POLICY BRIEF

Financial and Fiscal Commission (2021)

Measuring the financial and fiscal impacts of COVID-19 in South Africa: Financial stability and fiscal sustainability

Executive Summary

The COVID-19 pandemic has had severe financial and fiscal repercussions for the South African economy. The lockdown measures caused prices to fluctuate, with detrimental socioeconomic consequences, especially for the poor. On the other hand, economic stimulus – provided through government intervention in an attempt to protect citizens – has caused the country's fiscal position to deteriorate and increased concerns of a looming public debt spiral. In order to investigate these concerns, the Commission undertook a quantitative measurement of financial stability, fiscal sustainability and credibility based on the most recent empirical data in South Africa to inform policy.

The analysis found that, since the onset of the COVID-19 pandemic, a divergence between core and non-core inflation has emerged, raising concerns over the affordability of essential goods. The increase in production costs due to lockdown measures and heightened uncertainty is likely to also affect consumers negatively due to higher mark-ups. The fiscal analysis revealed that, at the national level, debt-servicing costs are a major contributor to debt-to-gross domestic product (GDP). At the intergovernmental level, the novel econometric analysis revealed that fiscal leakages pose major challenges to reducing the public debt burden, as it undermines economic growth and reduces the state's ability to meet its debt obligations, causing concerns of fiscal sustainability and credibility in South Africa.

Background

In the decade preceding the onset of the COVID-19 pandemic, South Africa's fiscus had been put under immense strain in the context of declining tax revenues, downgraded credit ratings and escalating debt-servicing costs.

FINANCIAL AND FISCAL COMMISSION

THE FINANCIAL AND FISCAL COMMISSION

The Financial and Fiscal Commission is a body that makes recommendations and gives advice to organs of state on financial and fiscal matters. As an institution created in the Constitution of the Republic of South Africa, it is an independent juristic person subject only to the Constitution itself, the Financial and Fiscal Commission Act, 1997 (Act No. 99 of 1997) (as amended) and relevant legislative prescripts. It may perform its functions on its own initiative or at the request of an organ of state.

The vision of the Commission is to provide influential advice for equitable, efficient and sustainable intergovernmental fiscal relations between national, provincial and local spheres of government. This relates to the equitable division of government revenue among three spheres of government and to the related service delivery of public services to South Africans.

Through focused research, the Commission aims to provide proactive, expert and independent advice on promoting the intergovernmental fiscal relations system using evidence-based policy analysis to ensure the realisation of constitutional values. The Commission reports directly to both Parliament and the provincial legislatures, who hold government institutions to account. Government must respond to the Commission's recommendations and the extent to which they will be implemented at the tabling of the annual national budget in February each year.

The Commission consists of commissioners appointed by the President: the Chairperson and Deputy Chairperson, three representatives of provinces, two representatives of organised local government and two other persons. The Commission pledges its commitment to the betterment of South Africa and South Africans in the execution of its duties.

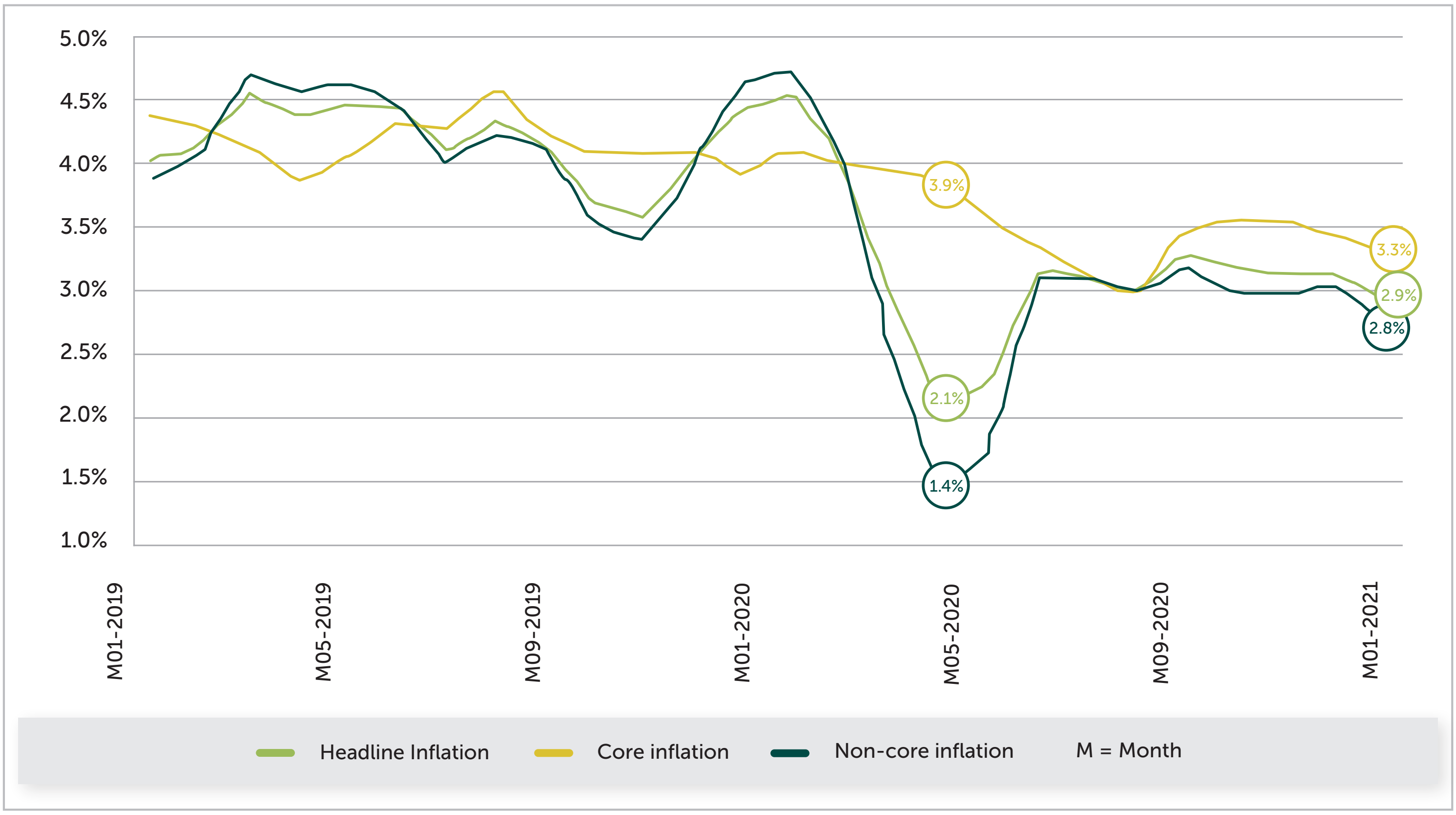
Financial stability has also been compromised with the commodity price winding down, currency depreciation and a decline in domestic productivity. The COVID-19 pandemic has caused an unprecedented shock to the domestic economy, with significant financial and fiscal consequences. Structural changes in the labour market in the form of loss of income caused by the pandemic will have lasting effects on the fiscus. The budget deficit has already reached 14% of GDP for the 2020/21 fiscal year, in breach of its initial trajectory.

Research findings

1. Financial stability

To evaluate financial stability in South Africa, the Commission's research considered trends in the Consumer Price Index (CPI)[1], as shown in Figure 1.

Figure 1: Core vs non-core inflation, January 2019 to February 2021



Source: Statistics SA (2021) and the Commission's calculation

On the consumer side, despite the moderation of headline inflation, Figure 1 shows that core inflation (of essential goods) remained high at 3.9% relative to non-core inflation at only 1.4%. This diverging trend, which re-emerged in the beginning of 2021, illustrates that the purchasing power of poorer households has eroded faster than that of affluent households, due to their greater reliance on essential goods for survival. This raises concerns over the affordability of goods and highlights the need for pro-poor policy action. On the producer side, the lockdown restrictions, which halted production activities in some sectors, caused prices to increase due to heightened uncertainty. The production costs of final manufactured goods – particularly of food products, beverages and transport equipment – increased relative to other final products, due to supply chain disruptions. These cost increases are likely to be passed through mark-ups to result in higher retail prices, thereby negatively impacting on consumers' purchasing power. Once more, the effects will be particularly harsh for poorer households, exacerbating inequality in the country.

[1] Analysis of the Producer Price Index (PPI) can be found in the full Annual Submission and the Technical Report publications.

2. Intergovernmental determinants of fiscal debt

For the purpose of developing fiscal rules that can be relied on to restore the credibility and sustainability of South Africa's fiscal position, three econometric models were developed to identify significant contributors of debt measured as a proportion of GDP, at both the macroeconomic and intergovernmental level, as shown in Table 1.

Table 1: Finding the determinants of fiscal debt

Dependent variable: DEBT_GDP						
Method: Least squares						
Sample (adjusted): 1995 2020						
Included observations (after adjustments):	25		25		26	
Variable	***Simple***		***Primary***		***IGFR***	
C	1.599		16.460		10.552	*
GDP growth	0.960		0.719			
GDP growth (-1)	-2.119	*	-0.116			
Inflation (CPI)	0.169		0.053			
Required yield on government bonds	2.356	*	1.857	*	1.818	*
Exchange rate depreciation (RSA/US)	0.011		0.020	*	0.011	*
Expenditure as a percentage of GDP			2.388	*		
Revenue as a percentage of GDP			-3.311	*		
Operating cash balance of:						
National government					0.000	*
Extrabudgetary institutions					-0.001	*
Social security funds					0.000	
Provincial government					0.000	
Local government					0.000	
Non-financial public enterprises					0.000	*
Financial public enterprises					0.000	
R-squared	0.75		0.88		0.94	
Adjusted R-squared	0.68		0.84		0.90	
Probability (F-statistic)	0.00		0.00		0.00	
Akaike info criterion	6.43		5.81		5.31	
Schwarz criterion	6.73		6.20		5.79	
Hannan-Quinn criterion	6.52		5.92		5.45	
Durbin-Watson statistic	1.04		1.53		1.91	

Source: *South African Reserve Bank (2021) and Commission's calculations*
Note: *The asterisk (*) signifies that the determinant concerned is statistically significant at a p-value of less than 5%.*

The *Simple* model (i.e. the baseline model) took into account the variables of economic growth, inflation, the interest rate and the exchange rate. The *Primary* model builds on the *Simple* model by including government revenue and expenditure. Finally, the *Intergovernmental Fiscal Relations* (IGFR) model does not include primary aggregates of revenue and expenditure, but rather operating cash balances of all spheres and organs of state. The required yield on government bonds (i.e. the costs of financing public debt) is found to be statistically significant throughout all three model specifications, illustrating its importance as a determinant of public debt. A positive relationship between this yield and the debt-to-GDP ratio is found, which confirms concerns surrounding a potential debt spiral, should South Africa's fiscal credibility continue to deteriorate.

Furthermore, the exchange rate variable became statistically significant as biases were controlled for, illustrating that a high currency depreciation results in a greater debt-to-GDP ratio. In the IGFR model, the results suggest that fiscal leakages undermine the positive spill-over effects that economic growth has on reducing the public debt burden. More precisely, it is found that fiscal leakages in national departments and in non-financial public enterprises are positively related to the debt-to-GDP ratio, due to the fact that public funds are not being used efficiently, which also undermines effective service delivery. Wasteful behaviour and fiscal leakages also affect investor behaviour, which further dampens growth prospects.

Conclusion and recommendations

The COVID-19 pandemic has negatively impacted the standard of living of South Africans. Poorer households are feeling the effects of the pandemic to a greater degree, which highlights the need for pro-poor policies. Increased producer prices, caused by disruptions in supply chains and increased uncertainty, are also likely to erode the purchasing power of consumers even further. The results from the econometric models substantiate the concerns surrounding a potential debt spiral in South Africa. Rising debt-servicing costs and fiscal leakages pose major challenges to fiscal sustainability and credibility. Government's greatest challenge is to balance, on the one hand, the need to restore fiscal credibility by eliminating fiscal leakages, keeping its debt and debt-servicing costs under control, and on the other hand, the need to provide support to households in order to ameliorate the devastating socioeconomic consequences of the pandemic.

The Commission makes the following recommendation:

1. The Minister of Finance should eliminate fiscal leakages and inefficiencies by adopting the following measures:
   i. A decisive and coherent strategy of fiscal reprioritisation
   ii. Fiscal consolidation and targeting cuts where performance is questionable
   iii. Eradicating duplication of functions (by merging and downsizing departments)
   iv. Investment in the use of technology to improve the capability
   v. Eradication of contract mismanagement and procurement irregularities

References:

South African Reserve Bank (SARB). 2021. Quarterly Bulletin (Q1:2021). Pretoria: SARB.

Statistics South Africa (Stats SA). 2021. Consumer Price Index, April. Pretoria: Stats SA.

Enquiries:

Research
research@ffc.co.za | info@ffc.co.za

Financial and Fiscal Commission
Montrose Place (2nd Floor), Bekker Street
Waterfall Park, Vorna Valley, Midrand

Private Bag X69, Halfway House, 1685

www.ffc.co.za

Midrand Office Telephone: +27 (0) 11 207 2300
Cape Town Office Telephone: +27 (0) 21 487 3780