Industrial Development Corporation

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Economic overview:

Recent developments in the global and South African economies

August 2018

Department of Research and Information

Contents

Highlights

- Escalating risks in the global trading and financial arenas are threatening to destabilise the world economy's performance. The IMF acknowledged such risks in its recent assessment of global economic conditions, but left its projections for world output growth unchanged at 3.9% for 2018 and 2019. The relative contributions were, however, altered, with those pertaining to the Eurozone, India and Brazil lowered, while Russia's growth forecasts were raised.

- Monetary policy normalisation in advanced economies is anticipated to accelerate as inflationary pressures are gradually building up. The US Federal Reserve is expected to raise interest rates by an additional 50 basis points during the remainder of 2018, while the European Central Bank and the Bank of Japan are likely to taper back their quantitative easing programmes.

- Risk aversion towards emerging markets (EM) has resurfaced strongly, largely due to the financial crisis unfolding in Turkey. Fears of contagion have come to the fore, with several EM currencies tumbling sharply over a very short period of time. The situation remains volatile, particularly as a result of inadequate action by the Turkish authorities.

- Economic growth in Sub-Saharan Africa is projected to gain some momentum over the next couple of years, but rising global risks are posing significant constraints. The key contributors to growth vary from country to country, but include stronger domestic demand, improving commodity prices, higher agricultural production and increased fixed investment activity. Despite a recovery in business and investor sentiment in parts of the region, this is unlikely to lift regional growth beyond the 4% mark.

- The South African economy is estimated to have recorded marginal growth in Q2 of 2018. Key sectors of the economy remained under considerable pressure as evidenced by available data. Whereas manufacturing output declined, mining production increased significantly, mostly on the back of higher PGM output. The difficult consumer environment has been reflected in lower retail and new passenger vehicle sales.

- The economy shed 90 000 jobs in Q2 of 2018, following a strong recovery in the previous quarter. The manufacturing sector recorded its second largest quarterly drop in employment (-104 947) since the new employment data was introduced in 2008.

- In order to stimulate inclusive economic growth, investment activity and employment creation, government announced an estimated R43 billion stimulus package focusing on a range of interventions. These include increased public sector spending on infrastructure development, development finance support, high rates of localisation associated with public sector procurement, support for entrepreneurial activity as well as for small- and medium-sized businesses, trade support measures for sectors experiencing increased import competition, as well as training for the youth.

- Rising tensions between the US and its key trading partners, primarily due to the former's protectionist moves, have the potential to seriously alter the patterns and quantum of global trade. An escalating trade war will not only affect the countries specifically involved, but will impact on economies throughout the world, including South Africa.

- The rand came under immense pressure as the Turkish crisis intensified, depreciating by 7.4% against the US dollar from the 6th to the 13th of August 2018. In the absence of significantly worse developments surrounding the Turkish economy and the

World GDP growth forecasts:

3.9% in 2018
3.9% in 2019

(IMF)

Sub-Saharan Africa GDP growth forecasts:

3.4% in 2018
3.8% in 2019

(IMF)

SA manufacturing output growth:

-0.5% q-o-q in Q2 2018

(Stats SA)

SA unemployment rate:

27.2% in Q2 2018

(Stats SA)

associated spill-over effects, the rand is expected to recover some of the lost ground, for economic fundamentals do not support its current trading levels.

- The growth outlook for the South African economy has worsened, especially for 2018. IDC forecasts for GDP growth have, accordingly, been revised downward to 1.3% for 2018 and 2.0% in 2019. Household consumption expenditure and fixed investment activity are projected to gain increasing momentum over the next five years, particularly from 2020 onwards. The export sector's performance is also expected to improve, barring adverse developments in the global trading environment.

SA GDP growth forecasts:

1.3% in 2018
2.0% in 2019

(IDC)

Implications for South African businesses

Globally …

- The extraordinary trade-related developments that have been manifesting in the world's economic environment are already affecting, and could increasingly impact on the flows of goods, services and capital around the globe:
  - Potential trade diversions and temporary disruptions to supply chains could affect the performance of South African exporters and import-competing domestic producers.
  - Although competition is likely to intensify in certain existing export markets, opportunities may also emerge, including in non-traditional markets.
  - The increased uncertainty is already being reflected in stock market performances and higher volatility in currency markets.
  - The relatively synchronised global growth momentum could be altered, affecting production activity, consumer and investment spending, with implications for world demand for goods and services, as well as foreign direct investment (FDI).
- Economic growth globally and rising commodity prices, particularly crude oil prices, are being reflected in higher inflationary pressures, most notably in the US. This could prompt an acceleration of monetary policy normalisation. Rising interest rates in advanced economies reduce the relative attractiveness of emerging market (EM) assets, potentially leading to increased capital outflows, which will weaken EM currencies, raise imported inflation and potentially force central banks, including the South African Reserve Bank, to raise policy rates.
- 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, aluminium and copper. Higher investment activity globally, including infrastructure development, is also positive for resource-based and intermediate product exports. However, it should be noted that investment growth is slowing in China due to deleveraging efforts and the changing structure of its economic model.
- Increased volume demand and higher prices for industrial commodities will support the performance of South Africa's resource-based companies, but also improve prospects for other African economies.
- As economic activity improves in several African countries, partly propelled by more favourable conditions in global energy and industrial commodity markets, so will their demand for imports, with positive implications for SA exporters. These will include input requirements associated with infrastructure development and other types of fixed investment activity, higher consumption spending, as well as rising demand for specialised business services.

- However, note should be taken of debt sustainability concerns in Sub-Saharan Africa, as many countries have been experiencing rising public debt levels alongside constrained revenue collection abilities.

Domestically …

- The South African economy is expected to continue posting subdued growth over the remainder of the year, with potentially challenging implications for businesses:
  - Consumer spending has been sturdier than anticipated, partly on the back of debt accumulation, while confidence levels improved significantly. However, households' budgets remain constrained, with the negative impact of higher VAT and fuel prices on disposable incomes, as well as the adverse employment trend aggravating the situation. As such, businesses focusing on the consumer segment of the domestic market are likely to see current challenges in their trading environment persisting for some time.
  - Business confidence declined in Q2 of 2018. The business community remains generally cautious in its investment plans due to several factors, including weak demand conditions, spare production capacity and policy uncertainty locally, as well as worrisome developments globally. Therefore, investment spending is likely to focus more on the maintenance and upgrading of existing production capacity rather than expansions, at least in the shorter term.
  - Business enterprises who rely on the investment cycle as suppliers of goods or services should continue to experience a difficult operating environment for some time. Not only is private sector investment still subdued, but the financially-constrained public sector will be making lower contributions to overall fixed investment activity, as well as containing consumption expenditure.
  - Rising US protectionism has, to date, only directly targeted South Africa's exports of steel and aluminium through higher import tariffs. Businesses involved in these value chains are likely to be affected not only directly (in terms of access to US markets), but also indirectly via increased competition in export markets as well as domestically. Furthermore, the range of producers affected could widen significantly if US protectionism and retaliatory measures by the affected countries escalate.
- It is too early to determine the potential impacts of the rand's recent sharp depreciation due to contagion effects from the Turkish financial crisis. However, should the currency continue trading at significantly weaker than anticipated levels, it will have ramifications for the South African economy. This would include higher inflationary pressures and, should these feed through to producer and consumer prices, potential hikes in interest rates. On the other hand, a weaker rand should support the performance of South African exporters in global markets, but these would have to compete with producers from other emerging markets.
- Government finances are highly constrained as revenue collection is being adversely affected by the economy's poor performance, while the higher than budgeted public service wage increase will place additional pressure on fiscal spending. The budget deficit is thus expected to be worse than that projected in the 2018 Budget. Moody's recently voiced its concern over government's fiscal consolidation efforts.
- The pace and nature of fixed investment activity in the South African economy should improve later in the outlook period. Considering the high import intensity associated with fixed investment activity in South Africa, this should also provide opportunities

for increased import replacement, with potential economies of large scale production possibly elevating their economic merit.

- Efforts to enhance the impact of public sector procurement on the localisation of production, including increased scrutiny of SOE and governmental tenders, are likely to translate into tangible benefits for South African industry and future investment activity.

- Encouraged by positive developments in the political arena, the economic recovery under way, and the promise of greater policy coherence and certainty, global investors may increasingly consider South Africa as an investment destination. However, the somewhat slow pace of reforms witnessed thus far has been affecting business and investor sentiment.

- The business sector at large should focus on reviewing their strategies in terms of investment and production, as well as marketing initiatives, so as to be prepared to take full advantage of business opportunities that will emerge from a progressively improving domestic and regional economic landscape in the years ahead.

Global developments and outlook

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

Concerns have increased over the sustainability of the world economy's growth momentum. Escalating risks in the global trading and financial arenas are threatening to destabilise its performance. These risks were highlighted by the International Monetary Fund (IMF) in its latest World Economic Outlook Update (July 2018), but its forecasts for global output growth were left unchanged at 3.9% for both 2018 and 2019 (see Figure 1). However, the IMF pointed to the unevenness of such growth, for some of the advanced economies seem to have reached their peak in terms of economic expansion.

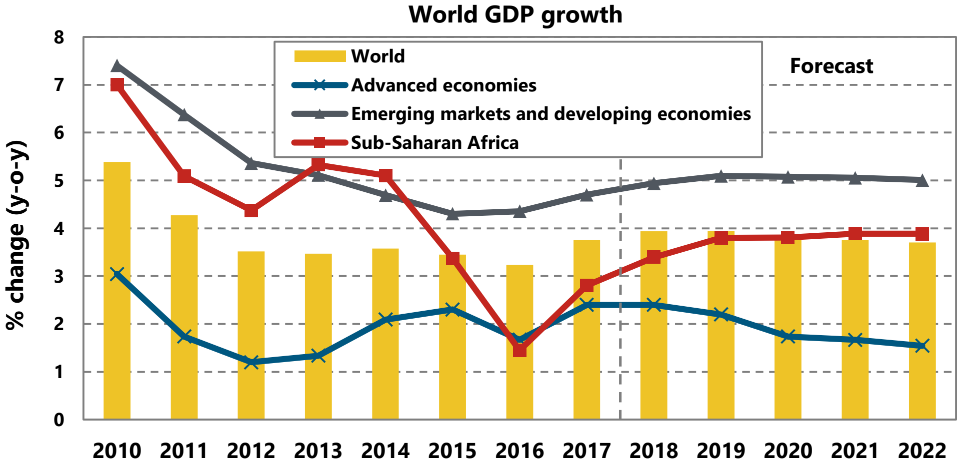
Trade tensions are compromising growth prospects

On the trade front, although the United States (US) and the European Union (EU) returned to the negotiation table to work towards greater trade liberalisation, the relationship between the US and China has become more confrontational. US protectionism and retaliatory measures by affected trading partners will affect trade flows, production activity and investment spending, thus compromising the global economic expansion.

Instability on the rise in world financial markets

In the financial markets, the risks are largely associated with the progressive normalisation of monetary policy in specific advanced economies, for the associated portfolio adjustments could be particularly destabilising for emerging markets (EM) considering the high levels of indebtedness of several economies. The unfolding crisis in Turkey, alongside the contagion effects on other EM currencies, is a manifestation of such risks.

Figure 1: Advanced economies expected to drag world growth downward



Source: IDC, compiled using IMF data

US growth remains robust for the time being, but is set to decelerate

The US economy recorded a robust rate of growth of 4.1% (quarter-on-quarter (q-o-q), seasonally adjusted and annualised rate) in the second quarter of 2018. This was driven by strong household consumption spending, non-residential fixed investment, as well as by government expenditure. However, the outlook for the US economy is being threatened by the potential impact of its own protectionist policies and by the pace of monetary policy normalisation, considering that core inflation has reached the 2% level targeted by the US Federal Reserve (Fed).

The Fed has raised interest rates by 50 basis points thus far in 2018, and two further hikes of 25 basis points each are anticipated over the remainder of the year. The flattening of the US yield curve has raised concerns over the possibility of a recession in the American economy, as an inverted yield curve has been a reliable indicator of recessions in the past. However, both the current and former chairmen of the Fed have pointed to distortions in the US Treasury bond market as being the driver of the yield curve inversion, for economic fundamentals are still considered to be sound.

Growth in the Eurozone lost momentum in Q2 of 2018, coming in at 1.4% (q-o-q, seasonally adjusted and annualised). This weakness was taken into account by the IMF in its full-year projections for economic growth in the regional bloc, which have been lowered to 2.2% in 2018 and 1.9% in 2019, from the previous 2.4% and 2.0%, respectively. Weaker sentiment levels, as reflected in the low Eurozone PMI, are impacting on economic activity, while inflationary pressures are expected to prompt the European Central bank to accelerate the scaling back of its quantitative easing programme.

The outlook for the Eurozone has weakened

The Japanese economy grew by 1.9% (q-o-q, seasonally adjusted and annualised rate) in Q2 of 2018, underscored by higher fixed investment activity and export demand. The Bank of Japan (BoJ) is continuing with its quantitative easing program, keeping interest rates near zero. At 0.7% in June, inflation is still well below the 2% level targeted by the BoJ, but discussions have started on bringing such extraordinary policy accommodation to an end.

Japanese economy posting relatively sturdy growth from an historical perspective

Growth in China rose to 7.2% q-o-q (6.7% year-on-year) in Q2 of 2018, underpinned by higher consumption expenditure. Deleveraging is, however, resulting in reduced infrastructure investment, while manufacturing output growth has weakened. The Chinese economy is projected to expand at softer rates of 6.6% and 6.4% in 2018 and 2019, respectively, due to tighter regulations in the financial sector and weaker export activity.

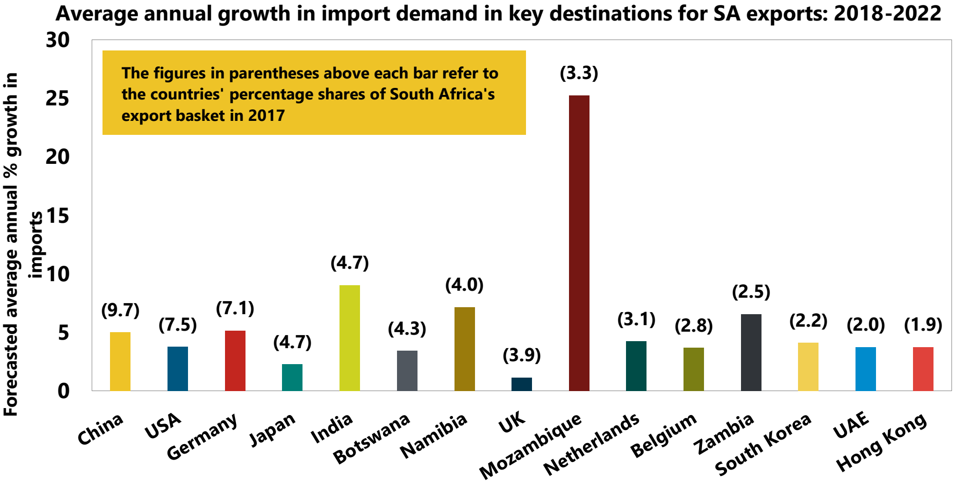
Mixed outlook for the BRICS economies, with both domestic and external factors at play

Although still robust, growth forecasts for India have been lowered as higher oil prices and the faster than anticipated tightening of monetary policy are weakening domestic demand. Continued political uncertainty and social unrest are hampering economic activity in Brazil, with the IMF having lowered its growth forecasts for both 2018 and 2019. In contrast, Russia's growth prospects are improving on the back of higher oil prices, which are offsetting to some extent the adverse impact of sanctions imposed on the country.

Global markets are an important source of demand for open economies such as South Africa's, where total trade represents 58% of GDP. IMF projections indicate that growth in overall import demand globally is expected to accelerate in 2018 to 5.4%, compared to 4.8% in 2017 and 2.3% in 2016. However, this strong pace is unlikely to be maintained throughout the outlook period, with growth slowing steadily towards 3.6% by 2023. Nevertheless, the average annual growth in world import demand over the period is forecast at 4.4%, which exceeds the 3.4% average for the preceding five years.

Import demand to accelerate in 2018, subsequently slowing

Figure 2: Growth in import demand in key global markets for SA exports set to remain strong



Source: IDC, compiled from IMF World

The Eurozone's demand for imports is expected to remain substantially above its economic growth rate, averaging 4.3% over the period 2018 to 2023. It will be underpinned by, among others, sturdy import demand in Germany, which is forecast to increase by 5.1% per year. Stronger commodity prices are expected to support faster growth in Sub-Saharan African economies. The associated investment and consumer activity should prompt increased demand for imports, which are set to rise by 5.9% per year over the outlook period. South Africa's ability to benefit from the anticipated growth in global demand for imports will depend largely on its competitive positioning relative to peer producers striving to increase or sustain their market shares.

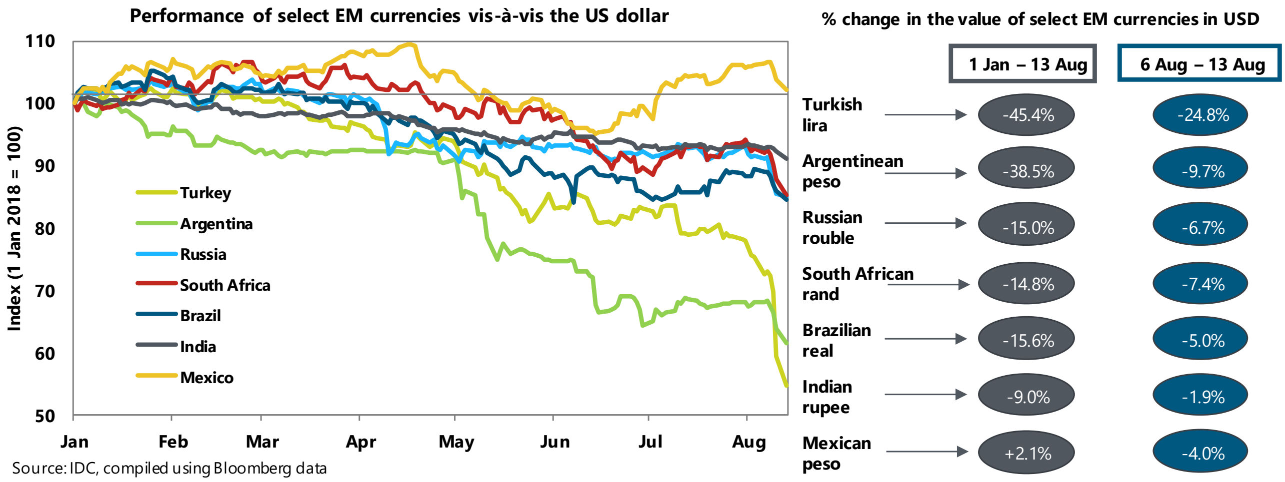
Rebalancing of global financial flows leaves emerging market currencies vulnerable

Some of the risks to IMF forecasts are already manifesting themselves. Uncertainty regarding the pace and scale of monetary policy normalisation in advanced economies, alongside the policy ambiguity that is affecting the global trading and investment environments, are disrupting flows in goods and capital markets. Emerging markets have become especially vulnerable to shifting financial flows, resulting in significant exchange rate movements.

Turkey has borne the brunt of unfavourable investor sentiment in recent times. Unease with Turkish macroeconomic policy, particularly political interference in the decision-making of the monetary authorities with regards to interest rates, alongside a widening deficit on the current account of the balance of payments and the high level of foreign currency debt incurred by the private sector (estimated at around USD242.5 billion), have impacted negatively on investor appetite for Turkish assets. The resulting capital outflows put the lira into freefall, with the US government's doubling of tariffs on Turkish steel and aluminium imports exacerbating the downward trend. The Turkish lira lost almost 25% of its value in US terms from the 6th to the 13th of August, taking its depreciation against the greenback to over 45% for the year to-date.

Contagion fears have come to the fore. Several other emerging market currencies tumbled, as shown in Figure 3, particularly those of countries with weaker macroeconomic fundamentals, among other vulnerabilities. The currencies of three BRICS member states – namely the Russian rouble, the South African rand and the Brazilian real - were amongst the worst performers. Should emerging market currency weakness persist, upward pressure on inflation will intensify. In response, the monetary policy authorities in the affected countries may be forced to raise interest rates, impacting negatively on growth prospects. Such developments would also compromise their contribution to global growth.

Figure 3: Emerging market currencies under pressure from shifting global flows



Source: IDC, compiled using Bloomberg data

The euro was also adversely affected due to concerns over the exposure of European banks to Turkish debt. These include Spain's BBVA (13% of its loans), Italy's UniCredit (4%), the Netherlands' ING (2%) and France's BNP Paribas (2%). Highly exposed banks could suffer considerable losses should their Turkish customers be unable to repay their debts, aggravating the fragility of the Eurozone's financial sector.

Recent developments in and prospects for Sub-Saharan Africa

Economic growth in SSA expected to improve in 2018 and 2019, but likely to remain below the long-term average

Following a relatively weak economic performance in 2017, when regional GDP expanded by only 2.8%, Sub-Saharan Africa is expected to post higher rates of growth in 2018 and 2019, at 3.4% and 3.8% respectively, on the back of firmer commodity prices, stronger domestic demand and improving agricultural conditions.

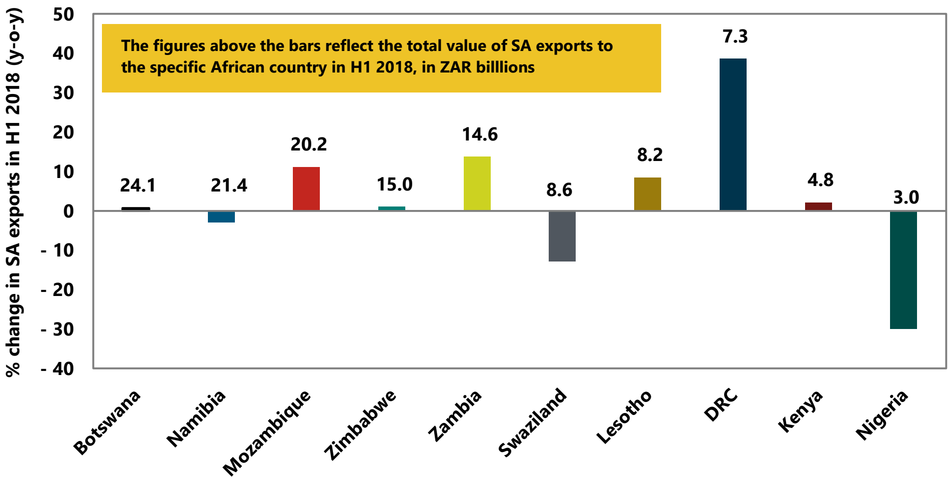
Tentative recoveries are under way in the region's two largest economies, Nigeria and South Africa. Growth in Nigeria is forecast to improve to modest rates of 2.1% and 2.3% in 2018 and 2019, respectively, largely driven by positive developments in global oil markets. This compares to 0.8% growth in 2017. Furthermore, robust performances are being recorded in non-resource-intensive economies such as those of Ethiopia, Rwanda, Côte d'Ivoire and Kenya, on the back of solid domestic demand.

However, rising headwinds in the global economy, coupled with increasing concerns over the fiscal and debt sustainability of some African countries, are likely to limit the Sub-Saharan African region's economic growth to below 4% over the medium-term.

South Africa's exports to SSA in the 1st half of 2018 were lower in real terms on a year-on-year basis

South Africa's exports to the rest of the African continent totaled R152 billion in the first semester of 2018, representing an increase of only 2.5% in nominal terms on the R148 billion reported for the corresponding period a year earlier.

Figure 4: South Africa's exports to its 10 largest African export markets in the 1st half of 2018



Source: IDC, compiled from SARS data

On the political front, Zimbabwean President Emmerson Mnagwagwa of the ruling ZANU-PF had a narrow victory over the Movement for Democratic Change Alliance's Nelson Chamisa in the recent elections. The opposition party is challenging the results in court over alleged fraud, a move that saw the cancellation of the presidential inauguration. A degree of political uncertainty prevails in the country pending the court judgement. However, the chances of a different outcome may be slim, implying that political risk in Zimbabwe is likely to remain elevated, affecting investor appetite.

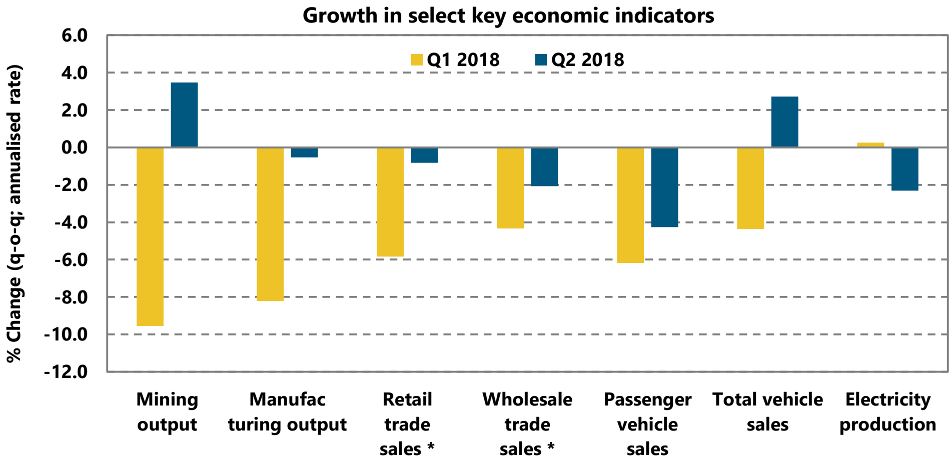
In the Democratic Republic of the Congo (DRC), after two years of speculation, President Joseph Kabila announced that he will not run for a third term as head of state. Instead, Emmanuel Ramazani Shadary was named as the candidate for the ruling party, Common Front for Congo. Shadary is a favourite to win the presidential election unless the opposition unites behind one candidate, which may prove practically difficult. Kabila's decision is viewed positively in the shorter term, as it reduces the risk of an escalation in civil unrest, while potentially improving relations with international donors. The DRC's prospects as an investment destination will, however, ultimately depend on a peaceful and fair election.

Recent developments in the South African economy

South Africa's economic growth estimated to have basically ground to a halt in the first semester of 2018

The South African economy is likely to have recorded, at best, marginal growth in the second quarter of 2018, judging from data released for specific indicators (refer to Figure 5). Challenging operating and trading conditions continued to take a toll on key sectors of the economy, while household spending may have lost some momentum. Business confidence retreated in the three months to June and consumer confidence came in at a slightly lower level, after having reached an all-time high in Q1 of 2018.

Figure 5: Difficult conditions persist, affecting production and consumption spending



Note: * refers to April and May 2018 only.

Source: IDC, compiled using SARB and Stats SA data

Mining output recovered in the second quarter, largely due to higher PGM production

Mining output rebounded by 3.5% in Q2 of 2018 (q-o-q, seasonally adjusted and annualised growth), mainly due to a sharp 57.7% increase in the output of the platinum group metals (PGM) sub-sector, following a steep decline in the previous quarter. The mining of nickel, copper and diamonds also recorded higher production volumes relative to the preceding quarter. However, all of the other mining sub-sectors reported lower output on a quarter-on-quarter basis, pointing to continued operational challenges and weak demand.

Manufacturing business confidence has been at low levels for a prolonged period of time

Lower confidence levels amongst manufacturers in Q2 of 2018 attest to unsatisfactory business conditions. The outlook for the next 12 months has also worsened, with manufacturers indicating weak demand, especially on the domestic front, as a key constraining factor for their production activity. Lower expectations regarding export sales are perhaps a reflection of concerns over intensifying tensions in the global trading arena.

Household purchasing power being eroded, affecting spending activity

The difficult consumer environment continues being reflected in declining retail trade and new passenger vehicle sales. Demand for new credit remains fairly muted, while the cost of living is on the rise, affected by the higher VAT rate and fuel-related price increases. This is eroding the discretionary purchasing power of households, with yet high levels of debt still preventing consumers from increasing consumption spending in a meaningful manner.

Weak export performance in real terms in the first semester of 2018

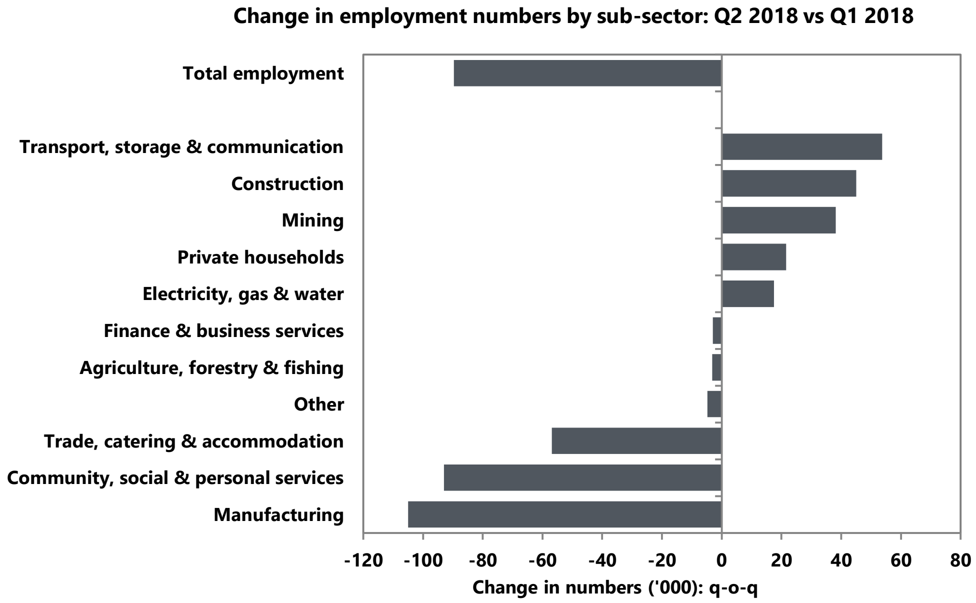
Despite generally improving conditions in global markets, South Africa's merchandise exports recorded year-on-year growth of only 1.5% in nominal value terms in the first half of 2018, with currency volatility affecting their performance. The export sector is also apprehensive due to increasing protectionism in world trade. South African exporters of steel and aluminium products are already facing import tariffs of 25% and 10%, respectively, in the US market. These trade barriers are not only limiting their direct export potential, but also affecting their performance in other export markets as well as domestically due to trade diversion effects.

The trade policy moves of the US government, alongside retaliatory measures by affected countries/regional blocs (particularly China and the EU), have the potential to affect the performance of several South African industries negatively or positively, directly and/or indirectly.

On the employment front, the economy shed 90 000 jobs, on a quarter-on-quarter basis, in the second quarter of 2018 (refer to Figure 6). The sharply lower employment level reported by the manufacturing sector mirrored its poor production outcomes. The sector employed almost 370 000 fewer people in Q2 of 2018 than at the start of 2008. The steep quarterly decline in community, social and personal services employment could be largely attributed to the high base set by voter registration efforts in the preceding quarter. The mining sector reported employment gains, but this may be partly reversed in the near-term in light of looming retrenchments, especially in the platinum mining sector.

90 000 jobs lost in the second quarter of 2018, largely due to sharply lower manufacturing employment

Figure 6: Employment losses as growth momentum falters



Source: IDC, compiled using Stats SA data

The unemployment rate rose to 27.2%, from 26.7% in Q1 of 2018. Out of a total population of working age (i.e. 15 to 64 years) amounting to 37.8 million, close to 16.3 million were employed in Q2 of 2018, 6.1 million were unemployed but actively seeking employment, almost 2.9 million were discouraged work-seekers (i.e. no longer actively seeking employment) and approximately 12.6 million people were not economically active (e.g. full-time students, homemakers and retirees who do not wish to work). With South Africa's overall population estimated at just over 57.7 million, this implies that, on average, every employed person in the country supports 3.54 people, making it imperative that economic activity be stimulated and that labour-absorbing investment be catalysed.

Following the latest Cabinet lekgotla, government announced a stimulus package that is expected to total R43 billion. It will encompass increased investment in public infrastructure, development finance support, higher localisation outcomes associated with public sector procurement, support for entrepreneurial and SME development, training for unemployed youth and, among others, trade support measures for specific sectors. Considering fiscal constraints, the stimulus package will be based on existing budgetary allocations as government remains committed to fiscal prudence.

A R43 billion stimulus package to boost economic growth and create jobs

Outlook for the South African economy

Economic growth projections for 2018 and 2019 revised downwards

Growth projections for the South African economy have been revised downwards to 1.3% in 2018 (1.7% previously) and 2.0% in 2019 (from 2.3%). These adjustments were deemed necessary in light of worse than anticipated GDP data for the opening quarter of 2018, a relatively weak economic environment in the second quarter and expectations of persistently challenging conditions at least in the shorter term.

Table 1: Key performance indicators for the South African economy

Variable (% change or % of GDP)	2013	2014	2015	2016	2017	2018f	2019f	2020f	2021f	2022f
Real GDP growth and its components:										
Household consumption expenditure	2.0	0.8	1.8	0.7	2.2	1.9	2.2	2.1	3.4	3.5
Government consumption expenditure	3.1	1.7	-0.3	1.9	0.6	0.8	1.0	1.4	1.8	1.8
Gross fixed capital formation (GFCF)	7.2	0.7	3.4	-4.1	0.4	1.2	3.2	3.8	5.7	5.4
Exports	4.0	3.6	2.8	1.0	-0.1	0.6	3.2	2.8	3.4	3.4
Imports	5.0	-0.6	5.4	-3.8	1.9	2.6	3.5	3.5	4.5	5.1
GDP growth (% change)	**2.5**	**1.8**	**1.3**	**0.6**	**1.3**	**1.3**	**2.0**	**2.2**	**3.1**	**3.0**
Consumer price inflation	5.8	6.1	4.6	6.3	5.3	4.8	5.9	5.8	5.1	4.5
Current account balance (% of GDP)	-5.8	-5.1	-4.6	-2.8	-2.5	-3.0	-3.6	-4.2	-4.8	-5.3
GFCF as % of GDP	20.4	20.4	20.4	19.5	18.7	18.1	17.9	17.9	18.3	18.8

Source: IDC, compiled using SARB historical data, IDC forecasts

Although still constrained, consumer spending is expected to remain the main driver of economic activity over the outlook period. In the shorter-term, however, the ability of households to increase consumption expenditure will be limited by relatively high levels of indebtedness (albeit on a declining trend), rising inflation, as well as unfavourable developments on the employment front.

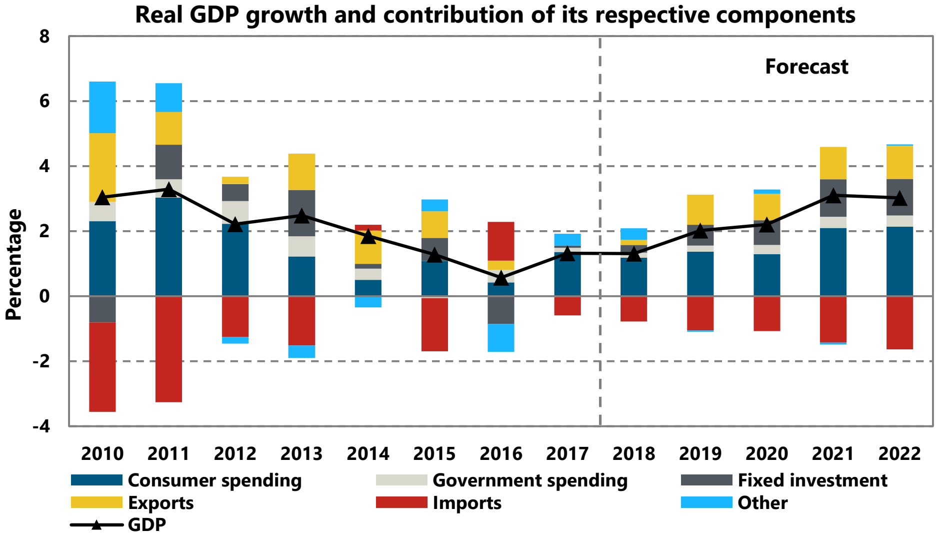
South Africa's attractiveness as an investment destination, both for local and foreign investors, is expected to improve over the outlook period, but policy certainty and consistency will be prerequisites. Constrained public finances underpin expectations of relatively lower contributions by government and state-owned enterprises to overall fixed investment activity. However, private sector investment is expected to recover gradually, as demand conditions improve and utilisation of production capacity increases across sectors.

Nevertheless, the ratio of fixed investment to GDP will, throughout the forecast period, remain significantly below the 30% mark targeted by the National Development Plan so as to alter substantially the economy's growth trajectory and make significant dents on unemployment.

The constrained fiscal space is likely to continue limiting government consumption expenditure. Although revenue collection by government appears to be somewhat on track to meet budgeted targets, expenditure is set to overshoot, with the higher than budgeted public service wage agreement as a key contributing factor.

Exports are also expected to contribute to the projected rise in overall economic growth, especially in the outer years of the forecast period. Stronger global demand, in the absence of further adverse developments in the global trading arena, could benefit the domestic export sector. Although export growth is expected to accelerate, it is likely to fall short of import growth. The economy continues to rely heavily on capital equipment imports for its fixed investment activity. As such, the investment momentum anticipated over the outlook period will impact on import demand. Consequently, the deficit on the current account of the balance of payments is projected to widen through the forecast period.

Figure 7: Household spending, fixed investment and exports are expected to make increasingly higher contributions to overall GDP growth over the outlook period



Source: IDC, compiled using SARB data; IDC forecasts

The risks to South Africa's growth outlook are to the downside, with factors such as weak business sentiment, policy uncertainty, inflationary pressures, protectionist tendencies in global trade and emerging market risks potentially altering the outcomes significantly.

The financial crisis currently unfolding in Turkey is a case in point. Recent adverse developments in the Turkish economy, as highlighted earlier in this report, have had negative repercussions for other emerging markets, including South Africa. The rand lost 7.4% of its value in US dollar terms from the 6th to the 13th of August, taking its depreciation over the year to date to 14.8%. These developments put further pressure on bond yields, raising the cost of government debt.

Risk aversion towards emerging markets on the back of developments in Turkey played a major role in this regard, but concerns over domestic economic factors also contributed, for the rand was amongst the worst performing emerging market currencies. These factors include the poor growth performance of the South African economy, the relatively large deficits on the current account of its balance of payments and government balance, challenges regarding fiscal consolidation and debt sustainability efforts, as well as policy-related concerns, particularly with regard to land expropriation without compensation.

Considering the extraordinary volatility in currency markets, it is too early to make a call on the rand's near-term trajectory at this point in time. However, the extent of the sell-off has not been justified by economic fundamentals and, as such, the rand is expected to recover lost ground.

Department of Research and Information

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