Industrial Development Corporation

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Economic overview:

Recent developments in the global and South African economies

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Department of Research and Information

Contents

Highlights

- Prospects for the world economy remain largely positive, but the downside risks are looming larger in an increasingly uncertain environment.
- The protectionist rhetoric and trade policy measures taken by the Trump administration have intensified and are leading to retaliation by several affected countries. The repercussions for world trade and investment flows, global value chains, production activity and employment, will, on balance, be negative. Importantly, the rules-based global trading system is being rattled in a non-constructive manner, as is multilateralism in general.
- Sentiment levels around the globe are being adversely affected in the process, as reflected by lower readings of the world economic climate indicator, particularly its forward-looking element, in the second quarter of the year.
- The re-imposition of US sanctions on Iran has had a substantial impact on the oil market, potentially widening the demand-supply gap. Higher oil prices are feeding into producer and consumer prices across the world and raising inflation expectations. Coming at a time when monetary policy is being normalised in advanced economies, this may accelerate the monetary policy tightening process.
- Expectations of tighter monetary policy in the US have largely underpinned the sell-off of specific emerging market assets, weakening the currencies of those with relatively larger macroeconomic imbalances. Rising oil prices bring about further pressure as these could aggravate current account deficits and reinforce inflationary pressures.
- The growth outlook for the Sub-Saharan Africa region remains generally favourable (averaging 3.6% per annum over 2018 and 2019), but performances will vary considerably across countries. Excluding the region's two largest economies (South Africa and Nigeria), growth is projected at 4.8% in 2018 and 5.4% in 2019.
- The South African economy recorded a disappointing performance in the first quarter of 2018. GDP contracted by 2.2% due to sharply lower output in the agriculture, mining and manufacturing sectors.
- Household spending continued to increase in real terms, albeit at a slower pace. The consumer environment is, nevertheless, showing encouraging signs of improvement, providing comfort for a continued and gradual recovery in household expenditure.
- Fixed investment spending fell by 3.2% in the opening quarter of the year as private business enterprises and general government reduced capital outlays. Gradually improving demand conditions, both domestically and globally, along with a recovery in business confidence and investor sentiment, should pave the way for higher fixed investment spending by the private sector going forward.
- Exports of goods and services dropped sharply in the first quarter of 2018. Their 16.5% decline on a quarterly basis was mostly due to lower mining and manufacturing exports, but a substantially stronger rand also affected the price competitiveness of many products in global markets.
- Despite the setback experienced at the start of the year, the South African economy is still expected to post a higher rate of growth in 2018. Business confidence is also expected to recover and, together with increasing consumer sentiment should translate into higher spending activity domestically, whilst sustained economic growth and increased investment activity globally should be supportive of the export-oriented sectors of the economy.

FDI flows into Africa in 2017:

down 21.5% to USD41.8 billion

(UNCTAD)

Sub-Saharan Africa GDP growth forecast:

3.4% in 2018
3.7% in 2019

(IMF)

SA GDP growth in the 1st quarter of 2018:

-2.2% (q-o-q, seas. adjusted)

(Stats SA)

Growth in household spend in the 1st quarter of 2018:

1.5% (q-o-q, seas. adjusted)

(Stats SA)

Implications for South African businesses

- Extraordinary trade policy moves by the US government and retaliatory measures by several affected countries are likely to affect global trade and investment in ways that are difficult to determine at this stage. Such developments could potentially affect the performance of the South African economy in general, and its export and import-competing sectors in particular. South African businesses should pay close attention to unfolding developments and plan accordingly.

- In the shorter term, higher crude oil prices are a leading indicator of prospects for an upturn in industrial commodity prices, particularly iron ore, coal, aluminum and copper. However, they also feed into inflationary pressures that may eventually have to be countered by monetary policy action.

- The US Federal Reserve may be inclined to hike interest rates at a faster pace than anticipated at the start of 2018. Other than the respective impact on borrowing rates in international capital markets, the associated capital flows may force the South African Reserve Bank to raise the repo rate sooner and possibly more aggressively than currently forecast.

- The worse than anticipated performance of the South African economy in the opening quarter of 2018 is likely to affect business sentiment to some extent, possibly prompting a more cautious stance regarding investment decisions for the time being. However, the South African economy is still projected to post a gradual recovery over the remainder of this year, with the pace of expansion likely to accelerate in subsequent years.

- Similarly, the credit rating agencies will be scrutinising developments across numerous economic indicators. These agencies have been expressing concern over the slow pace of economic growth and its implications in addressing key challenges facing the domestic economy, including fiscal and current account imbalances, government debt ratios, as well as high levels of unemployment, among others.

- The anticipated increase in spending by South African households on durable as well as semi-durable goods should be supportive of business enterprises operating in these market segments.

- Businesses that rely specifically on the investment cycle as suppliers of goods or services should witness a progressive improvement in demand conditions, initially due to a recovery in private sector fixed investment and, later in the outlook period, by a revival in public sector spending on infrastructure development.

- Improving prospects for the manufacturing sector, especially with regards to export sales, should bode well for South Africa's export-oriented businesses. A weaker rand should improve price competitiveness in global markets, but competing producers in other emerging markets may also be benefitting from currency depreciations.

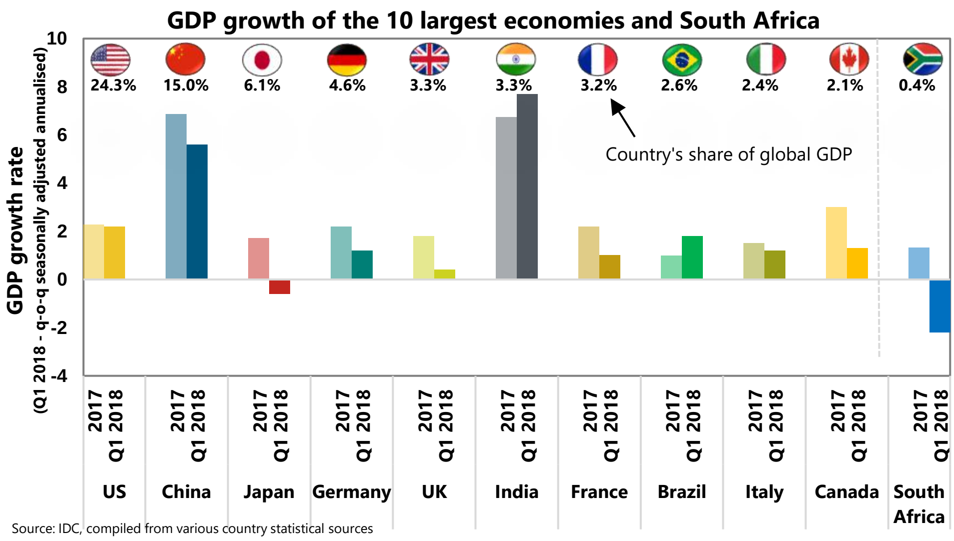
Global developments and outlook

Global growth still expected to improve in 2018, but downside risks are mounting

The world economy's growth momentum is being tested by extraordinary developments that are already affecting, or are expected to impact significantly on the flows of goods, services and capital around the globe.

Gross domestic product (GDP) data for the first quarter of 2018 (refer to Figure 1) revealed a slower growth performance, on a quarter-on-quarter basis, in the world's ten largest economies, with the exception of India and Brazil. The South African economy's contraction (included in the chart simply for comparative purposes) was unexpectedly large at -2.2%. Germany, Canada and South Africa saw their export performances detract from overall growth, with contributing factors including relative currency strength and demand conditions in external markets. The decline in Japan's GDP was largely due to lower consumption spending by households and fixed investment activity.

Figure 1: Growth performances of the 10 largest global economies and South Africa



Source: IDC, compiled from various country statistical sources

These performances reflect the fragility of the expansion momentum in several of the world's major economies. Furthermore, they preceded the adverse developments in the global trading and geo-political arenas that have largely characterised the second quarter of 2018.

Rising US protectionism is threatening the global trading system

The protectionist rhetoric and trade policy threats/measures taken by the Trump administration have intensified. The meetings of the Group of Seven held at Charlevoix, Canada, from 8 to 9 June, exposed the current rift and mounting tension between six of its member states (Canada, France, Germany, Italy, Japan, United Kingdom) and the United States (US). The outcome was, in practical terms, negative for the global economy, for it reinforced the protectionist stance of the US regardless of the costs for the world economy, including the American economy per se.

Countries previously excluded from the imposition of tariffs on steel and/or aluminium imports into the US, which have been justified by the latter on the basis of the "threat posed to national security", are no longer spared. These include Canada and Mexico, both co-members of NAFTA, and the European Union (EU). At this stage, only Australia, Argentina, Brazil and South Korea appear to have negotiated their exclusion from such US import tariff measures with a degree of success. In the case of Australia and Argentina, the US has put quotas or volume restrictions in place, with both countries having also agreed to reduce excess aluminium production and capacity.

Countries affected by US tariffs on imports have announced retaliatory measures

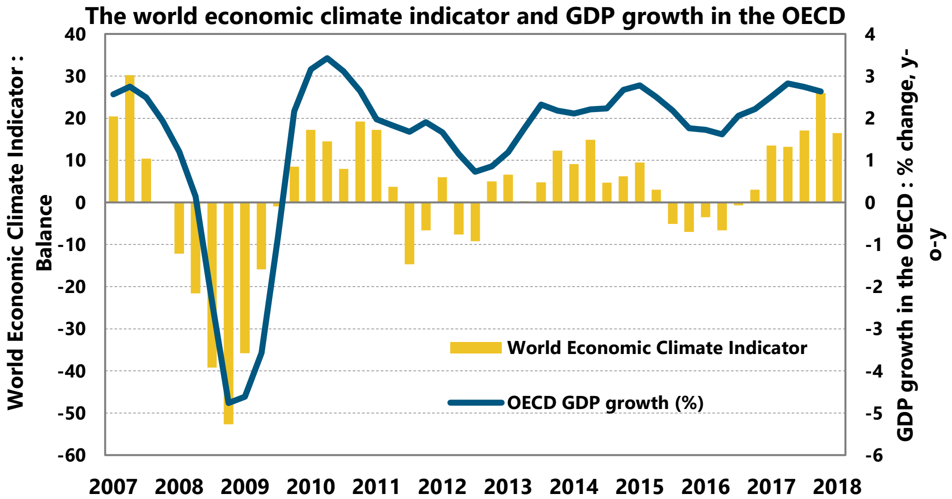
Many affected countries have announced that they will be taking retaliatory measures. The EU plans to introduce additional import duties on US goods such as jeans, whiskey, orange juice, maize, steel, motorcycles, cosmetics and pleasure boats, amongst many others. Canada is likely to target US steel and steel products, aluminium and aluminium products, boats, chemical products, and, among others, several consumer items such as orange juice, chocolate and other food products, whiskies etc. Mexico will impose equivalent measures on various US steel products, pork and food preparations, several types of fruit, and, among others, various cheeses. After having succeeded in preventing a trade war, China has again been expressing major concerns over future trade relations with the US. Aggravating an already tense situation, the Trump administration appears intent on bringing car and truck imports into the set of "protected" items, and others may follow.

The unpredictability and about-turns of US trade policy are raising uncertainty in a still fragile global economy. The repercussions for world trade and investment flows, global value chains, production activity and employment, will, on balance, be negative. Importantly, the rules-based global trading system is being rattled in a non-constructive manner, as is multilateralism in general.

Expectations of future economic conditions have moderated significantly

Sentiment levels have, consequently, taken a knock. This was captured in the second quarter readings of the Ifo's world economic climate indicator (refer to Figure 2), particularly its forward-looking element covering economic expectations, basically across all regions.

Figure 2: World economic climate indicator fell sharply in the second quarter of 2018



Source: IDC, compiled from Ifo & OECD data

Italy's new coalition government has put the European project again under the spotlight

Geo-political developments have added to the uncertainty. With Italy's new government consisting of a coalition of two euro-sceptic parties, fears over the future of the European project resurfaced. Italy is not only the fourth largest economy in the EU but also its biggest debtor - its €2.3 trillion public debt represents 132% of GDP. However, its new Finance Minister recently stated that Italy leaving the Eurozone was not up for discussion and that his government would block market forces that would push towards an exit. Financial markets reacted positively to this reassurance.

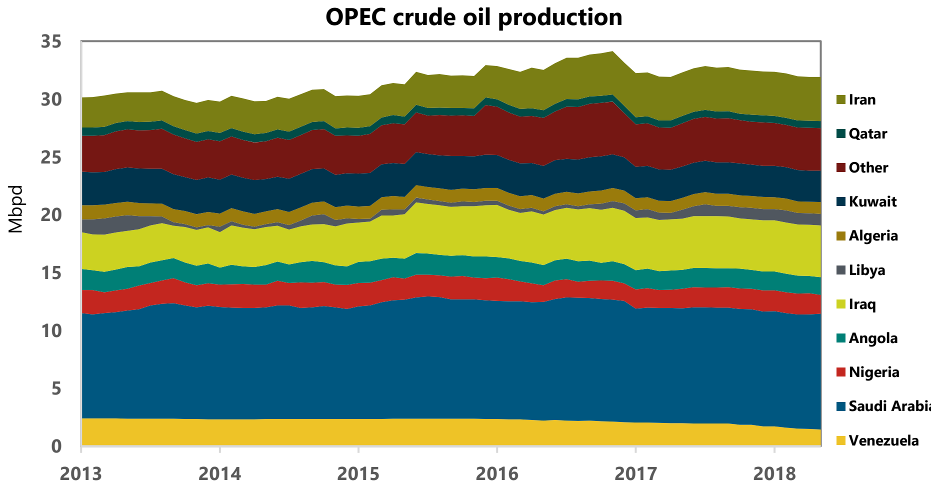
The US withdrawal from the Iran nuclear deal and the re-imposition of sanctions on the country have not only added to instability in the Middle East, but the ramifications extend well beyond the region. Any company that violates these sanctions will itself attract US sanctions and be excluded from the US financial system (and thus any dollar-denominated transactions). Whilst the EU has been attempting to negotiate exemptions for its companies from these secondary sanctions, a number of players have either postponed their investment plans in Iran or have started to withdraw completely from the country. These developments have pushed oil prices higher, with Brent crude oil briefly rising above USD80 per barrel (bbl), before consolidating just below this level.

Demand as well as supply side factors are supporting a higher level of crude oil prices

Incremental growth in global demand for oil, which currently stands at 1.6 million barrels per day (mbpd), has remained above supply growth (1.2mbpd at present) since mid-2016, underpinning sustained gains in the oil price. On the demand side, the global economic expansion continues to drive robust crude oil demand growth, led by China, India and the US. Notably, China's demand is trending above expectations largely on the back of strong industrial productivity, with the country reporting record oil import volumes as well as refinery runs. Going forward, global incremental oil demand growth is expected to rise to 2.0mbpd by the fourth quarter of 2018.

Supply-side developments are expected to contribute towards a sustained deficit in the global oil market, which was estimated at 0.5mbpd in the first quarter of 2018, over the months ahead. While higher oil prices are expected to trigger increased US shale production, restrained growth in OPEC output alongside the renewed curtailment of Iranian oil exports are likely to compensate for increases in non-OPEC production.

Figure 3: Restrained OPEC production has been supportive of high crude oil prices



Source: IEA data, IDC analysis

Overall OPEC supply has been below the agreed level due to the underperformance of major OPEC members including Saudi Arabia, Angola and Venezuela (the latter's production is 93% below its OPEC quota). As a result, OPEC oil production is expected to remain at least 900 000 bpd below the current quota limit over the outlook period to 2019. It should be borne in mind, however, that Saudi Arabia has scope to increase its oil output in this higher oil price environment. This country accounts for more than 30% of OPEC crude production and has more than 1.5mbpd in spare production capacity.

Industrial commodities may generally benefit from higher oil prices

A scenario of sustained higher oil prices would raise industrial commodity production costs, especially iron ore, copper, aluminium and palladium, while also translating into higher market prices for these commodities owing to their positive correlation with oil prices. An overwhelming surplus in the global platinum market, however, has culminated into a structural breakdown between platinum and oil prices. As such, this precious metal is unlikely to benefit from structurally higher oil prices at least in the shorter-term.

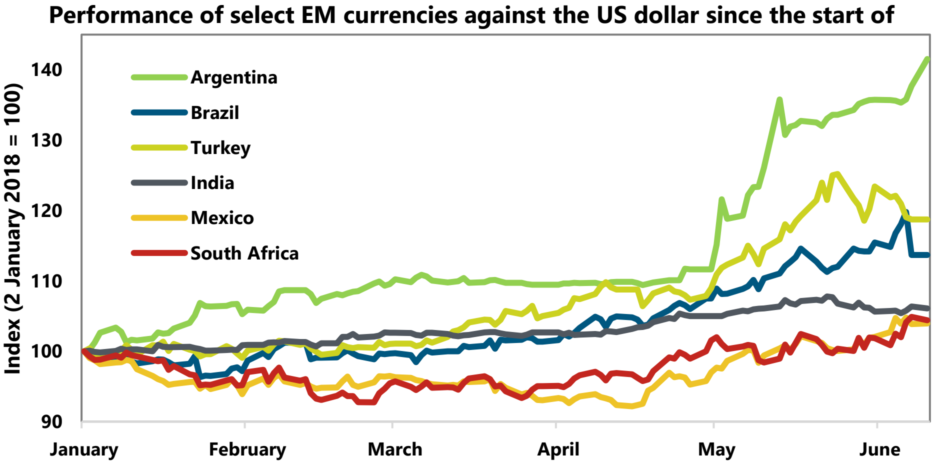
Higher oil prices are feeding into producer and consumer prices across the world and raising inflation expectations. Coming at a time when monetary policy is being normalised in advanced economies, this may accelerate the process. In the US, the economy is expanding at a sturdy pace, the unemployment rate is at an 18-year low, and wage increases have been above targeted inflation levels. Cost-push pressures associated with sharply higher fuel prices are now likely to be progressively accompanied by the impact of import tariffs on key inputs on industrial production structures. The US Federal Reserve may thus be inclined to hike policy rates at a faster pace than anticipated at the start of 2018.

Inflationary pressures on the rise, potentially leading to a faster pace of US monetary policy normalisation

Expectations of tighter monetary policy in the US have largely underpinned the sell-off of specific emerging market (EM) assets, weakening the currencies of those with relatively larger macroeconomic imbalances. Rising oil prices brought about further pressure as these could aggravate current account deficits and reinforce inflationary pressures. Amongst the most affected EM currencies have been those of Argentina and Turkey, which are particularly exposed to higher US interest rates due to their large external funding requirements, but also those of Brazil, Mexico and South Africa. In certain cases, monetary authorities were left with little option but to raise interest rates in an effort to stabilise their currencies. The largest move was made by Argentina's central bank, which hiked interest rates from 27.25% to 40% during the week of 30 April to 4 May, and the authorities approached by IMF for credit support. Although concerns over a possible EM debt crisis have re-emerged, it should be pointed out that EM macroeconomic fundamentals have improved in the aggregate.

Emerging market currencies have been under renewed pressure

Figure 4: Emerging market currencies under renewed pressure



Source: IDC, compiled from various Bloomberg data

The outlook for the world economy is still positive, but the momentum is being affected by prevailing uncertainty

Prospects for the global economy remain largely positive, but the downside risks are looming larger in an increasingly uncertain environment. A surely favourable development on the geopolitical front was the historic Singapore summit between US President Donald Trump and Chairman Kim Jong Un of North Korea, which appears to pave the way for the denuclearisation process.

There is, without question, substantial room for improvement in certain aspects of the global economic architecture, but the manner in which change is ultimately realised should be consultative, consensual and, most importantly, responsible. The Trump administration's approach is not only threatening the sustainability of the global economic expansion, but may bring about irreparable damage. Furthermore, its conduct is harming the United States' standing in the global community of nations. This could lead to its increasing isolation as alliances are reoriented around the globe, much to the detriment of the world's largest economy and the chief architect of its long-standing multilateral governance frameworks.

Recent developments in the Sub-Saharan Africa region

The outlook for the Sub-Saharan African region remains positive, following two consecutive years of relatively weak economic activity. According to the International Monetary Fund (IMF), regional growth is expected to gain momentum towards 3.4% in 2018 and 3.7% in 2019, compared to 2.8% in 2017 and 1.4% in 2016. However, these aggregated figures mask wide variations across countries. Excluding the region's largest economies - Nigeria and South Africa - which are still expected to post muted (albeit improved) rates of economic expansion, growth in the region is projected at 4.8% and 5.4% in 2018 and 2019, respectively. This is expected to be driven by robust performances in some of the relatively larger economies such as Ethiopia, Côte d'Ivoire, Senegal, Tanzania, Ghana, Kenya and Uganda, which are forecast to post annual average growth rates of above 5.5% in 2018 and 2019.

Improved growth prospects for many African economies

Figure 5: Developments in SA's top 5 export markets on the continent and in other select African markets

Ghana*

Key drivers: Higher output in the oil and gas sector as well in gold mining + easing domestic credit conditions to support growth

Potential risks: Ongoing fiscal consolidation and accordingly reduced government consumption and capital spending to adversely impact growth in the non-oil sector.

Namibia**

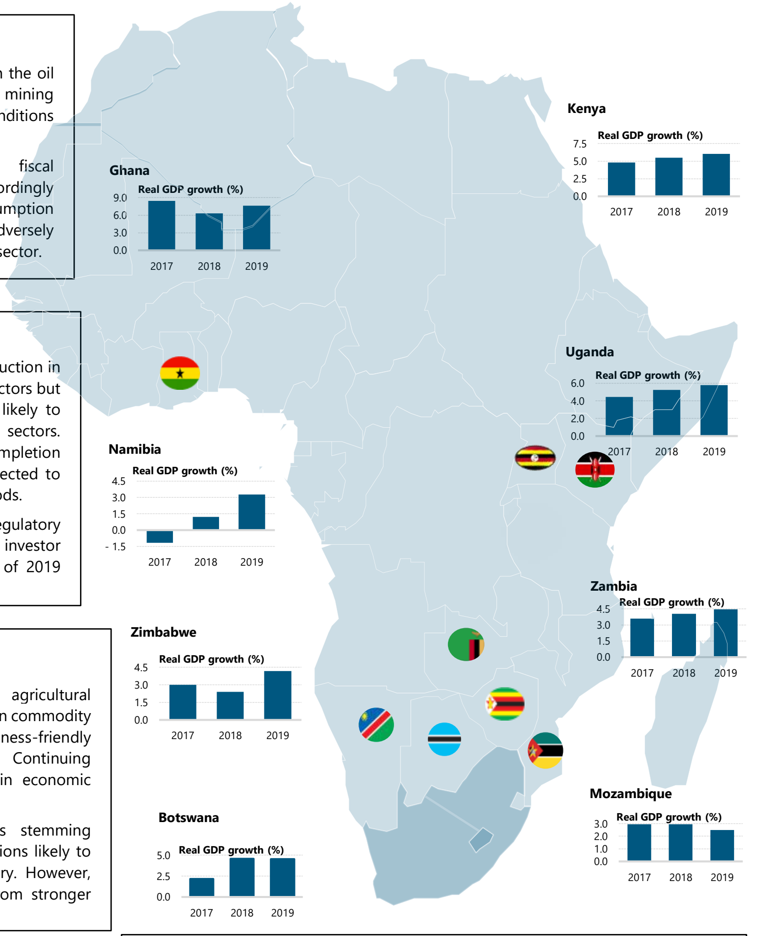
Key drivers: Recovering production in the mining and agricultural sectors but lower government spending likely to constrain activity in other sectors. Weak consumer demand + completion of infrastructure projects expected to soften demand for capital goods.

Potential risks: Regulatory uncertainty likely to impact on investor confidence, especially ahead of 2019 elections.

Zimbabwe**

Key drivers: Improved agricultural production, a modest recovery in commodity prices and expectations of business-friendly reforms to underpin growth. Continuing liquidity shortages to constrain economic activity in the short-term.

Potential risks: Uncertainties stemming from the upcoming 2018 elections likely to limit pace of expected recovery. However, upside risks could emanate from stronger foreign investments.



Botswana**

Key drivers: Recovery in mining, particularly in copper and diamond; and increased public capital expenditure on the back of the economic stimulus programme.

Potential risks: Reduced external demand, particularly for diamonds, from the US.

Kenya*

Key drivers: Strong public investments in infrastructure, a buoyant services sector, improved agricultural activity and tailwinds emanating from subsiding political tensions that followed the 2017 elections.

Potential risks: Fiscal consolidation and reduced private sector credit extension due to caps on bank lending rates.

Uganda*

Key drivers: Ongoing large-scale investments in infrastructure likely to be given impetus by decision to issue oil exploration licenses; and increased agricultural production on improved weather conditions.

Potential risks: instability in key regional markets could disrupt import demand and delays in projects implementation.

Zambia**

Key drivers: Higher copper prices and increased investments in the mining sector, which are, in turn, likely to support demand in other related industries and services.

Potential risks: Rising concerns over debt sustainability.

Mozambique**

Key drivers: Weak growth due to low foreign investment and budgetary support + weakening mining activity.

Potential risks: Failure to re-engage with the IMF and foreign donor community, sovereign debt defaults and renewed attacks on civilians to weigh on growth and investor sentiment.

Source: IDC, data compiled from IMF database, April 2018 - **denotes SA's top 5 export markets and where IDC has an exposure (except for Botswana & Lesotho): * denotes where IDC has an exposure.

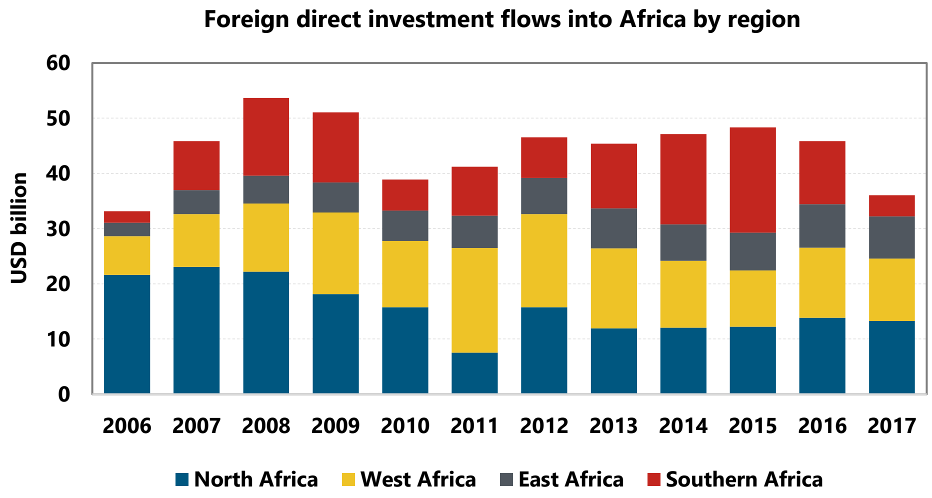
Nonetheless, downside risks to this outlook remain. Relatively high debt levels, continued vulnerability to fluctuations in the global financial and commodity markets, alongside the adverse impact of possible trade wars and wider geo-political risks could weigh on growth, trade and investment into Sub-Saharan Africa.

Foreign direct investment activity in Africa

Notwithstanding the ongoing efforts across the region to attract foreign direct investment (FDI), foreign investor interest continued to wane in 2017, with FDI inflows falling by 21.5% to USD41.8 billion, according to UNCTAD. This is their lowest level since 2006, with various regions and individual countries posting sharp declines. Contributing factors included unfavourable conditions in international commodity markets, particularly crude oil prices, macroeconomic vulnerabilities, as well as policy and political uncertainties.

FDI flows into Africa plummeted 21.5% to USD41.8 billion in 2017

Figure 6: FDI flows into Africa declined sharply in 2017



Source: IDC compiled, from UNCTAD data, June 2018

The decline was more pronounced in the Southern African region, where FDI inflows plummeted by 66% in 2017 compared to the previous year. FDI turned negative in Angola (-USD2.3 billion), while South Africa recorded a 41% decline to USD1.3 billion (USD2.2 billion in 2016). Amid liquidity constraints and sovereign debt defaults, Mozambique's FDI inflows were 26% lower, but remained at a relatively strong level of USD2.2 billion in 2017. This compares with annual average inflows of USD4.7 billion over the five years to 2016.

Southern Africa recorded the most pronounced fall in FDI inflows

FDI flows to West Africa declined by 11%, largely on the back of weak economic conditions in Nigeria and ongoing fiscal constraints in Ghana. Côte d'Ivoire and Senegal, on the other hand, recorded strong increases, partly reflecting their economic diversification efforts, which have seen investments in a diverse range of sectors. The West African sub-region attracted the second largest FDI inflows in 2017 at USD11.3 billion.

Although FDI into East Africa fell by 3%, this sub-region continued to absorb both efficiency- and market-seeking investments, with Ethiopia becoming the second largest recipient of FDI in Africa in 2017. The region is attracting investments into industries ranging from light manufacturing to automotive, clothing and textiles, information and communications technologies, pharmaceuticals, food processing and beverages, among others.

More market- and efficiency-seeking investments in Ethiopia

In North Africa, despite a 4% decline, FDI inflows remained high at USD13.3 billion. Egypt attracted the bulk at just over 55% of total regional inflows. Morocco was also amongst the top investment destinations, attracting investments in various new car technologies.

Flows into the Central African region were 22% lower in 2017, dragged downward by the continuing economic crisis in the Republic of Congo, brought about by relatively lower oil prices. Increased investments in the copper and cobalt mining sector boosted inflows into the Democratic Republic of the Congo to USD1.3 billion.

Advanced economies continue to dominate investor activity in Africa as reflected in the table below. However, the sources of FDI to Africa are becoming more diversified, with China raising its FDI stock level to about USD40 billion in 2016, from USD16 billion in 2011. South Africa dominates intra-African FDI and is the fifth largest investor in Africa.

Africa's top 5 investor economies by FDI stock: 2016 and 2011 (USD billion)

		2016	2011
1.	United States	57	57
2.	United Kingdom	55	54
3.	France	49	52
4.	China	40	16
5.	South Africa	24	23

Source: UNCTAD FDI database, 2018

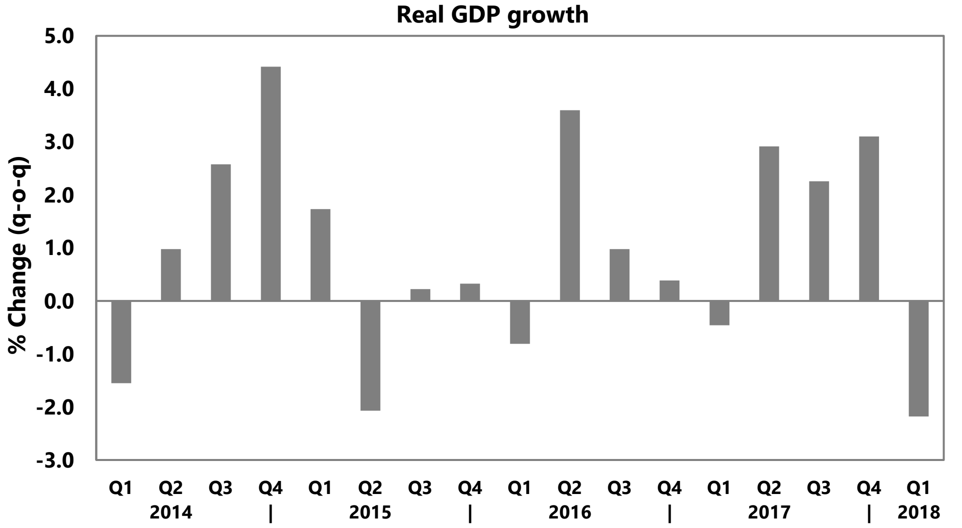
Although FDI flows to Africa are expected to rise to about USD50 billion in 2018, on the back of improving economic conditions and positive developments in commodity markets, the 9% decline in the value of announced greenfield FDI projects suggests a relatively moderate increase in FDI going forward. Disconcertingly, the value of China's announced greenfield projects in Africa fell by about 75% to only USD8.9 billion in 2017, compared to USD36.1 billion in 2016.

Recent developments in the South African economy

Sharp contraction in real GDP in Q1 2018, with generalised weakness across all broad sectors

The performance of the South African economy in the first quarter of 2018 was far worse than anticipated. Real GDP contracted by 2.2% (on a quarter-on-quarter, seasonally adjusted and annualised basis), the worst quarterly growth performance since the same quarter in 2009. This is in stark contrast to the much better than expected expansion in the final quarter of 2017, at 3.1%, which created a high base.

Figure 7: Economic performance reflecting widespread weakness



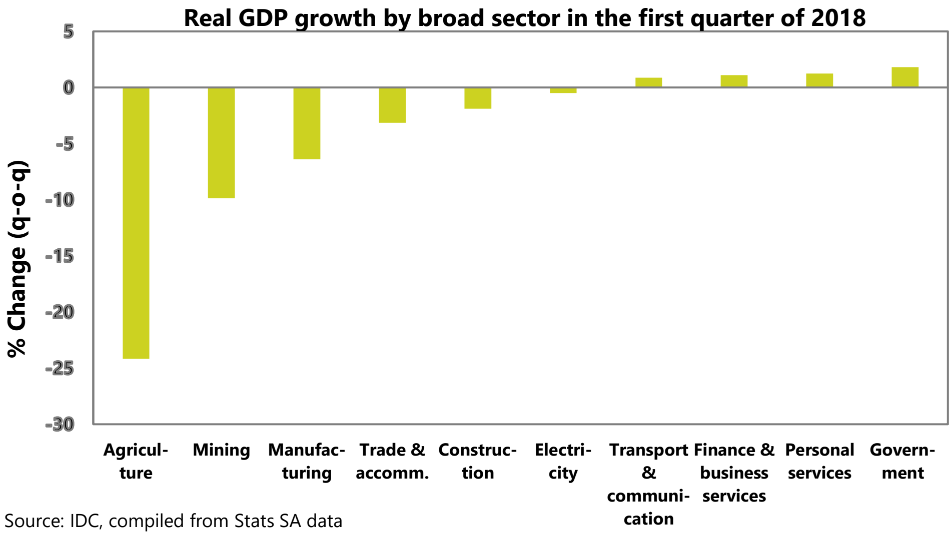
Source: IDC, compiled from Stats SA data

Sectoral performance

Sharply lower agricultural output relative to the high base of the preceding quarter

The decline was mainly due to substantially lower output in the agriculture and mining sectors. Real GDP would have declined by a more modest 0.8% if the impact of these two sectors was to be excluded. As anticipated, agricultural output was substantially lower (-24.2%), mainly due to a very high base on the back of a record maize crop in the 2017 season, and the effects of the ongoing drought in the southern regions of the country, particularly the Western Cape.

Figure 8: Goods-producing sectors recorded very weak performances



Source: IDC, compiled from Stats SA data

Looking ahead, agricultural output will be negatively impacted by the smaller maize crop anticipated for the 2018 season. Currently estimated at 12.9 million tons (16.8 million tons in 2017), this will still be the fourth largest maize crop on record. Considering the large share of approximately 22% claimed by the Western Cape's agricultural sector, the crippling effect of the drought on wine production, as well as on citrus and deciduous fruit production, among others, could weigh heavily on the performance of the agriculture sector in 2018.

Mining sector taking strain, with lower output in several key sub-sectors

Following a strong rebound in 2017 as a whole, mining output fell by 9.9% in the opening quarter of the year. This followed a 4.4% decline in the final quarter of 2017. Lower output levels were recorded across most of the main sub-sectors, with the exception of coal mining, which managed to record a marginal rise in output. A greater incidence of derailments on the Sishen iron ore line caused Kumba to declare force majeure on its international contracts. Combined with winter-related steel production capacity restrictions in China, which impacted adversely on global demand for steel input materials (including iron ore and manganese) during the 1st quarter of 2018, this weighed on South Africa's iron ore production.

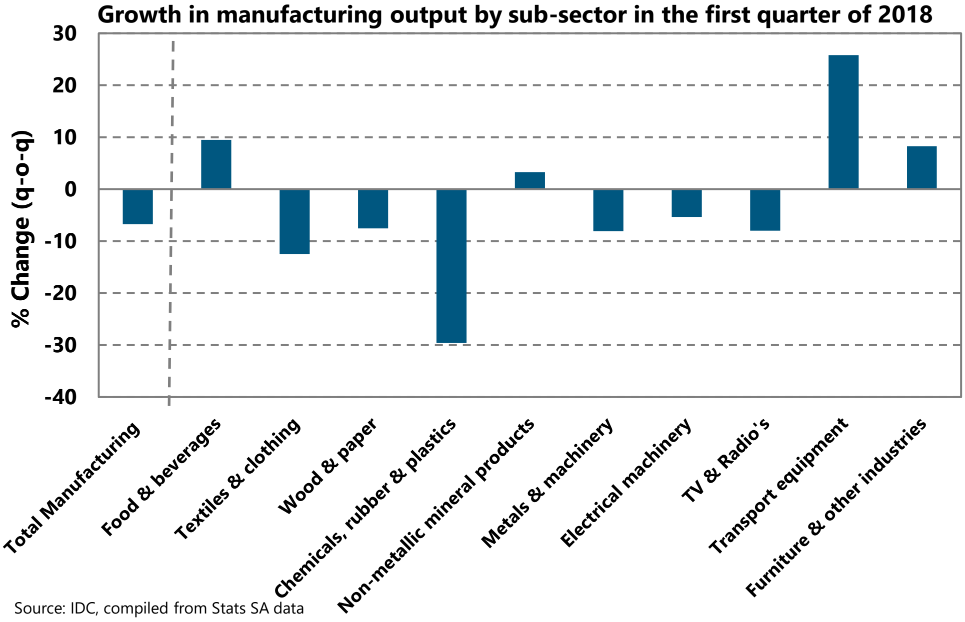
Platinum mining production has been affected by sustained low prices as a result of a global market surplus, culminating into more than 30% of mine production capacity in South Africa being unprofitable at prevailing prices. The continuing European diesel market share loss remains a key drag on platinum market sentiment and could result into a sustained underperformance in platinum mining production into the foreseeable future.

The imposition by the US of a 25% tariff on imports of select steel and steel products will have considerable ramifications across the respective global markets and, by implication, will affect steel-related mining input industries. These import tariffs will not only have a direct impact on the production of South African steel destined for the US market, but will also have indirect effects as countries like Canada and Mexico, as well as the European Union, among others, seek alternative markets for their products.

Manufacturing output under renewed pressure, with most sub-sectors recording lower production

After three consecutive quarters of higher output, manufacturing GDP contracted by a sizeable 6.4% in the opening quarter of 2018. A particularly large decline in production was recorded in the chemicals sub-sector, but lower output was also reported by the sub-sectors producing clothing, textiles, leather and footwear; base metals, fabricated metal products and machinery; as well as wood and paper. The manufacturing sector's weak performance in the first quarter of 2018 was largely attributable to weak domestic demand. Operating conditions are, however, expected to improve over the remainder of the year on the back of a gradual recovery in both domestic and global demand.

Figure 9: Manufacturing sector taking renewed pressure at the beginning of the year



Source: IDC, compiled from Stats SA data

The decline in the GDP of the trade and catering sector in the opening quarter of the year (see Figure 8) can be ascribed to lower household spending on durable and semi-durable goods, whilst the wholesale trade sector also recorded lower sales in real terms. Positively, foreign tourist arrivals during the quarter represented a 6.4% increase year-on-year. Expectations of a gradual recovery in the consumer environment and business confidence should underpin a rebound in this sector going forward.

Weak construction activity reflected in all-time low confidence levels in civil engineering sector

Activity in the construction sector was adversely affected by substantially lower spending on residential buildings and construction works, with confidence levels in the civil engineering sub-sector falling to a record low in the first quarter of 2018. The short-term outlook for the sector does not look very promising in light of weak investment activity. Despite positive growth in sectors such as finance and business services (+1.1%), transport and communications (+0.9%), personal services (+1.2%), and general government (+1.9%), this was not enough to counter the steep drop in output of the primary and secondary sectors of the economy.

Improving sentiment amongst consumers, businesses and investors

The economy's performance in the first quarter of the year was certainly disappointing. Moreover, the 6 point drop in the business confidence index to a reading of 39 in the second quarter of 2018 illustrates the fragility of the recovery and the many challenges still to be overcome for a sustained, albeit very gradual economic recovery.

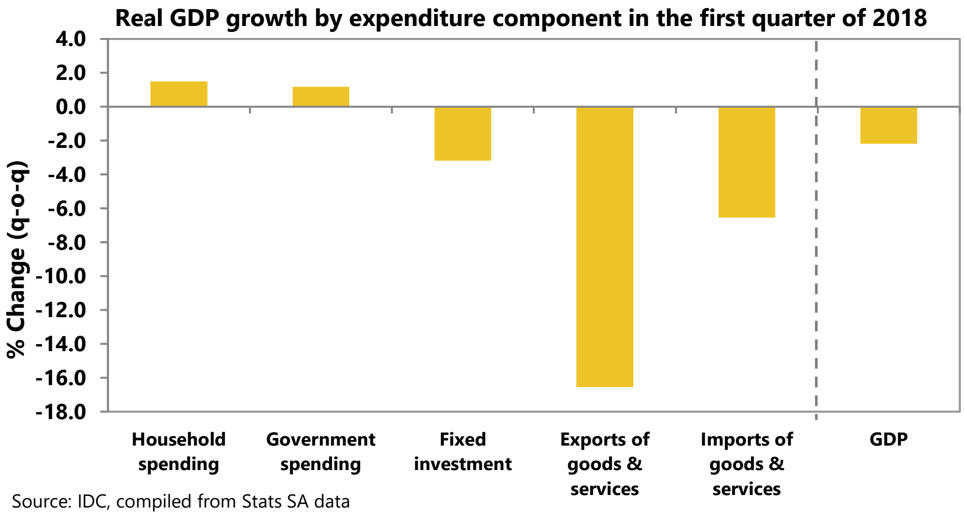
Expenditure on gross domestic product

The upward trend in household spending remained in place during the opening quarter of 2018, albeit at a more moderate pace of 1.5%. Nonetheless, still facing financial constraints and a relatively high debt burden, consumers cut back on spending on durable and semi-durable items. In contrast, consumption expenditure on non-durable goods (e.g. food and beverages), as well as on household services, recorded positive growth over this period.

Household spending still on the rise, but growth slowed

An improving consumer environment, gradually rising demand for credit, higher disposable incomes in real terms, anticipated declines in the household debt-to-income ratio, as well as a relatively favourable outlook for inflation and interest rates, should support a steady rise in household spending over the short- to medium-term. However, the steep rise in the petrol price more recently will be a drag on consumption expenditure.

Figure 10: Positive contribution made by households outweighed by lower investment and exports



Source: IDC, compiled from Stats SA data

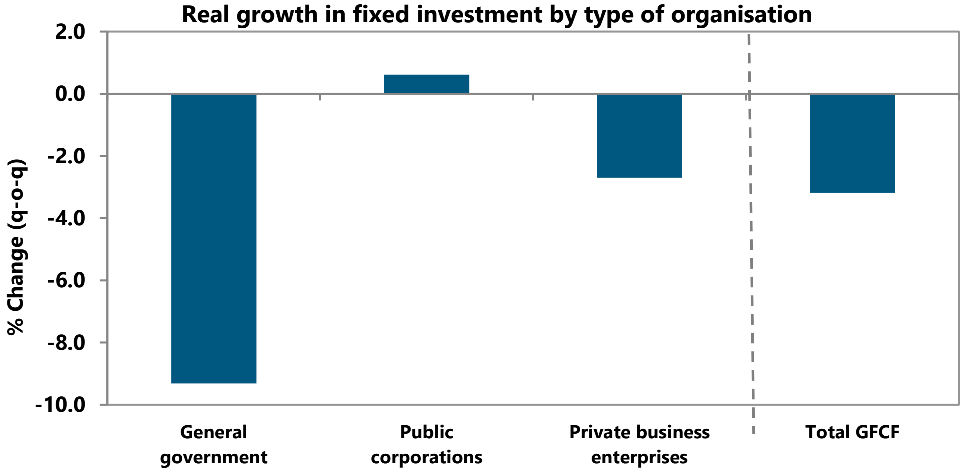
Despite ongoing fiscal challenges, spending by general government increased by 1.2% in the first quarter of 2018. This was principally due to the Independent Electoral Commission's registration drive in compliance with the Constitutional Court's judgement to obtain the residential addresses of all voters. Such an increase in spending was of a temporary nature. The public sector wage bill, however, is a key focus area for the rating agencies due to its impact on fiscal consolidation efforts. The wage increases of between 6% and 7% negotiated with public sector employees are likely to be viewed favourably, for they are in line with the budgeted increase of 7.3% over the Medium Term Expenditure Framework period.

Fixed investment spending declined by 3.2% (+7.4% in the final quarter of 2017) as both the public and private sectors reduced real capital outlays. Notwithstanding the clear improvement in confidence levels, the business environment remains challenging, with many economic sectors still operating below full capacity. This reduces the immediate need for private sector investment in new plant and equipment for the expansion of productive capacity.

Challenging operating conditions and surplus capacity impacting on fixed investment

Gradually improving demand conditions, both domestically and globally, along with a recovery in business confidence and investor sentiment, should pave the way for higher fixed investment spending by the private sector going forward. Growth in fixed investment spending by the broad public sector, in turn, is expected to remain limited due to financial constraints, at least in the shorter-term.

Figure 11: Challenging operating environment affected fixed investment activity



Source: IDC, compiled from Stats SA data

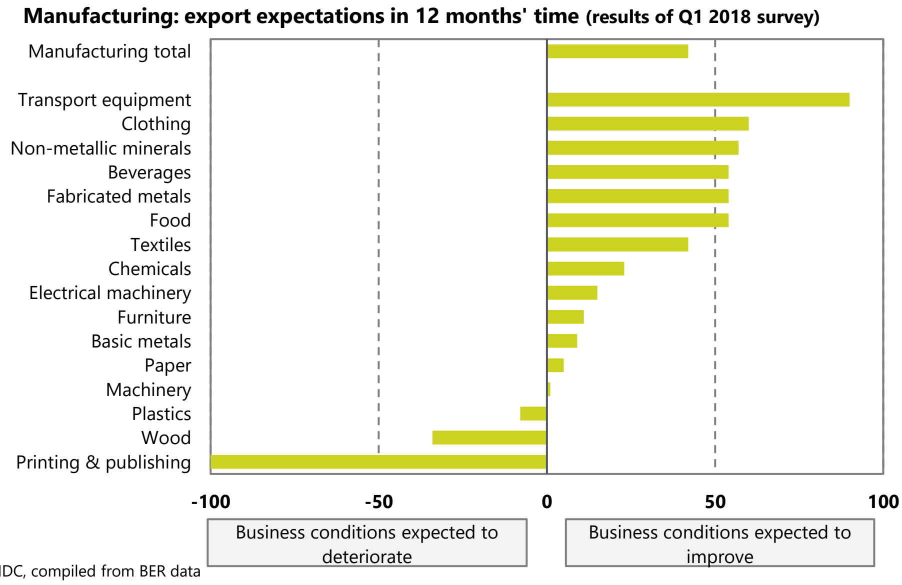
Exports adversely affected by the strong rand and by the poor performance of key outward-oriented sectors

Exports of goods and services dropped sharply in the first quarter of 2018. Their 16.5% decline on a quarterly basis was mostly due to lower mining and manufacturing exports. A substantially stronger rand in the opening quarter of the year (average of R11.96 per USD, compared to R13.64 per USD in Q4 2017), affected the price competitiveness of many products in global markets.

The nominal values of exports of platinum group metals, coal, iron ore, as well as gold, were lower than in the final quarter of 2017. In total, the value of mining exports was R29.2 billion lower than in the preceding quarter. This may also be partly explained by an anomaly in the export data in the fourth quarter of 2017, which captured crude oil exports from South Africa to the value of R10.8 billion due to an extraordinary transaction. However, in the absence of this item, exports would still have been substantially lower in the opening quarter of 2018.

Manufactured exports were R27.2 billion lower in nominal value terms compared to the final quarter of 2017. This was mainly due to a very sharp drop in exports of motor vehicles; machinery and equipment; food and beverages, as well as chemicals.

Figure 12: Manufacturers expect export sales to improve over the next 12 months

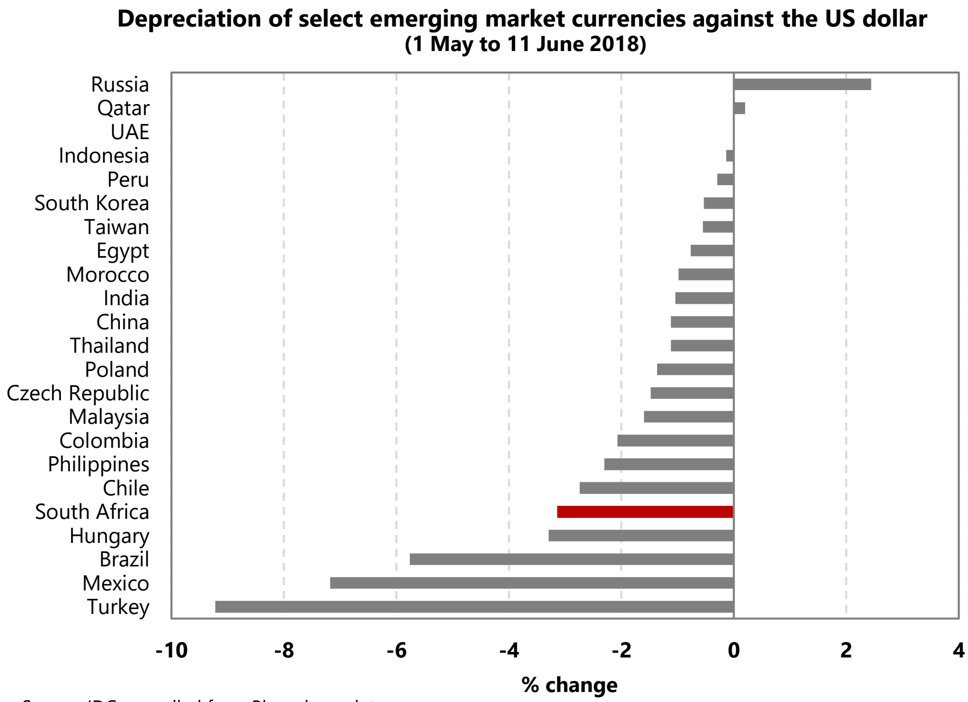


Source: IDC, compiled from BER data

Improving global demand and expectations of a weaker rand (see Figure 13) should be supportive of a better performance by South Africa's export sector over the short- to medium-term. This is confirmed by recent surveys, with manufacturers anticipating a substantial improvement in export sales in 12 months' time. The respective survey reading in the first quarter of 2018 was the second highest of the past 15 years. However, the exports of sectors such as base metals, machinery and equipment, as well as wood and paper are anticipated to be under pressure.

Improving global demand and a weaker rand may lead to an improved export performance going forward

Figure 13: Emerging market currencies under renewed pressure in recent weeks



Source: IDC, compiled from Bloomberg data

Department of Research and Information

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