Gearing for Growth: How countries recover from crisis – Considering the case studies

Outcomes report
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Welcome and context

Gearing for Growth is an essential agenda for South Africa as the discussion focuses on the future well-being of the state of the country’s economy. In the midst of political change, this discussion series looks to contribute to the discourse on how South Africa can breakout from its current low-growth environment and prevent a possible crisis. While poverty, inequality and unemployment are key challenges in the economy, there is still disagreement surrounding the necessary steps that need to be taken to rectify these issues.

What is agreed upon is that the economy needs to start growing again. The current economic growth pace of approximately 1.5% per annum is inadequate to rectify South Africa’s socio-economic problems. The growth target should be between 5% and 6%, as it is only at these rates that the economy can start bringing those left behind and historically excluded into the mainstream economy, ensuring that all South Africans benefit from the prosperities of growth.

Sihlalo Jordan, Deputy CEO, Deloitte Africa

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Although global economic growth has been improving since the financial crisis, South Africa has not been able to piggyback off the momentum of the growing global economy.

To gear the South African economy for higher growth, it is important to determine what the current economic trend is and where South Africa finds itself within the business cycle. Currently, South Africa is positioned in the trough or the recovery phase of the business cycle with GDP growth rates at approximately 1.5%. Due to the severe effects of the 2008 global financial crisis, South Africa is struggling to escape its low growth trap and achieve growth levels of 3%. Although global economic growth has been improving since the financial crisis, South Africa has not been able to piggyback off the momentum of the growing global economy.

After the financial crisis, the South African Reserve Bank pointedly decreased the repo rate to 5% in 2012, from 11.5% in 2008, and combined with a fiscal surplus of 1% this provided a noteworthy stimulus to the economy. The economy, however, did not respond in the way that policymakers had hoped. Globally, central banks started proposing structural reforms as a means to stimulate growth as the ability to do this from the demand side or macro-policy framework had become limited.

In the South African context, while many of these issues apply, the infrastructure gap is of significant concern. In the peak of the business cycle in 2008 and before the global financial crisis, South Africa was only investing an equivalent of 23% of GDP in infrastructure, whereas the rule of thumb suggests that South Africa should be investing the equivalent of approximately 30% of GDP to meet its developmental needs.

Furthermore, South Africa’s inability to absorb new labour market entrants into productive sectors of the economy and reduce unemployment is preventing the country from capitalising on growth. If a substantial dent in unemployment could be made, the economy could be revived and once again achieve 3% to 4% growth.

There are also over 800 000 firms registered as tax-paying businesses in South Africa, however only 2 000-3 000 firms account for 70% of the total turnover. Exports are also highly concentrated with 300 firms accounting for 75% of all exports.

Issues such as excessive red tape and barriers to entry need urgent attention and reform in order to open the economy to new entrants, and to enhance South Africa’s competitiveness and ultimately increase growth.
Just before the 2008 global financial collapse, South Africa was achieving growth rates of over 5%. These growth levels sound unachievable currently. The last time South Africa had a GDP growth rate above 7% was in 1967, and the highest growth recorded was 7.9%, in 1964. These two facts show South Africa’s urgent need to learn from other countries’ strategies to unlock and enable economic growth.

The recent change of leadership in the South African government brings optimism around the country’s political and economic future. For the new executive leadership to avoid an economic crisis South Africa’s structural impediments to achieving higher growth will need to be rectified.

South Africa can learn important lessons from Asia. Emerging Asian economies have gone through multiple crises; however, this has not prevented them from achieving annual GDP growth rates ranging from 6% to 7%.

Dr Martyn Davies, Managing Director: Emerging Markets & Africa, Deloitte Africa

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South Africa can learn important lessons from Asia: Korea has shown the fastest recovery going from junk status to investment grade in only 13 months. Emerging Asian economies have gone through multiple crises; however, this has not prevented them from achieving annual GDP growth rates ranging from 6% to 7%. A key question going forward will be “How can South Africa achieve Asia’s levels of growth in the medium term?”

The recent change of leadership in the South African government brings optimism around the country’s political and economic future. For the new executive leadership to avoid an economic crisis South Africa’s structural impediments to achieving higher growth will need to be rectified.
The narrow focus globally on monetary policies and financial markets, which has been a predominant narrative for the past years, has become increasingly misleading. This narrow focus has not resolved efficiently the destruction caused by the financial crisis. In its aftermath, the world has witnessed a prolonged and uneven recovery.

A wider perspective of the global economic outlook includes incorporating the profit cycle as the prime force of economic growth.

The profit cycle lies at the heart of value creation in an economy. It strongly depends on profit-making companies. However, profit-making companies cannot thrive without a competitive and vibrant business environment. Investment is affected by the profit cycle. At the top of the profit cycle curve, when profit starts struggling, investments stagnate. Once profit starts waning, investments shrink. At the bottom of the curve when profit stabilises, investments recover. Finally, when profit starts climbing, investments accelerate.
A faster normalisation of interest rates that move according to the profit cycle is needed. Interest rates should rise when there is profit growth and decline when growth is plunging. When the real lending rate is too low the profit cycle truncates, and the investment quality declines as unviable businesses are able to refinance their debt. Consequently, debt rises faster than income. In contrast, when the real lending rate is too high, investment is constrained and the expansion of consumption slows. Between 2011 and 2014, China had extremely low lending rates; consequently, there was an increase in lending, overcapacity, rising debt and a collapse in industrial enterprise profits.

Currently, global interest rates are very low and this could unleash a financial crisis. Quantitative easing and zero interest rates caused a dramatic increase in passive investment and a large withdrawal from active funds, increasing volatility. This trend will not be reversed in the short term; therefore, the global market is expected to remain volatile. Central banks have an instrumental role to play in normalising interest rates at a higher speed to avoid truncating growth.

The profit cycle analysis postulates that emerging Asia is the most dynamic economic region in the world. Excluding Japan, Asia’s profit growth was double the rest of the world’s growth since the 2008 global financial crisis. In addition, emerging Asia’s investment growth surpassed the growth of developed economies such as Japan, the US and the Euro Zone. Between 2010 and 2017, emerging Asia’s global economic growth contribution surpassed the US, the UK, Japan and the EU’s combined contributions.

In fact, two decades after the Asian financial crisis, developing Asia is driving global economic growth and this trend is expected to continue in the coming years until these economies reach their respective technological frontiers.

A lot of this will continue to be driven by China, with the county anticipated to grow at more sustainable levels in the medium to long term. In 2017, China’s GDP per capita reached 21% of GDP per capita in the US. When Japan, Taiwan and Korea’s GDP per capita reached 21% of US GDP per capita figures, their economies grew at an annual rate of approximately 6% until their GDP per capita reached 60% of that of the US. Their economies then reached the technology frontier and GDP growth slowed. This could well imply that China will continue growing at rates of near 6% until it too reaches its own technology frontier.

Given the recent growth performance of emerging markets, the gap between emerging markets and developed economies is closing and tending towards convergence. At the same time, emerging markets and developed economies however are diverging away from frontier markets. Today, the richest country in the world is more than 300 times richer than the poorest. It is essential for the future of the global economy to achieve convergence between frontier economies, emerging markets and developed economies. This will contribute to combating inequality and increase the size of the middle class – seen as the backbone of a successful society.

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Resilience, within an economic context, refers to the capacity of an economy to deal with shocks. Resilience should be embedded in the architecture of any economy in order to reduce the adverse consequences that any shock, whether domestic or external, may bring. The components of a strong, resilient economy include diversification, with multiple sources of income, sound balance sheets, good governance, effective policy-making, credible institutions, the capacity to manage external debt and a sound financial system.

The focus of a government should not be to ensure that the economy is invulnerable to exogenous shocks, as a shock cannot be prevented; but rather ensuring that shock amplifiers are balanced by shock absorbers in order for the economy to be resilient. The 1997 Asian financial crisis was caused by a relatively small shock that was amplified through the integrated and interconnected Asian region. The shock led countries to the brink of complete social, economic and political collapse.

Since the crisis, Asian economies have ensured the necessary reforms were made to improve their economic resilience substantially. As a result, Asian economies were able to emerge from the 2008 financial crisis relatively unscathed without any significant asset price adjustments or currency corrections.

The Asian experience has shown that governments need to recognise the early warning indicators that point to a potential crisis. These early warning indicators include rising current account deficits, which may be the result of irresponsible investing or growing foreign debt. The exchange rate regime must be stable and securely anchored to ensure that it is not vulnerable to speculation and shocks. Consistent monitoring of a country’s financial balance sheets must be conducted in order to draw attention to any potential vulnerabilities.

A credible central bank is vital to ensure that policy-making is aligned with the needs of the economy and that policy implementation is effective. Credibility can be enhanced through transparent communication and well-managed bank supervision. The government and central bank must ensure that strong buffers are built in times of economic well-being to prevent any structural vulnerabilities during a crisis. The buffers include a surplus of external reserves and fiscal savings in case of emergencies and that pragmatic ties with international institutions are established for assistance.

It is also important to understand that an open, investor-friendly economy promotes and generates large stocks of foreign direct investment (FDI), which are an essential stimulus for growth. Affirmative action should be well balanced in order to promote the social health of society while still attracting FDI and incentivising domestic investors.

Economic diversification is a critical component of resilience. It increases the likelihood of a faster recovery as well as promotes a healthy investment environment.

Similarly, entrepreneurship must be promoted and stimulated so that there is capacity for the creation of new areas of growth and diversification.
South Africa should not wait for shocks to occur to put in place the corrective policies to enhance resilience and recovery.

South Africa remains a deeply divided society. A lack of trust between government and the private sector, as well as workers and employers prevails. This lack of trust undermines efforts to overcome South Africa’s socio-economic challenges.

Although South Africa does not exhibit the characteristics of a full-blown crisis, it is evident that the ‘long-lasting slow burn’ that the country finds itself in has the potential to quickly spiral into an acute crisis once the system is exposed to domestic and external shocks. Therefore, South Africa should not wait for these shocks to occur to put in place the corrective policies that will enhance the economy’s resilience and recovery.
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Ensuring the credibility of institutions

The creation of credible institutions, such as those in Korea prior to 1997, is a critical underpinning for economic development and plays a fundamental role in effective policy implementation. For example, a credible and independent central bank is vital to ensuring the effectiveness of monetary tools such as the interest rate.

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Creating efficient SOEs

While government should focus on policy-making and implementation, SOEs play an important role in the provision of public goods. For an optimal outcome, this requires that SOEs be run efficiently. This entails that SOEs are given hard budget constraints, do not receive government subsidies, and are allowed to fail to prevent complacency. In Singapore, Government Linked Corporations (GLCs) and SOEs have to be profitable and competitive to survive. This leads to competitive SOEs that are unable to crowd out the private sector through monopolistic practices.

In addition to providing public goods, SOEs can be leading examples of good governance as is seen in Singapore, by abiding by good business principles that do not tolerate any corruption, mismanagement or nepotism.

South Africa can learn valuable lessons from the Asian countries that were pushed to the brink of economic collapse during the 1997 Asian financial crisis. Countries such as Korea, Singapore and Malaysia acted swiftly to put corrective measures in place to enhance the respective countries’ resilience against future shocks, allowing them to weather the 2008 financial crisis relatively well and enjoy prolonged periods of robust growth.

While each country reacted differently to the 1997 crisis, common features underpinning the resilience of these countries were:

- Credible institutions
- Efficient state-owned enterprises (SOEs)
- Enabling infrastructure
- Complementary labour networks
- A globally competitive manufacturing sector
- A balance between short-term needs and long-term objectives.

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Building enabling infrastructure
Infrastructure is a critical factor in the well-being and prosperity of a country’s economy, enabling businesses and individuals to produce goods and services more efficiently. Gross fixed capital formation (GFCF) as a percentage of South Africa’s GDP was only equivalent to 19.4% for 2016. GFCF, which includes land improvements and the construction of infrastructure by both the private and public sector, is indicative of infrastructure spend. In contrast, China is investing 44.4% of GDP into GFCF.

South Africa’s weak infrastructure development hampers its potential productivity and, therefore, undermines growth. South Africa needs to direct a greater share of expenditure towards growth-enabling infrastructure, such as transport, electricity and communications networks, and not towards unproductive ‘white elephant’ infrastructure.

Creation of complementary labour networks
While many countries understand the importance of skills development and a lot of money has been invested into education, the results have been underwhelming. The bias on nurturing tertiary and theoretical education creates small pockets of specialised knowledge.

Coupled with tertiary education investment, there is a need to focus on building complementary labour networks through diverse skills development. Individual productivity is rarely determined by individual skills but rather by a connection to networks with complementary skills.

This is evident in South East Asia with the creation of cross-border supply chains in multiple industries, such as the automotive manufacturing sector. A connected network of skills will stimulate the formation of a large pool of innovative and agile small businesses. This allows big corporations to acquire small businesses, allowing them to scale quickly and grow exponentially.

Enabling a globally competitive manufacturing sector
Traditionally, the manufacturing sector has had high labour absorption capacity and the ability to provide middle-income jobs even for lower-skilled workers. However, given the changes to the global manufacturing sector which has transitioned from being labour-intensive to technology and skills-intensive, the labour-intensive manufacturing model applied in most of Asia, and most recently used in China where it created hundreds of millions of jobs, can no longer be replicated.

Nonetheless, manufacturing will remain an important driver of growth. While the services sector also has the potential to absorb large numbers of workers, its ability to provide a large number of middle-income jobs is limited, due to the higher skills required for these jobs. This inability has contributed to a widening income gap between low- and medium-skilled jobs in the services sector, worsening inequality overall.

In South Africa, new technology in the manufacturing sector should be leveraged in such a way that it increases productivity, allowing South African companies to be globally competitive. The introduction of technology should be used to bridge the skills gap. It is therefore necessary to find a balance between productivity and job creation in the manufacturing sector.

While manufacturing will be driven by the private sector, government should play a role by providing enabling infrastructure such as reliable electricity, efficient transport networks and decreasing the bureaucracy of institutions.

State funding is useful when it is directed into sectors in which the private sector would not usually invest in, due to high risks. The state should focus on long-term investments, taking risks that the private sector cannot, while at the same time ensuring that it does not crowd out private sector investment. The Chinese government has been investing significantly into Special Economic Zones (SEZs), aimed at increasing trade, investment, job creation, innovation and productivity and has been largely successful in spurring growth. The right infrastructure investment has the potential to reap large returns and benefits by stimulating the economy, enhancing overall productivity and creating the capacity for the economy to grow going forward.

Enabling infrastructure can also play an important role in driving regional integration as intra-regional transport networks allow for the flow of goods and people. This enables the development of cross-border supply chains and the expansion of markets.

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Striking the right balance
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The innovative public housing project in Singapore, which was replicated to a certain degree in other Asian countries including Malaysia and China, serves as a good example of how a government programme, aligned to the common features mentioned above, was able to drive growth and socio-economic development.

The mixed-use buildings were structured in such a way that diverse communities were created that gave residents the opportunity to run their own small businesses. The composition of the inhabitants of these new buildings were made to mirror Singapore’s diverse society.

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The government housing project had multiple intended positive spillovers. It created jobs on construction sites, provided skills transfer, stimulated the economy by sourcing from local suppliers, provided housing by moving people from slums to formalised housing and created a market for small businesses.

Arguably, the greatest benefit was that the housing project distributed wealth and decreased inequality, giving citizens a stake in the economy through home ownership. Today, approximately 80% of Singaporeans live in government-built flats.

Through its housing project, Singapore was able to strike the balance between short-term and long-term needs by providing employment and housing in the short term, while driving social cohesion and building wealth in the long term.

Summary and close
South Africa should not wait for a crisis to make the structural reforms that are required to encourage economic growth. The current unemployment levels are economically, politically, socially and ethically unacceptable. Inclusive economic growth is vital to decrease the (narrow) unemployment rate, which currently stands at 26.6%, and the youth unemployment rate, estimated at close to 65%.

An urgent budget reform is needed as well as a redirection of government spending towards key enablers of economic growth. Political and economic interests need to reconcile and find common objectives for the well-being of the country. In addition, public spending should be directed towards the correct enabling infrastructure to encourage manufacturing investment and prevent further de-industrialisation.

A 2018 released survey involving 28 countries uncovered that South Africa has the lowest trust in government and that 77% of the participants agreed that CEOs need to take the lead on change rather than waiting for the government to impose it.

South Africa’s new leadership should focus on promoting trust to encourage social cohesion. Social cohesion is essential to achieve this change. Each part of society needs to make the necessary sacrifices to encourage growth and development.
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