three shocks were particularly important: the electricity shortages of 2007; the increase in food prices between 2008 and 2009; and the global financial meltdown that started in 2009. These shocks were instrumental in the slowdown that has been witnessed since 2007. The fact that Europe and the US are South Africa's largest trading partners, and that these regions were hit the hardest by the crisis, did not help South Africa. Further, given that these regions have not fully recovered from the crisis, the chances of a quick recovery for South Africa are also very slim.

Would it matter for growth if, for the same deficit, a government spent its budget on consumption or investment?

Fig 1: **Government expenditure and economic growth**

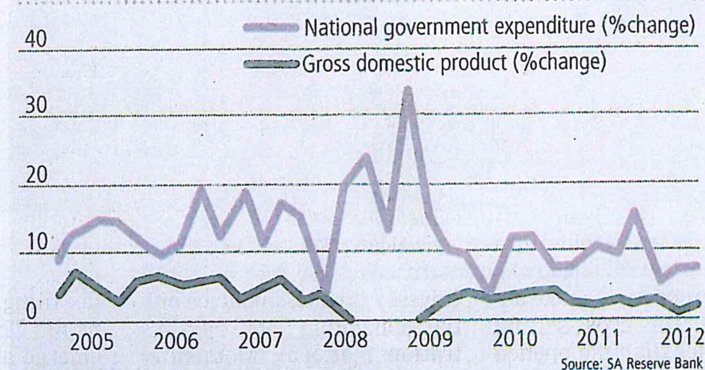


Fig 2: **Government deficit**

As percent of GDP

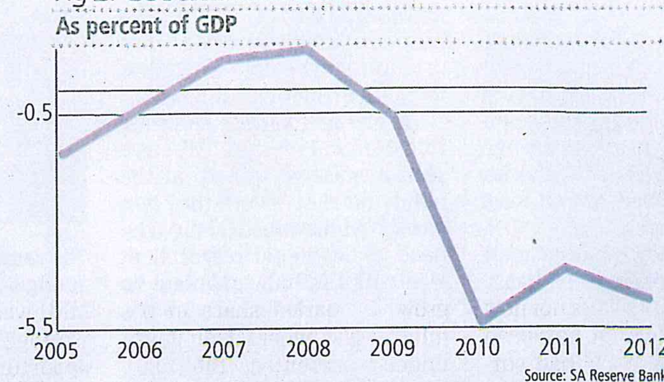
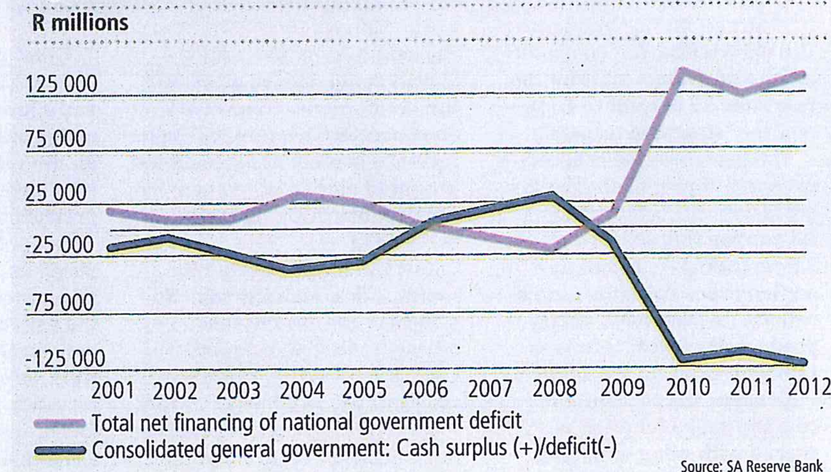


Fig 3: **Government deficit**

R millions



The labour market dynamics in South Africa could also have played a part in the country's economic dilemmas. The recent unrest in the mining and the agricultural sectors has not been favourable for attracting new investments. More investments imply higher growth and more revenue to assist in reducing government debt.

The strength of the unions has meant that wage growth has been higher than productivity. This could have meant a push on the industries to more capital intensive growth and thus more unemployment. In addition, it is generally agreed that the level of competition in major industries in the economy is so low that it is difficult to bring inflation down. Hence, consumption, which drives economic growth in South Africa, is depressed.

The current account was in the negative even before the financial crisis, although it worsened with the crisis.

There are two legs to the current account. One is the trade account which captures data on the export and import of goods. The other is the services account, which reflects flows relating to transactions like insurance and transport. The balance on the current account is the gap between income from exports of goods and services and the import bill.

Net income from abroad and net current transfers are normally very small, allowing movements in exports and imports to dominate the current account. Therefore, a country running a current account deficit, such as South Africa is doing at the moment, is importing more goods and services than it is exporting.

A worsening of the deficit could result in a sharp depreciation of the rand as well as an increase in the country's interest rates, and this could drive it into a recession. In addition, a large current account deficit can undermine foreign investors' confidence in South Africa, which may ultimately result in it being unable to secure further loans from abroad.

A number of factors are preventing South Africa from realising its full potential. Eskom's now infamous load shedding negatively affected investor confidence. Other factors that have dampened investor confidence are the on-going labour strife in various sectors, especially in mining.

These are also the main contributing factors to South Africa's downgrading by international credit rating agencies. What this ultimately means for the country is that investments that are needed to boost the balance of payments will be adversely affected. It also means that borrowing money from abroad becomes quite expensive, which could further worsen the country's fiscal deficit.

A central question is, of course, whether it would matter for growth if, for the same deficit, a government spent its budget on consumption or investment? It should, but most fiscal policy discussion ignores the key channel for fiscal policy to influence growth, that is, the effect of the composition of expenditure (and taxation).

Not surprisingly, fiscal adjustment has often been achieved in ways that would have undermined long-term growth. These insights are corroborated for South Africa by our recent simulations that focused on the intertemporal impact of increased current and investment spending.

Budget 2013 has not drastically changed the composition of spending. In this regard, to the extent that the deficit reduction programme is premised on reducing growth in the public sector wage bill, this in itself removes one of the pillars driving rapid growth in consumer spending between 2010 and 2012. With the planned substantial reduction in real growth of remuneration of public sector employees, growth in consumer spending is bound to slow, not only because of the planned effective erosion in disposable income of public sector employees, but also because the growth of unsecured lending to the public services is likely to diminish if the government refrains from employing more people in the service.

However, hope still exists that in terms of the overall GDP growth rate, the slowdown in the growth of consumer spending will be counterbalanced by increased infrastructural investment spending and an improvement in exports and the trade balance on the back of the real depreciation of the rand over the past year.

Professor Margaret Chitiga-Mabugu is the executive director of economic performance and development research at the Human Sciences Research Council and Dr Ramos Mabugu is the head of research and policy at the Financial and Fiscal Commission of SA.