Industrial Development Corporation

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Economic overview:

Recent developments in the global and South African economies

August 2016

Department of Research and Information

HIGHLIGHTS

- **In a world economy that is still struggling to sustain its growth momentum, Brexit has brought about greater uncertainty and substantial downside risks.** Global output is now expected to expand by 3.1% in 2016 and 3.4% next year, according to the IMF. The uncertainty created by the United Kingdom's decision to leave the European Union is not only weighing on the economic outlook for Europe, but will impact other world regions.

- **The United States remains the key driver of growth amongst advanced economies, but its performance in the first half of 2016 fell short of market expectations.** Nevertheless, several indicators reflect underlying strength, particularly high employment levels and improving consumer spending. Cognisant of the mixed performance of the US economy and low inflationary pressures, as well as the fragile nature of the global economic recovery, the US Federal Reserve is keeping policy rates steady for the time being.

- **Economic growth halved in the Eurozone to 0.3% in the second quarter of 2016 and slowed to 0.4% in the wider European Union.** Most member states reported weaker performances, but the French and Italian economies recorded no expansion whatsoever. Germany, the bloc's economic powerhouse, turned out a 0.4% reading, while Spain's growth came in at 0.7%. The EU's expansion momentum will remain muted over the next couple of years, held back significantly by the impact of the UK's forthcoming exit.

- **The recent improvement in commodity prices, basically across the board, is not supported by market fundamentals.** Prevailing physical market imbalances and the pending resumption of US policy rate normalisation are expected to impact negatively on commodity prices, at least in the shorter-term.

- **Near-term growth prospects for Sub-Saharan Africa (SSA) have worsened substantially, dragged down by the region's two largest economies, South Africa and Nigeria.** Unfavourable terms of trade, mounting fiscal constraints and lower investment activity associated with adverse developments in commodity markets continue to weigh on the region's growth outlook. The IMF now projects 1.6% growth for SSA in 2016, the lowest rate since the early 1990s.

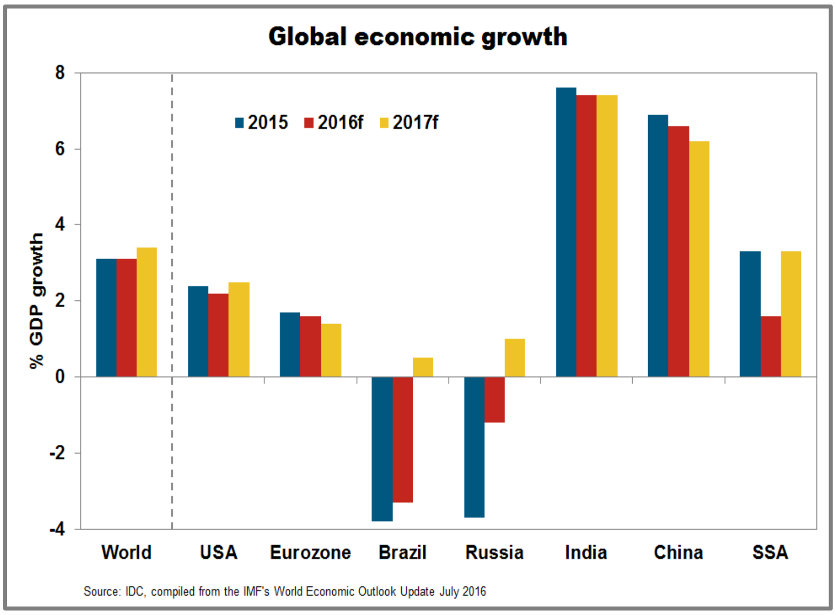
- **South Africa's economy is likely to have recorded positive growth in the second quarter of 2016, following a 1.2% contraction in the opening quarter.** Production activity in its mining and manufacturing sectors surprised on the upside, retail trade sales gained further momentum in recent months and, after a poor start to the year, wholesale trade sales rebounded strongly in April and May. Nonetheless, economic conditions remain generally challenging.

- **The second quarter also saw the domestic economy recording its first quarterly trade surplus in more than four years.** Mining and mineral exports rose considerably, supported by higher commodity prices and a rebound in the volume of PGM exports. Likewise, manufacturing exports gained momentum, and fruit products underpinned the agricultural sector's improved export performance. In total, exports were 18.4% higher than in the first quarter, while import demand fell 1.4%, resulting in a R23 billion trade surplus.

- **South Africa's economic growth is expected to be barely positive in 2016, but a gradual recovery should ensue in subsequent years.** Household spending will remain constrained due to a large debt burden, modest income growth and poor employment prospects. Considering the difficult operating environment and spare production capacity, fixed investment activity will be weak in 2016 and 2017. However, gradually improving trading conditions and the normalisation of electricity supply as new generation capacity comes on stream, should result in higher fixed investment growth later in the outlook period. Export demand, which is an important driver of production activity in many domestic economic sectors, is expected to increase as the global economy resumes a higher growth trajectory.

GLOBAL ECONOMIC CONDITIONS

The world economy's growth momentum continues to struggle for traction and serious downside risks are compromising it further. The International Monetary Fund's July 2016 *World Economic Outlook Update* reported a marginal downward revision (0.1 of a percentage point) of its global growth projections to 3.1% in 2016 and 3.4% in 2017. This was principally due to the uncertainty brought about by the United Kingdom's referendum vote to exit the European Union, colloquially known as Brexit. The IMF also indicated that in the absence of Brexit it might have revised global growth higher. This not only highlights the potential scale of the Brexit impact, but also the increasing strength of the global economic recovery in the absence of major shocks.



Economic growth in the United States was much weaker than anticipated in the second quarter of 2016. Gross domestic product (GDP) expanded by only 1.2% (quarter-on-quarter, seasonally adjusted and annualised basis) as inventories declined and business investment spending on equipment and structures contracted.

However, a range of indicators point to some underlying robustness in the US economy, including improved consumer spending and a low unemployment rate (averaging 4.9% in 2016). With the economy deemed to be close to full-employment, higher wage growth is on the cards, although the rate of increase has been fairly muted thus far in 2016 (averaging 1.4%, year-on-year, over the period to June). The overall Purchasing Manager's Index (PMI) as well as its manufacturing component has remained above the 50 point level throughout 2016, indicating a continued expansionary trend. Nevertheless, the US Federal Reserve (Fed) remains cautious in its policy rate normalisation process, holding rates steady in light of low inflationary pressures and the impact of US monetary policy moves on global capital flows, which have adverse effects on emerging and developing economies' currencies and external accounts.

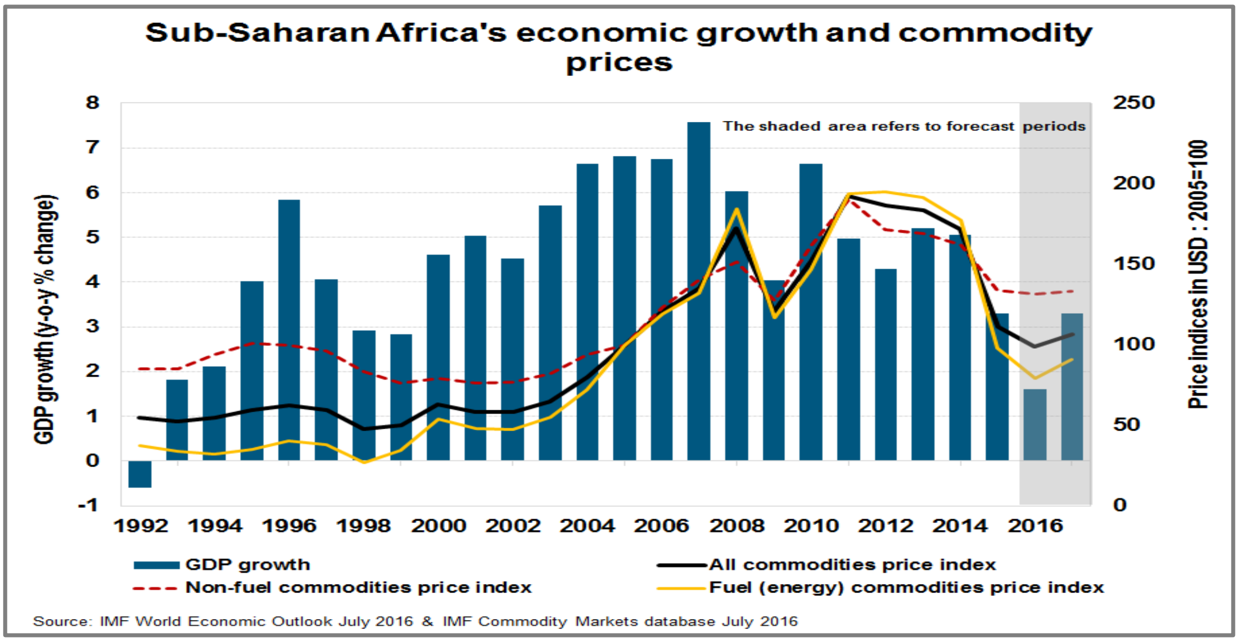
Growth prospects for the United Kingdom and the other 27 member states of the European Union have been negatively impacted by the Brexit referendum result, as the timing and outcome of the negotiations are still unclear. Business sentiment soured in the UK, with the composite PMI dipping below 50 in July 2016. The risk of a looming recession is rising. Although the composite Eurozone PMI remains above the 50 level, indicating that the underlying economic momentum is still sound, Brexit has brought about a considerable degree of uncertainty, while concerns remain over the stability of Europe's financial sector. Growth in the Eurozone is projected by the IMF to remain muted at 1.6% and 1.4% over the next two years.

The latest (July 2016) European banks' stress results provided a degree of reassurance with regard to capitalisation levels, particularly in relation to their position in the previous round of stress tests in October 2014. However, despite this reassurance, the Euro Stoxx banks equity index declined by a cumulative 8% over the course of the week following the release of the results. Investor perceptions of the health of the European banking sector thus remain broadly negative, exacerbated by the exclusion of Greek, Portuguese and Cypriot banks from the stress testing exercise. Concerns have also remained over the capital adequacy ratios of banks in countries such as Ireland and Italy.

Growth in the Chinese economy is expected by the IMF to continue slowing to 6.6% and 6.2% in 2016 and 2017, respectively. The struggle to sustain growth rates at high levels is being compounded by adverse developments in key external markets, particularly the Eurozone, which is a major destination for Chinese exports. Overcapacity in China's manufacturing sector is slowly being addressed, in line with the authorities' efforts to transform the economy so as to make it less dependent on infrastructure development and exports. Employment losses in heavy industry are being partly offset by gains in consumer focused operations. However, the ability of the Chinese government to direct economic performance is being increasingly compromised by the weakening of especially local government finances and large state-owned companies' balance sheets, as well as eroded by the introduction of more market-based policies.

The Indian economy's expansion momentum remains vigorous, as internal policy adjustments and economic reforms are supporting growth rates of over 7%. Improved agricultural production is contributing to this sterling performance. Improvements in consumer and business confidence and higher oil prices underpin the IMF's projections of less severe contractions in GDP both in Brazil and Russia in 2016, with marginal rates of expansion forecast for 2017. However, their growth performances could be adversely affected should commodity prices come under renewed pressure.

Following about two decades of accelerating and relatively fast economic growth in Sub-Saharan Africa (SSA), averaging around 5% per year from 1995 to 2014 (refer to the chart below), the rate of expansion in the region's output has slowed visibly since the end of the commodity super-cycle around 2011, measuring an estimated 3.3% in 2015.

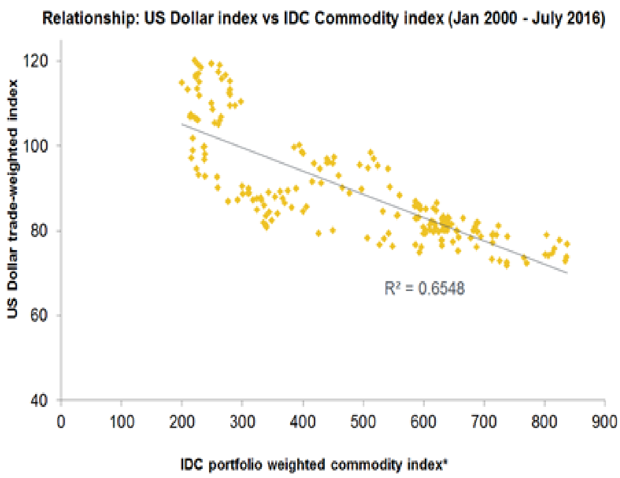


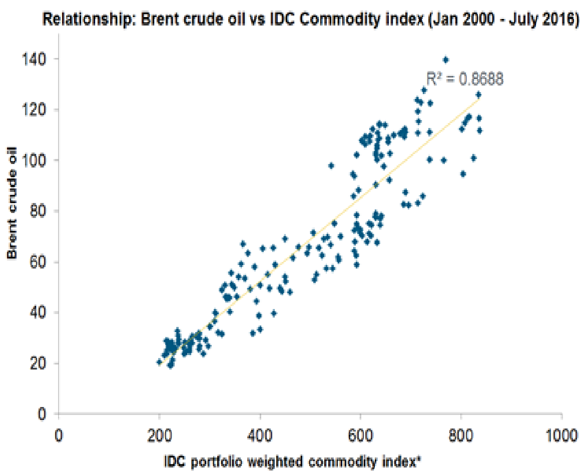
Persistent weakness in the global economic environment, underscored by lower international demand for commodities and consequently depressed prices, among other factors, continue to pose serious challenges to the growth performance and outlook for many of SSA's commodity exporting economies. The region's output is now expected to expand at a much slower pace in 2016, especially since its two largest economies - Nigeria and South Africa - face strong headwinds both on the domestic and international fronts. With Nigeria's economy forecast to contract by 1.8% in 2016 and South Africa's anticipated to post very marginal growth, the IMF has revised its projections for SSA's growth in 2016 sharply down to 1.6%, from the 3% forecast last April. A substantial recovery to 3.3% is anticipated in 2017.

However, these aggregated figures mask wide variations between countries. Some of the region's economies are, for instance, importers of oil and food and thus benefit, to a certain extent from the lower commodity price environment. Hence, growth is expected to remain above an annual average of 5% in 2016 and 2017 in countries such as Côte d'Ivoire, Rwanda, Tanzania, Kenya, Senegal, Ethiopia, Ghana and Uganda. Despite some recoveries in commodity prices earlier in 2016, SSA economies that are highly dependent on export of oil and industrial commodities have been hit particularly hard, with this trend expected to continue in the short-term.

The fiscal balances and external accounts of most countries in SSA are, therefore, likely to remain under pressure, with many countries facing severe liquidity constraints with respect to hard currencies. On balance, economic conditions in the region will remain challenging in the short-term, but a gradual improvement is anticipated from 2017 onwards as global demand for Africa's commodities recovers and supply is progressively tempered.

Despite significant recoveries during the first half of 2016, commodity prices remain depressed. Precious metal prices have been supported by renewed investment capital flows toward perceived safe-haven assets, especially since the Brexit vote, while those of industrial commodities were buoyed by the recovery in crude oil prices. The latter raised the production cost structures of most industrial commodities, contributing to higher market prices. In turn, weaker trade-weighted US dollar exchange rates, driven by market expectations of a postponement in US Fed policy rate increases towards year-end, at the earliest, also broadly supported the commodities complex.





Source: Bloomberg data, IDC analysis
*IDC commodity index weights: iron ore (44%), brent crude oil (34%), PGM (6.6%), aluminium (6.2%), copper (3.9%), other (5%)

However, oil prices started to weaken again in July, with Brent crude falling and staying below USD50 per barrel (generally seen as a key pivot price level for overall global commodity market sentiment). This has been largely driven by renewed growth in non-OPEC crude oil supplies, adding to the global supply glut that has plagued the oil market since mid-2014.

Barring coordinated strategic supply-side intervention between OPEC and non-OPEC oil producing economies, unfavourable fundamentals in the global oil market are expected to continue weighing on prices in the short- to medium-term. Considering the strong positive historical correlation between Brent crude prices and the IDC portfolio-weighted commodity price index (refer to the previous chart), the more recent fall in oil prices forewarns of potential downside risk for industrial commodity prices in general in the second half of 2016.

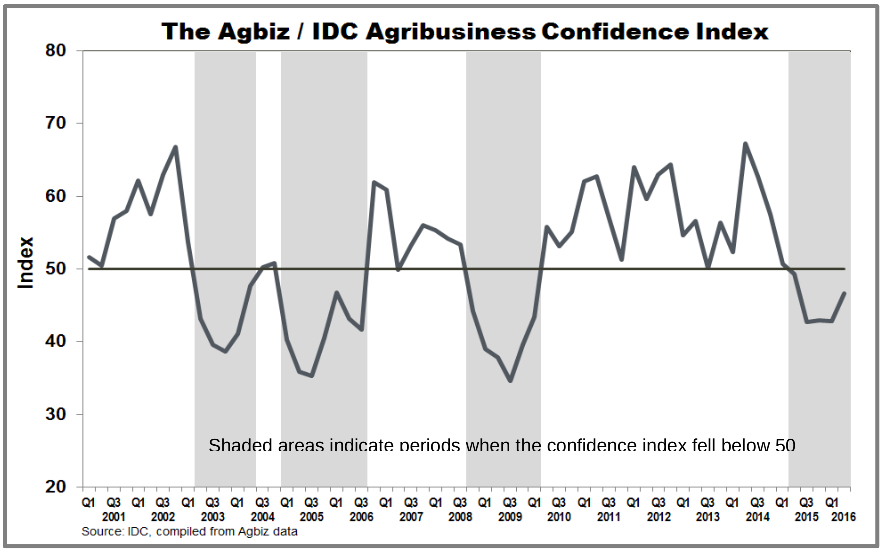
The resilience of the US economy, especially its labour market, has positioned market expectations of the next policy rate move by the US Federal Reserve in December 2016 (44% probability, following the release of July's employment data). This is expected to support the US dollar in the latter part of the year, which is another potential downside risk factor for commodity prices in the months ahead.

ECONOMIC DEVELOPMENTS IN SOUTH AFRICA

Sector performances

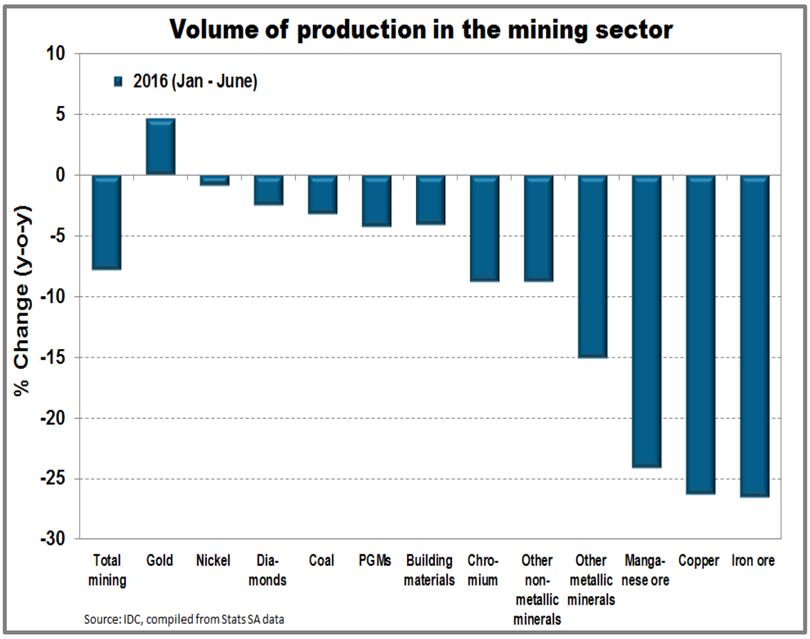
Two years of severe drought have taken a serious toll on South Africa's **agricultural sector**. Summer crops such as maize, soybeans and sorghum recorded substantially lower output levels during the 2016 harvesting season. The most recent crop estimate for maize stands at just over 7.26 million tons for 2016, a drop of 27% from the 9.96 million tons produced in 2015. Many farmers are consequently experiencing financial hardship, including cash-flow constraints and difficulties in raising new debt. Overall farming debt has increased significantly over the years, from R36 billion in 2005 to R117 billion in 2014 and just over R133 billion last year.

Business confidence in the agribusiness sector remained below the crucial 50-point mark in the second quarter of 2016 (a reading below 50 indicates a contraction in output, while a reading of more than 50 reflects an expansion), but edged 4 index points higher compared to the previous quarter to 47. Expectations regarding agricultural exports fell, which is not surprising considering the sharp drop in output volumes. Concerns over policy uncertainty (land reform) continue to affect business sentiment and investment activity in the sector. Although climatic



conditions are forecast to improve later in the year, expectations are that 2017 could still be a difficult year for some segments of the agricultural sector (e.g. livestock farming, as farmers will have to re-build their breeding stock and cattle herds). Should rainfall patterns normalise, a strong rebound in agricultural output could be expected in the coming years.

The **mining sector** has now experienced ten consecutive months of declining output on a year-on-year basis. Sub-sectors such as iron ore, copper, manganese, chrome, platinum group metals and coal recorded lower production levels during the past couple of months. Total mining output declined by 7.9% in the first six months of 2016 compared to the same period in 2015, despite the modest up-tick in commodity prices in general since the start of the year. Iron ore prices, for example, recovered from an average of USD40 per ton in December 2015 to around USD60 per ton at present. Although this has provided some relief to the financial performance of mining companies, volume demand remains generally weak while the considerable strengthening of the rand in recent times is impacting on earnings.

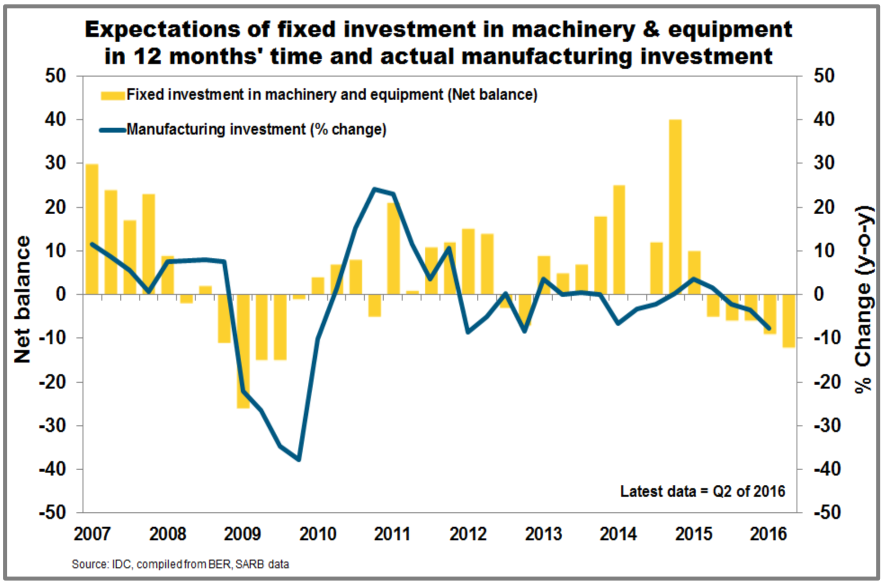


The month-on-month improvements in mining sector output in May and June were mostly due to a robust performance by the platinum group metals (PGMs) segment, as most other sub-sectors either reported lower production levels or very modest rates of expansion. The domestic mining sector is likely to continue facing tough conditions for quite some time as market conditions should remain generally unfavourable, as highlighted in the previous section.

Operating conditions in the **manufacturing sector** have seemingly improved to some extent in recent months. At 4.5% in June 2016, manufacturing output growth (year-on-year) was the strongest since September 2014. This took the rate of expansion in manufacturing production in the second quarter of the year to 2% on a quarter-on-quarter and seasonally adjusted basis, up from the 0.3% recorded in the first quarter.

The subsector producing motor vehicles posted the strongest growth at 14% q-o-q in the second quarter of the year, followed by producers of beverages, rubber products, sawn and planed wood, other transport equipment, basic chemicals, as well as basic iron and steel. All of these manufacturing subsectors recorded quarter-on-quarter growth rates of around 7% or over. In contrast, manufacturers of paper and paper products; bodies for motor vehicles, trailers and semi-trailers; plastic products; and structural metal products reported substantially lower output levels in the second quarter of 2016.

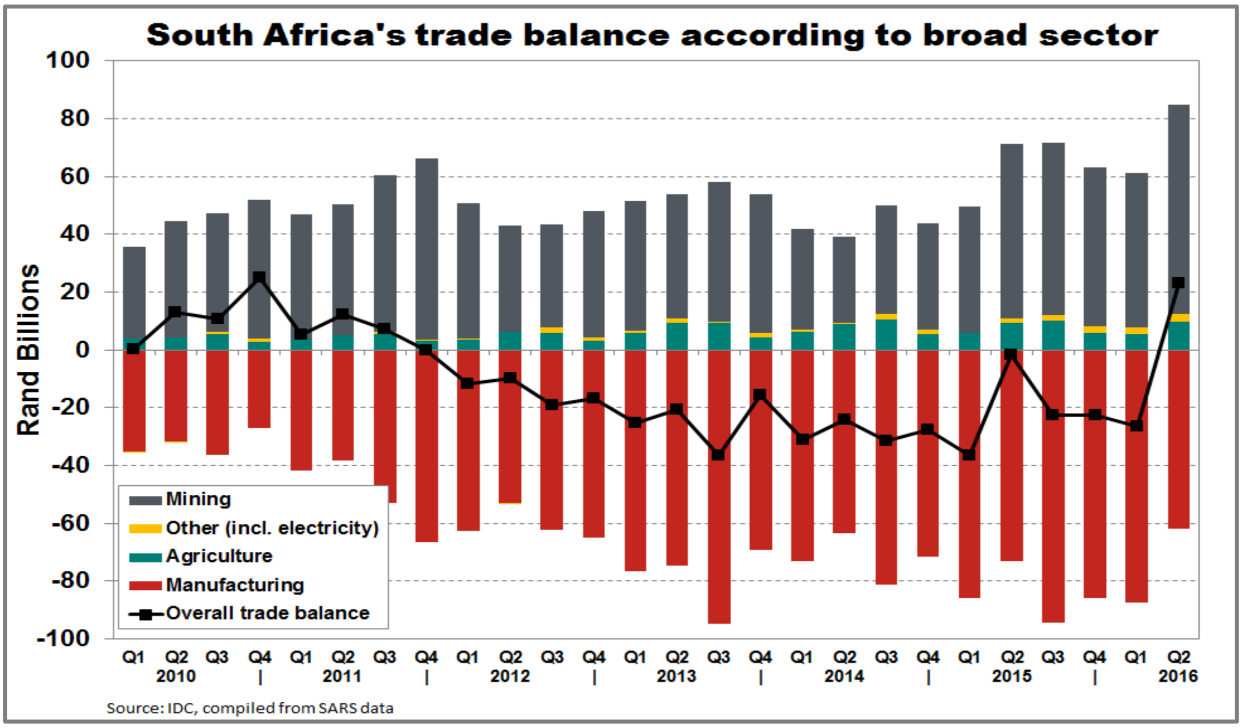
Despite this welcomed rebound in manufacturing activity, business conditions remain generally challenging in the local manufacturing sector. The business confidence index stood at a mere 23 points in the second quarter and has remained below the 50-point mark since the third quarter of 2011 – the second longest period on record. Domestic sales and order volumes have disappointed thus far in 2016, and fixed investment outlays declined over the past year. According to the second quarter survey of manufacturers, the outlook for capital spending over the next twelve months remains unfavourable, and further job losses are anticipated. Considering the relatively weak demand conditions domestically, the subdued rates of economic expansion in key export markets for South Africa's manufactured goods, as well as the recent strengthening of the rand, the sector will continue to experience a very difficult trading environment at least in the short-term.



Source: IDC, compiled from BER, SARB data

External trade performance

In the second quarter of the year, South Africa recorded its first quarterly trade surplus since the final quarter of 2011. Exports exceeded imports by approximately R23 billion, largely due to the effects of a weaker rand and the recovery in commodity prices.



Source: IDC, compiled from SARS data

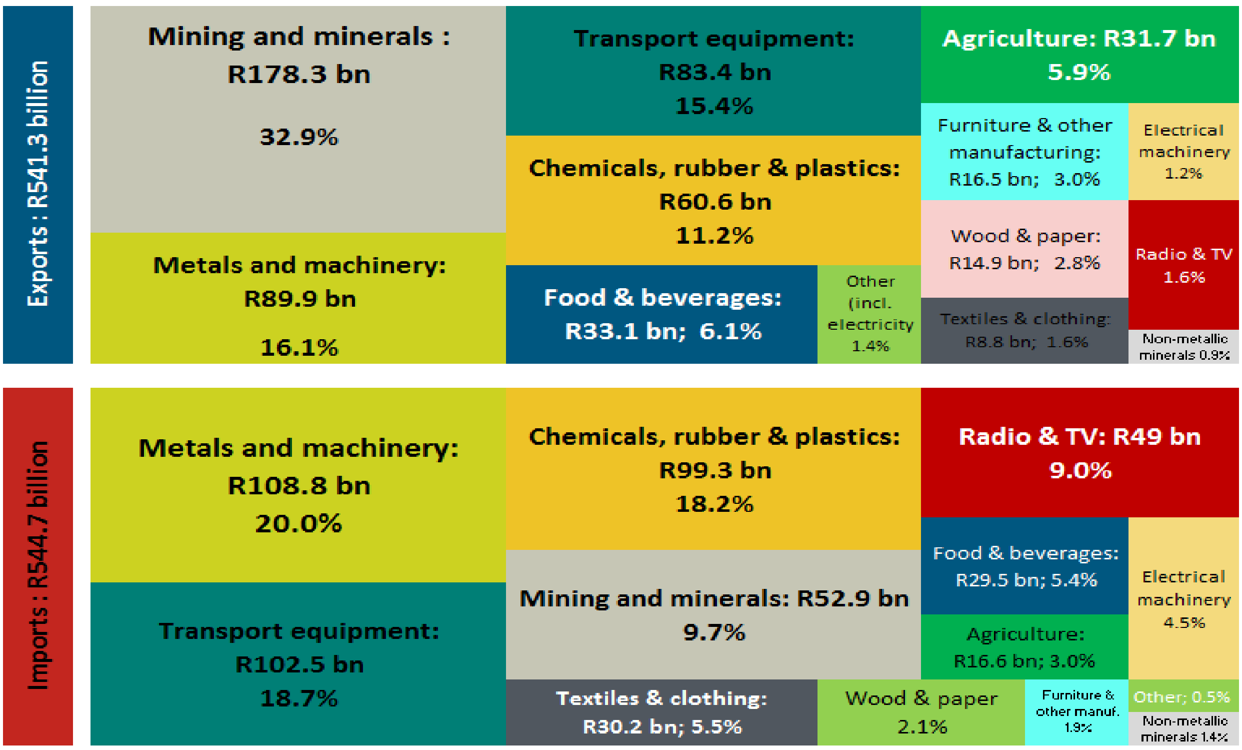
The trade surplus in mining products exceeded R72 billion in the second quarter of 2016. Higher commodity prices contributed to the 27% rise (quarter-on-quarter) in the value of mineral exports to R99 billion - the highest quarterly figure since at least 2010. In turn, South Africa's import bill for mineral products, mostly crude oil, increased by around 9% to R27.6 billion.

Manufacturing exports also increased strongly in the second quarter of 2016, specifically by 13.5% to R172 billion in nominal value terms. Motor vehicle exports were the principal contributors to this increase. Set against a modest decline in imports, this translated into a significantly lower trade deficit in manufactured products, which amounted to R61.7 billion compared to the R87.5 billion deficit recorded in the opening quarter of the year.

The sharp 26.7% rise in agricultural exports to R17.7 billion in the second quarter of 2016 was largely underpinned by exports of fruit. The country's demand for imported agricultural products dropped by 6.7% to R8 billion over this period, resulting in a trade surplus for this product category.

As illustrated below, South Africa's merchandise export basket in the first semester of 2016, which totalled R541.3 billion, was dominated by mining and mineral exports with a 32.9% share. These were followed by exports of metal products and machinery (including basic iron and steel, fabricated metal products, non-electrical machinery and equipment) with a 16.1% share; transport equipment (15.4%); chemicals, rubber and plastics (11.2%); as well as processed food products and beverages (6.1%).

Composition of South Africa's import and export baskets in the first six months of 2016



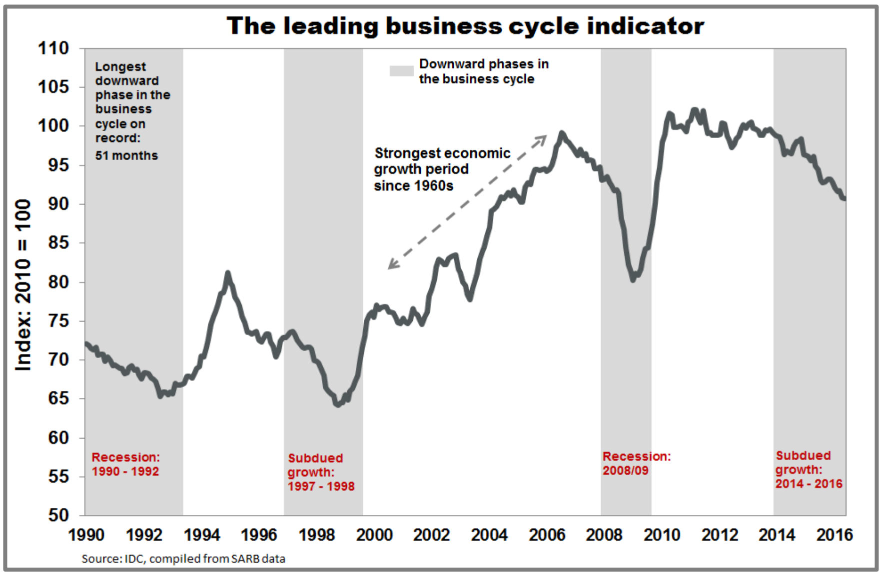
Source: IDC, compiled from SARS data

South Africa's imports, which were valued at R544.7 billion in the first half of the year, were led by metals and machinery (20% of the merchandise import basket), followed by transport equipment (18.7% share) and by chemicals, rubber and plastics (18.2%).

Economic outlook

South Africa's growth prospects remain generally unfavourable over the short-term, with expectations of a gradual improvement thereafter.

After a worse than expected GDP growth outcome in the first quarter of 2016 (-1.2% quarter-on-quarter), a slight rebound is expected in the second quarter. Stronger output growth in the mining and manufacturing sectors, as well as an up-tick in real retail trade sales should underpin a modest positive growth rate during the three months to June 2016. However, the momentum is likely to weaken in the second half of the year, as forewarned by the down-trending leading business cycle indicator (refer to the chart) of the South African Reserve Bank (SARB). At 90.8 index points in May 2016, the indicator was at its lowest level since October 2009, when the economy was in recession.

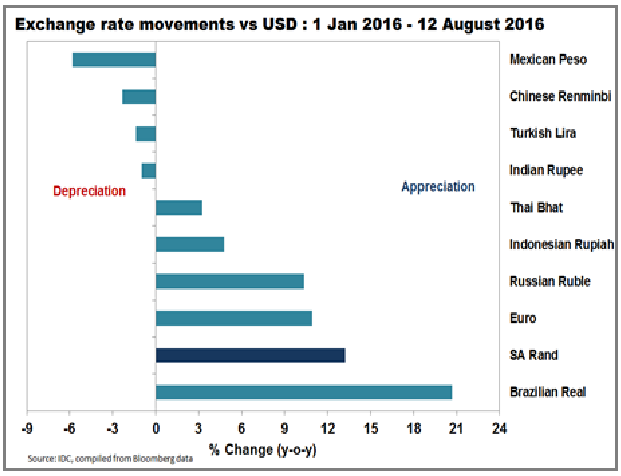


Consumer sentiment is currently at very low levels, reflecting the fragile state of household budgets. Household debt levels are likely to remain high over the short- to medium-term as consumers' battle to reduce their indebtedness in a higher interest rate environment, and considering the high dependency rates associated with excessive unemployment, which stands at a rate of 26.6%. Although spending by households is expected to recover gradually through the forecast period, the rate of increase will remain well below the levels recorded before the 2009 recession.

A poorly performing economy resulted in sharp declines in both formal and informal sector employment over the first two quarters of 2016, totalling a cumulative 473 000 job losses. Considering the operating environment presently faced by the private sector as well as efforts to contain public sector employment, the outlook for job creation is particularly unfavourable in the short-term.

Standing at 32 index points in the second quarter of 2016, the business confidence index compiled by the Bureau for Economic Research (BER) is also at its lowest since the 2009 recession. South Africa's business sector is not only facing weakening demand in local markets, largely due to slowing household expenditure as well as generally low levels of production and investment activity in many sectors of the economy, but continues to experience challenging conditions in foreign markets. Demand remains subdued in key export markets, particularly in the Eurozone and increasingly in the rest of Africa, where manufactured exports are concerned, as well as in China with respect to industrial commodity exports.

Furthermore, renewed search for yield globally and a recovery in net exports more recently, underpinned the 13% strengthening of the rand vis-à-vis the US dollar thus far in 2016, ahead of most emerging market currencies (refer to the following chart). This is affecting the relative price competitiveness of South African products in world markets, as well as domestically, while reducing the rand earnings of export-oriented companies. Although the carry trade, which is being supported by the Bank of Japan's negative interest rates and larger quantitative easing programmes in a number of advanced economies, may lead to further rand appreciation in the very near-term, the currency's strengthening trend is unlikely to be sustained for long for the following reasons: domestic economic fundamentals are still relatively unfavourable; policy rates in the US will soon resume their upward trend, leading to ZAR depreciation alongside other emerging market currencies; and the rand should come under renewed pressure ahead of the forthcoming credit rating agencies' reviews of South African economy's performance and prospects.



Many domestic industrial operations therefore have spare production capacity and are unlikely to consider expansionary investments at least in the short-term (although capital spending will continue for the maintenance of capital equipment). Falling capital expenditure by public corporations in real terms is also contributing to lower overall investment activity. The public sector's contribution to overall fixed investment is declining as very large projects are nearing completion. Consequently, a 1.3% decline in gross fixed capital formation is projected for 2016, with a marginal recovery (+0.7%) anticipated in 2017.

Key performance indicators for the South African economy

Variable (% change or % of GDP)	2013	2014	2015	2016f	2017f	2018f	2019f	2020f	2021f
Real GDP growth and its components:									
Household consumption expenditure	2.0	0.7	1.7	0.2	1.2	1.8	2.1	2.1	2.1
Government consumption expenditure	3.8	1.8	0.2	1.0	1.4	2.0	2.4	2.3	2.4
Gross fixed capital formation (GFCF)	7.0	1.5	2.5	-1.3	0.7	4.2	5.7	4.7	3.8
Exports	3.6	3.3	4.1	4.5	4.3	5.2	4.9	5.2	5.4
Imports	5.0	-0.5	5.3	1.2	5.0	6.1	5.7	4.2	4.4
GDP	**2.3**	**1.6**	**1.3**	**0.2**	**1.2**	**2.0**	**2.7**	**3.0**	**2.9**
Consumer price inflation	5.8	6.1	4.6	6.6	6.0	5.4	4.8	4.9	4.5
Current account balance (% of GDP)	-5.9	-5.3	-4.3	-4.2	-4.4	-5.0	-5.2	-4.4	-3.5
GFCF as % of GDP	20.3	20.5	20.6	20.1	20.1	20.7	21.7	22.6	23.3

Source: IDC, compiled from SARB data, IDC forecasts

However, on-going public sector infrastructure investment spending, estimated at R865 billion over the next three years in nominal value terms, will go a long way in addressing the bottlenecks (in electricity, transport & logistics, water infrastructure) that have been hindering South Africa's growth potential. The normalisation of electricity supply as new generation capacity comes on stream in the next few years should trigger higher rates of fixed investment growth later in the outlook period.

Private sector fixed investment should, over time, also be stimulated by the positive spin-offs of public sector procurement, as government encourages increased localisation. Furthermore, the designation of a wide range of products for public sector procurement will surely have a positive impact on production activity in the beneficiary sectors.

Export demand is an important driver of production activity in many economic sectors, especially when subdued trading conditions locally leave domestic businesses with little option but to target export markets. As the global economy eventually resumes a higher growth trajectory, South African exporters are likely to benefit, with an undervalued rand also providing a degree of support, albeit only temporarily.

Overall economic growth in 2016 is now projected at 0.2%, down from the 0.4% forecast at the start of the year. This is partly due to revisions made by Statistics South Africa to gross domestic product data in June 2016. Real GDP is anticipated to expand at an average rate of around 2% per year over the outlook period.

Department of Research and Information

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