Can the R500 billion COVID-19 lifeline steady the ship?

By Arthur Kamp, chief economist at Sanlam Investments

When measured relative to the size of our economy, South Africa's COVID-19 targeted economic programme is extensive, comparable to some of the largest pandemic-related interventions in other countries. In total, above-the-line and below-the-line measures, including guarantees, amount to R500 billion - 10% of GDP.

Given the risks, SA's policymakers had to box clever

Given South Africa's precarious fiscal position, potential balance of payments pressure (reflecting a dearth of foreign capital inflows), seizing credit markets and a damaging negative supply-demand feedback loop that threatens to send the economy into a tailspin, our policymakers had to box clever.

And they did. The package addresses the key immediate concerns for the economy and should 'cost' the fiscus relatively little. Indeed, the direct addition to the Budget deficit may be as low as R26 billion (the relief portion of the R70 billion in tax measures announced).

That is just as well, since the deficit is likely to balloon to more than 12% of GDP in 2020/21, as economic recession hits government revenue, while its debt ratio is expected to climb above 80% of GDP over the medium term.

Immediate humanitarian and health needs called for some re-prioritisation

In order to meet immediate humanitarian and health expenditure needs, in spite of limited resources, the National Treasury aims to *re-prioritise* R130 billion of spending in the 2020/21 fiscal year. This includes a R50 billion boost to social grant spending and R20 billion in spending on COVID-19 related health expenditure needs, including the all-important intervention of testing, tracing and isolating, but does not add to overall spending.

Further, lockdown is fueling a downward economic spiral

At the same time, the hit to economic activity should not be underestimated. Effectively, most production has been shut down for 9.6% of the year, while production will only return to pre-COVID levels over a long period guided by the government's risk-adjusted strategy. The immediate threat to economic activity lies in an unfolding damaging negative feedback loop as business closures and social distancing decrease domestic demand. In turn, falling domestic demand reduces profits, adding additional pressure onto businesses, leading to declining investment spending and the retrenchment of workers. This lowers consumption (demand) further. Business liquidations and individual insolvencies follow, fueling the downward spiral.

It's vital that government breaks the negative feedback loop

An immediate consequence of the downward spiral is erosion of the tax base, without which the government cannot maintain its socio-economic efforts. It is, therefore, imperative that the government should break this negative feedback loop by ensuring businesses continue to operate and workers remain in their jobs. A special, supplementary COVID-19 Survey of 707 businesses, released on 21 April 2020 by Statistics South Africa, indicated 46.4% of firms had closed temporarily or paused trading by mid-April 2020, while 36.8% indicated they expected their workforce size to decrease.

R100bn for job protection, but now not the best time to sell UIF assets

During the first phase of the government's response to COVID-19 a raft of measures were introduced to address this specific problem, including wage subsidies for employees of distressed companies. These measures were, however, relatively limited relative to the size of GDP. In contrast, the additional measures announced recently are extensive. To start, R100 billion will be uitilised to support job protection and creation. It is not clear whether this will be funded through the Unemployment Insurance Fund (UIF). It may, after all, not be an ideal time to sell UIF assets, which included a relatively high share of bonds in 2018/19, considering that bonds were hit hard post the Moody's downgrade. Also, one imagines the job creation portion of the intervention is not a function of the UIF. However, the point is the programme is sizeable.

External funding carries additional benefits

Moreover, the government aims to procure close to R100 billion in external funding from the IMF, New Development Bank and World Bank, presumably on concessionary terms, since we are dealing with a humanitarian crisis. Hence, even if the jobs programme impacts the budget deficit (which we do not expect to be the case) there should be no additional *immediate domestic* funding pressure.

Use of external funding has the added bonus of assisting in the event of any potential balance of payments pressure (although the flexible rand exchange rate goes some way towards achieving that, while the collapse in oil prices is a great help too).

R200bn loan scheme helps protect the tax base

Over and above the R100 billion jobs programme, the R500 billion package also includes a R200 billion guaranteed loan scheme for small and medium enterprises (SMEs). Ostensibly, this intervention aims to help otherwise solvent SMEs, which are susceptible to cash flow difficulties, through this treacherous phase until business conditions 'normalise'. Initially, R100 billion will be made available over the 'next few weeks' (to be scaled up to R200 billion in time) for businesses with annual turnover of less than R300 million, given certain criteria that must be met. The lending rate will track the repo rate. Ostensibly, the guarantee should help keep the lending rate low.

Note, the scheme receives all "profits" on the loans (including a guarantee fee charged to banks). Profits will be used to offset losses on the scheme. Additional losses are to be absorbed by the banks, capped at 6% of the size of the loan. Any further losses are, ultimately, for the account of the taxpayer. But, rather this than allowing businesses to fail and workers to be retrenched. Ultimately, the intervention helps protect the tax base.

R44bn of tax deferral measures help with cash flow

Finally, the Treasury has added R44 billion worth of tax deferral measures, which also helps with cash flow, in addition to the R26 billion in tax relief mentioned earlier.

Overall, therefore, the government has managed to put together a large COVID-targeted package that assists in addressing the negative supply-demand feedback loop, while keeping credit lines open without needing to tap even more into domestic savings.

Let's not forget the easing of bank regulations

It should also not be forgotten that bank regulations have been eased significantly by the Reserve Bank to facilitate more lending, although banks will probably be reticent to extend new loans in a highly uncertain environment, in addition to the recent cumulative 200bp decrease in the Bank's repo rate.

Hopefully, these measures can help steady the listing ship, although we should bear in mind that given the size of the hit to the economy, we are still faced with a large 'permanent' hole in income and that the road to recovery will be long and arduous. The next phase of economic interventions will require structural economic reforms and measures to ensure the tax base is not eroded further, but rather broadened, failing which meaningful long-term recovery seems a bridge too far.

Image not found or type unknown

Arthur Kamp

Arthur has been an investment economist at Sanlam since 2005, providing economics input on the domestic and global economy to the asset allocation team. Before Sanlam, Arthur worked as an economics consultant at Eskom from 1990 to 1995 and thereafter spent 10 years working as an economist at stock broking firm Simpson McKie, which was later bought by global investment bank HSBC.