Economic overview:
Recent developments in the South African economy

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Department of Research and Information
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Economic overview

Highlights

- At the outset of his State of the Nation Address on June 20, 2019, President Cyril Ramaphosa stated: “Our economy is not growing. Not enough jobs are being created. This is the concern that rises above all others. It affects everyone.”

- The weakness of the South African economy in the opening quarter of the year was much worse than anticipated. The sharp 3.2% contraction in real GDP, on a quarter-on-quarter (q-o-q), seasonally adjusted and annualised (saar) basis, was the worst quarterly performance since the 2009 recession.

- Almost all broad economic sectors recorded negative growth, particularly agriculture (-13.2%), mining (-10.8%) and manufacturing (-8.8%). This was underpinned by weak demand conditions domestically and a sharply lower export performance. Load-shedding by Eskom later in the 1st quarter of 2019 impacted on production activity in many sectors, affecting their export performance to some extent.

- Household consumption fell by 0.8% as domestic households continued struggling with relatively high levels of indebtedness and debt-servicing costs, while disposable incomes rose only marginally in real terms and labour market conditions remained feeble. These factors are affecting the ability and willingness of households to spend.

- Fixed investment activity weakened in a difficult operating and trading environment. Subdued demand and the associated spare production capacity in many industries, alongside low business confidence and a cautious stance ahead of the national elections, underscored the 9.8% drop in capital outlays by the private sector in real terms. Overall fixed investment was 4.5% lower in the 1st quarter of 2019.

- South Africa’s open economy is highly reliant on economic developments globally. After having made a positive contribution to economic growth in 2018, exports tumbled by 26.4% (q-o-q, saar) in the 1st quarter of 2019 - the largest contributor to the dismal GDP growth performance. The escalation of trade tensions between the US and some of its major trading partners continues to rattle the multilateral trade order and, through extensive transmission effects, is reinforcing the world economy’s slowing momentum. The World Trade Organisation expects growth in the volume of merchandise trade globally to slow to 2.6% in 2019, from 3% last year.

- A more growth-supportive monetary policy stance is likely in this difficult economic climate, for inflation appears to be well anchored around the mid-point of the Reserve Bank’s target band. The Monetary Policy Committee may thus cut the repo rate by 25 basis points in the 3rd quarter of the year. President Ramaphosa has unequivocally confirmed the central bank’s constitutional mandate and independence.

- Fiscal limitations will be a constraining factor for general government, leaving it with very limited room to raise expenditure to provide some stimulus to a fragile economy. However, the impact of public sector spending on the economy can be significantly enhanced through a more effective roll-out of its localisation strategies.

- Arresting and ultimately reversing the long-term decline in the economy’s growth potential and the rising trend in government debt are deemed crucial by the credit rating agencies. They are also highly concerned with the enormous burden that financially-constrained state-owned companies, especially Eskom and South African Airways, are placing on the fiscus.

- In the SONA, the President asserted government’s commitment to a confidence- and investment-boosting macroeconomic and fiscal policy framework, underpinned by “prudent borrowing and stringent expenditure management to stabilise our public...
finances and lower the debt trajectory”. In the currently difficult environment, steps are indeed being taken to restore confidence in South Africa’s future, for its economy and people present enormous potential, but time is of the essence.

Implications for South African businesses

- The operating environment is likely to remain challenging for longer than previously anticipated. Business enterprises whose activities are largely focused on the domestic consumer market, particularly those operating in the durable and semi-durable goods segments, are anticipated to continue facing difficult trading conditions over the remainder of 2019. A gradual recovery should ensue in subsequent years.

- Slower world growth and the disruptive effects of increased protectionism on global trade flows and investment activity may impact adversely on the performance of several export-oriented business enterprises. However, export market development opportunities may also emerge due to trade diversion effects. Industrial commodity markets may be adversely affected by the slowing pace of expansion of the Chinese economy, with implications for volume demand and prices.

- A potential reduction in interest rates as the South African Reserve Bank adopts a more accommodative monetary policy stance should partly alleviate the hardship faced by financially-constrained businesses and households. However, in the current environment such a move is unlikely to stimulate investment activity or household spending to a significant extent, at least in the short-term.

- Although limited financial resources will constrain public sector spending, both of a capital and operational nature, the emphasis on localisation may mitigate the negative impact to a considerable extent. Companies whose activities are closely aligned to the investment cycle, or which could benefit from a more effective application of product designations in public sector procurement, should stand ready to tap into the associated business opportunities.

- In his State of the Nation Address, President Cyril Ramaphosa highlighted:
  - The implementation of master plans developed by government in conjunction with business and labour in industries such as clothing and textiles, chemicals and plastics, gas, renewables, steel and metals fabrication;
  - Support for key agricultural and agro-processing value chains, including new market development and the pursuit of import replacement opportunities;
  - Mining sector development through targeted minerals beneficiation, the lowering of input costs and increased research and development;
  - The imminent commencement of the spectrum licensing process, which will open-up opportunities for business in the sector; and, among others,
  - Spatial interventions such as the development of special economic zones, the revitalisation of local industrial parks and the establishment of digital hubs.

- Business confidence in the South African economy should gradually improve as the year unfolds, resulting in a relatively more conducive investment and business environment.
Economic overview

Introduction

Hopes of a relatively strong rebound in South Africa’s economic performance have been dealt serious blows.

The economy’s weakness is much worse than anticipated, as reflected by the shocking 3.2% drop in its gross domestic product in real terms in the first quarter of 2019 (on a quarter-on-quarter, seasonally adjusted and annualised (saar) basis). This was the worst quarterly contraction since the 2009 recession. Demand conditions worsened, as evidenced by the decline in household consumption and fixed investment spending, while exports fell sharply.

Lower output levels were recorded by most broad sectors, specifically agriculture, mining, manufacturing, electricity, transport and communication, trade and accommodation, as well as construction. The resulting job losses took the unemployment rate up to 27.6%.

Figure 1: SA economy’s contraction in Q1 2019 was the worst since the 2009 recession

In his State of the Nation Address (SONA) on June 20, 2019, President Cyril Ramaphosa pointed to the adverse impact of load shedding by Eskom on the economy’s performance in the first quarter. Operational and financial challenges at the power utility are posing major risks to the economy at large, with electricity supply interruptions having not only affected activity levels in resources, industrial and services sectors, but also sentiment amongst businesses, investors and consumers. As part of a wider effort to address Eskom’s financial predicament, the President announced in the SONA that part of the R230 billion in fiscal support planned for the power utility over a 10-year period would be brought forward.

Confidence has been at low levels for an extended period, and the much-anticipated rebound premised on expectations of swift and effective structural reforms in a growth-supportive politico-economic landscape post-elections has not yet materialised. Recent damaging populist utterances regarding the Reserve Bank prompted President Ramaphosa to reaffirm its mandate and independence.

Externally, adverse developments are affecting the world economy’s performance and clouding its growth prospects. Trade tensions have escalated between the United States and China, with little sign of an agreement in the near-term. The Trump administration appears resolute to use import tariffs not only as a trade policy instrument but also as part of a broader arsenal of tools, including economic and enterprise-specific sanctions, in pursuit of foreign policy and domestic objectives, such as immigration control. Through spill-over effects, these developments are disrupting trade and investment flows around the globe.

With inflation largely in check and concerned with the possibility of significant economic slowdown, the US Federal Reserve appears increasingly inclined toward cutting interest rates in the near future, affecting financial, currency and commodity markets in the process.
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Weak domestic demand amidst a crisis of confidence

**Struggling households holding back on spending**

Household consumption is the single largest contributor to economic activity in South Africa from the expenditure side. As such, the financial health of households and confidence in their prospects are of critical importance.

The 0.8% quarter-on-quarter drop in household consumption spending in the first quarter of 2019 contributed -0.5% to the 3.2% contraction in overall GDP (refer to Figure A1 in the Annexure). The weakness in consumer spending is rooted in various factors such as real disposable income levels, existing household debt and the cost of servicing such debt, access to further credit, as well as employment prospects, all of which influence the ability and willingness of households to spend.

Household disposable income increased by 0.6% in real terms in 2018, providing limited scope for increased spending. Household debt levels remain high, representing 72.7% of disposable income in the final quarter of 2018. The affordability of such debt is reflected in debt servicing costs, that is the interest payments made by households on their outstanding debt. At 9.3%, the debt servicing cost of households is significantly above the long-term average of 7.7%, hence their reluctance to incur additional debt. Slow-rising disposable income, high indebtedness and debt-servicing costs indicate that households do not have much room to increase their spending activity, at least in the near- to short-term.

Labour market conditions are also a key determinant of the propensity of households to spend. Employment prospects deteriorated further in the first quarter of the year, as the economy shed 237 000 jobs. The unemployment rate shot up to 27.6% and the total number of unemployed people rose to 6.2 million, from 6 million a year earlier. Prospects for a meaningful recovery in job creation remain poor, considering the challenging environment facing both the private and public sectors.

Consumer confidence, which had been weak since the start of 2012, eventually re-entered positive territory at the start of 2018. The spike recorded in the first quarter of 2018 was associated with the so-called “Ramaphoria”, but the optimism proved fleeting as consumer sentiment declined over the remainder of the year as well as in the first quarter of 2019. The second quarter, however, witnessed a slight improvement in consumer confidence, which was partly confirmed by the 3.2% month-on-month rebound in real retail sales in April 2019.

*Figure 2: South African households are exhibiting considerable restraint*

![Graph showing consumer confidence and household consumption expenditure](Image)

Source: IDC, compiled using SARB, BER data
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**Sharp fall in private sector fixed investment**

Fixed investment by private business enterprises fell sharply (-9.8% q-o-q, saar) in the first quarter of 2019. The difficult operating and trading environment, where weak demand has resulted in spare production capacity across many industries, alongside the weak outlook for the South African economy, were among the key determinants of such an outcome. A cautious investor stance was also evident ahead of the national elections.

The manufacturing sector has witnessed a steady decline in fixed investment activity over the years, with the quantum of capital spending in 2018 being almost 10% lower in real terms than the peak recorded in 2011. Several manufacturing sub-sectors are operating well below production capacity largely due to insufficient demand (particularly in the domestic market), while strong competition from foreign producers both in local and export markets, rising operational costs (electricity, input materials, logistics), shortages of key skills, infrastructure-related challenges (particularly intermittent electricity supply outages, transport and logistics constraints) and uncertain prospects are aggravating their plight. The investment outlook remains unsatisfactory, as manufacturers expect difficult business conditions to prevail for the remainder of the year.

Where the mining sector is concerned, fixed investment spending rebounded strongly over the past two years, but this was from a very low base. Furthermore, bearing in mind the relatively uncertain outlook for key commodity markets, investment activity may remain subdued in specific mining segments for some time.

**Figure 3: Private business enterprises holding back on capital investment**

Considering the strong correlation between fixed investment activity and business confidence (refer to Figure 4), low sentiment levels at present do not bode well for a swift recovery in capital spending. The overall RMB/BER Business Confidence Index measured 28 points in the second quarter of 2019, unchanged from the previous quarter, basically indicating that more than 70% of respondents to the respective surveys remain unsatisfied with current business conditions.

Sentiment levels fell further in the manufacturing and motor trade sectors, primarily due to insufficient demand and continued declines in domestic sales, which are forcing business enterprises to absorb higher costs of production due to an inability to pass them on to consumers. Concerns over the political landscape have also been contributing to weak confidence amongst business enterprises. Nominal year-on-year growth in bank credit...
extended to corporates declined from around 16% in May 2015 to 6.1% by March 2019, partly pointing to a reluctance by business enterprises to incur debt for investment purposes.

**Figure 4: Low business confidence affecting investment decisions**

The import penetration rate (i.e. merchandise imports as a ratio of gross domestic expenditure or domestic demand) reached an all-time high of 27.5% in the third quarter of 2018, but subsequently fell slightly to 26.8% by year-end. This reflects to some extent the increasing competition between foreign and local producers for a share of the domestic market.

However, it should be noted that South Africa remains highly reliant on a range of imported products, particularly crude oil, refined petroleum and related products; machinery and equipment; and, among others, parts and accessories for motor vehicles. In the opening quarter of 2019, imports of goods and services declined by 4.8% in real terms (quarter-on-quarter, saar), following a 3.3% rise in 2018.

The relatively smaller share of capital goods in South Africa's import basket, as shown in Figure 5, partly reflects reduced domestic spending on machinery and equipment.

**Figure 5: Capital goods claiming a smaller share of SA’s import basket**
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Export performance below potential

Against the backdrop of persistently subdued demand conditions domestically, external markets have provided some cushion for South African producers in recent years. With a relatively open economy, the country has relied on exports to sustain production activity and employment levels across many sectors. In 2018, exports of goods and services accounted for 30% of GDP, contributing 0.8 percentage points to overall economic growth.

Several sectors of the economy have relatively high export propensities, implying a heavy reliance on foreign markets for their performance. Besides the externally-oriented mining sub-sectors, in recent years exports have accounted for close to 50% or more of total output in sectors such as motor vehicles, parts and accessories; machinery and equipment; non-ferrous metal products; as well as television, radio and other communication equipment.

A dismal export performance in the opening quarter of 2019

However, the first quarter of 2019 witnessed a massive 26.4% decline in exports (quarter-on-quarter, saar) in real terms. Both domestic and external factors underpinned this dismal export performance, which was the single largest detractor to national GDP during this period, subtracting a massive 9 percentage points from overall economic growth (refer to Figure A1 in the Annexure).

In nominal rand terms, South Africa’s exports declined by 14.2% (q-o-q) in the opening quarter of the year. Exports of motor vehicles, parts and accessories fell by 20%, contributing 3 percentage points to the overall drop in exports. Other sectors that contributed significantly to the weaker export performance in the first quarter of the year included the mining of platinum group metals (-29.7% quarter-on-quarter); coal mining (-23.6%); machinery and equipment (-22.4%); and paper and paper products (-56%).

Stage 4 load-shedding by Eskom towards the latter part of the first quarter of 2019 impacted on production activity in many sectors, affecting their export performance to some extent. The mining sector reduced its inventory holdings during this period, mitigating some of the production losses due to electricity outages.

South Africa’s export sector underperforming in global terms

South Africa’s export sector has underperformed relative to its emerging market peers as well as advanced economies. The volume of world export trade increased, on average, by 4.2% per year over the period 2010 to 2017, exceeding the 2.8% average annual growth in South African exports over the same period.

Figure 6: South Africa’s sub-par export performance from a global perspective

Source: IDC, compiled using data from the Netherlands Bureau for Economic Analysis and Statistics South Africa
This sub-optimal performance is indicative of the fierce competition faced by South African producers in global markets, calling for concerted efforts by the domestic private and public sectors to enhance the competitiveness of export products in terms of price, quality and/or service delivery. The infrastructure-related constraints that are hindering export performance must be addressed, and external markets should be developed further through effective marketing campaigns and by taking full advantage of preferential access arrangements.

**Developments in global markets bringing forth considerable downside risks**

The escalation of trade tensions between the US and some of its major trading partners is raising uncertainty in the global trading arena to levels not seen in many decades. US protectionism continues to rattle the multilateral trade order and, through extensive transmission effects, is reinforcing the world economy’s slowing momentum. Growth in the volume of global trade weakened to 2.8% over the year to the end of the first quarter of 2019, and the prevailing uncertainty is elevating downside risks.

South Africa’s export sector is highly reliant on the economic performance and associated import demand of the world’s two largest individual economies, the US and China, and, from a regional standpoint, on prospects for the European Union and the African continent. Collectively, these external markets accounted for 68% of South Africa’s overall merchandise export basket over the period January to April 2019.

**Table 1: Best and worst performing SA export sectors: % change in the nominal rand value of exports (January–April 2019 compared to equivalent period in 2018)**

<table>
<thead>
<tr>
<th>Best performing SA export sectors</th>
<th>Worst performing SA export sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iron ore mining</td>
<td>Paper &amp; paper products</td>
</tr>
<tr>
<td>+49.9%</td>
<td>-44.7%</td>
</tr>
<tr>
<td>Other transport equipment</td>
<td>Gold &amp; uranium mining</td>
</tr>
<tr>
<td>+39.5%</td>
<td>-28.9%</td>
</tr>
<tr>
<td>Motor vehicles, parts &amp; accessories</td>
<td>Leather &amp; leather products</td>
</tr>
<tr>
<td>+32.2%</td>
<td>-13.5%</td>
</tr>
<tr>
<td>Coke &amp; refined petroleum products</td>
<td>Metal products (excl. machinery)</td>
</tr>
<tr>
<td>+31.6%</td>
<td>-13.0%</td>
</tr>
<tr>
<td>Furniture</td>
<td>Glass &amp; glass products</td>
</tr>
<tr>
<td>+22.2%</td>
<td>-5.6%</td>
</tr>
</tbody>
</table>

Source: IDC, compiled using SARS data

The trade war between the US and China is not showing signs of abating. Furthermore, recent US threats to impose import tariffs on Mexico if its efforts to stem the flow of migrants are not intensified, demonstrated a willingness to utilise trade barriers to achieve non-trade outcomes. Early in June, India lost its preferential access to the US market due to the Trump administration’s frustration with New Delhi’s own protectionist policies.

The G20 summit, which will be held in Japan towards the end of June, shall provide opportunities for both bilateral and multilateral discussions on trade matters, although the probability of significant progress being made does not appear high.

The adverse effects of the trade war on the China’s economy are becoming increasingly discernible. The Chinese authorities continue providing stimulus measures to maintain the pace of economic growth above 6%. Key indicators such as industrial output and retail sales have recorded muted rates of increase in recent months. The manufacturing purchasing managers’ index (PMI) fell below the crucial 50-point level in May to 49.4, due largely to lower export orders.

Fiscal policy efforts to sustain the economy’s expansion momentum have focused on infrastructure development, while China’s central bank can still play a more accommodative role. However, corporate confidence is being increasingly dented by the trade spat, countering the impact of policy support measures to a significant extent. Such measures also raise debt sustainability risks. The longer the trade talks with the US stall, the higher the downside risks to China’s growth outlook.
In the US, growth in private sector investment slowed to 2.3% (annualised rate) in the first quarter of 2019, from an average of 7% last year, and business confidence is being clearly affected by the lingering uncertainty around trade policy. The latest employment data reported that 75 000 jobs were created in May, significantly below market expectations and possibly confirming a slowing trend in economic activity. The latest National Association for Business Economic Outlook Survey reported expectations of US growth decelerating throughout 2019 and 2020, with the risk of a recession increasing from 15% in 2019 to 35% in 2020. The US Federal Reserve also foresees a slowing US economy, but it does not expect recessionary conditions to emerge. Having expressed concern over the potential impact of trade tensions, the Fed stands ready to pre-emptively ease policy rates if so needed.

The European Union economy posted a fragile recovery earlier in the year, but risks abound and growth is expected to moderate, even from the current low levels. The regional bloc is feeling the impact of the US-China trade war, as both countries are important destinations for EU exports of goods and services. Furthermore, the EU still faces the threat of US tariffs on its auto exports. Uncertainty over the eventual form of Brexit continues to weigh on consumer and business sentiment. In light of the weaker economic outlook for the Eurozone, the European Central Bank indicated that interest rates will remain unchanged until at least the first half of 2020, while it could consider reactivating its quantitative easing programme. The impact, however, would likely be limited.

Slower than projected growth in Africa would adversely affect South Africa’s export performance. The continent is a key external market, having accounted for a total of R330.5 billion or 26.5% of South Africa’s total merchandise exports in 2018. Manufactured exports represented 84.8% of the country’s export basket destined for other African markets collectively in 2018. Amongst the manufactured exports to the rest of the continent, machinery and equipment claimed the largest share at 12.6% of the total export basket, followed by processed food (9.6%) and motor vehicles, parts and accessories (8.1%). Over the first four months of 2019, the total nominal value of exports to other African markets increased by 8.3% on a year-on-year basis, the lowest of the abovementioned regional and individual country markets.

**Figure 7: South Africa’s exports to other African economies and the top 5 regional destinations**

Although regional growth has been improving gradually, the anticipated recovery may fall short of expectations in light of the unfavourable developments unfolding in the world economy, particularly those affecting trade flows, foreign direct investment (FDI) activity and the performance of commodity markets. The International Monetary Fund (IMF) estimates
that economic growth in Sub-Saharan Africa could be reduced by 2 percentage points in 2019 and by 1.5 percentage points in 2020 as a result.

A sustained period of relatively low crude prices would not only affect prospects for Africa’s oil exporters, but also other resource-reliant economies through the potentially adverse spill-over effects on industrial commodity prices. Increased trade, investment and financial linkages between China and African economies over the past couple of decades indicate that weaker growth in China is expected to impact negatively on the region’s performance. Metals’ exporters are likely to be the most affected by a slowdown in China.

**Figure 8: Commodity markets affected by unfavourable developments globally**

![Commodity price trends](https://idc-commodities.com/images/commodity-price-trends.png)

Source: IDC, compiled using IMF data

The United Nations Conference on Trade and Development (UNCTAD) recently reported that FDI flows into the African continent increased by 11% in 2018 to USD46 billion, after having declined in 2016 and 2017. This recovery contrasted with the 13% drop in FDI flows globally, to USD1.3 trillion last year. Resource-seeking investments largely underscored the improved outcome for the Africa region, but economies such as Kenya, Morocco and Tunisia also attracted diversified investment activity.

FDI into South Africa more than doubled to USD5.3 billion in 2018 (2017: USD2 billion), on the back of intra-company loans and significant equity inflows. Substantial investments were made in the automotive industry (such as the investment of China’s Beijing Automotive Industry Holding, alongside the IDC, in the Coega IDZ, and expansions of the facilities operated by Germany’s BMW and Japan’s Nissan) as well as in the renewable energy sector (for example, Ireland’s Mainstream Renewable Energy started the roll-out of its 110 MW wind farm). Nonetheless, South Africa ranked only 7th in Africa as a recipient of FDI in 2018.

UNCTAD anticipates higher FDI flows into Africa in 2019, lured by faster economic growth, progress towards the implementation of the African Continental Free Trade Area (AfCFTA) and the potential commissioning of some of the larger greenfield investments announced last year.

World trade will continue to face strong headwinds in 2019 and 2020 due to prevailing tensions in the global marketplace, lingering uncertainty and the associated repercussions for consumption demand, production activity and investment spending, not only in the directly affected economies, but across the world. The World Trade Organisation (WTO) expects growth in the volume of merchandise trade to slow to 2.6% in 2019, from 3% in 2018, potentially rebounding to 3% in 2020 contingent on an easing of trade tensions.
Policy space and efforts to support the economy’s recovery

The leader of the IMF mission which visited South Africa from May 27 to June 3, 2019 issued the following statement upon its conclusion:

“Following President Ramaphosa’s election, there is a sense of cautious optimism about economic prospects as the new government formulates its policy agenda. Amid challenging global economic conditions, the growth outlook will depend critically on the pace of implementation of reforms that address long-standing structural constraints.

If reform implementation accelerates sufficiently to lift business confidence and jump-start private investment, growth would be reignited. However, if reforms are delayed, investment would fail to pick up, economic growth would remain weak in the medium-term, and per capita income would continue to decline.” (Ana Lucia Coronel, IMF, June 3, 2019)

Confidence plays an indispensable role in driving economic activity. Concerted and consistent efforts across the higher echelons of government towards structural reform, policy coherence and certainty, the eradication of corruption, and the restoration of trust in the organs of state and parastatals are essential for the revival of confidence amongst consumers, businesses and investors. Uniform, united and relentless messaging of such commitments will reinforce the sense of purpose and direction towards a common and clear vision. This is crucial for confidence-building and long-term investment decision-making by business enterprises and the investor community, particularly in light of the very limited fiscal resources and other forms of policy space for economic stimulation.

Monetary policy accommodation

The South African Reserve Bank’s cautious approach to monetary policy in recent years has succeeded in keeping inflation largely under control, gravitating around the mid-point of its 3% to 6% target range. In so doing, the Monetary Policy Committee (MPC) has remained cognisant of the economy’s poor performance, the fragility of its recovery and the plight of millions of unemployed South Africans.

Figure 9: Headline consumer price inflation firmly within the target band

A more accommodative monetary policy stance could be justified considering the economy’s weakness and moderate outlook for inflation. Inflationary pressures remain contained and emanate mainly from the supply side, for there are hardly any demand-pull forces at play in the current economic environment. Major upside risk factors include...
adverse movements in international oil prices and the rand exchange rate, as well as escalations in domestic administered prices (e.g. electricity tariffs). Such price changes are not interest rate sensitive, implying that monetary policy has limited impact in containing inflationary pressures in the current environment. Interest rate changes may, however, affect capital flows and, consequently, imported inflation outcomes via the associated exchange rate movements. Furthermore, by anchoring inflation expectations, tight monetary policy may persuade producers not to pass cost increases entirely on to consumers.

The recently announced 13.9% increase in electricity tariffs has added significant cost pressures for businesses and households, with energy-intensive electricity users being the hardest hit. Volatility in the rand exchange rate, in turn, could persist or even increase in a global environment characterised by high levels of uncertainty, which can drive international capital towards investment assets perceived to be safer.

The rand exchange rate is also likely to be influenced by changes in the policy rates of major economies such as the US, Eurozone and Japan. Lower policy rates in the US or further quantitative easing in the Eurozone, for instance, tend to be rand supportive and, by implication, reduce imported inflation. Concerned with the sustainability of the US economy’s expansion momentum in an increasingly challenging trading environment, the US Federal Reserve recently affirmed its readiness to act in a supportive manner. As illustrated in Figure 10, market expectations are that the Fed will cut rates by 50 to 75 basis points (bps) over the remainder of 2019 (indicated in the chart by the highest probabilities being associated with 2 to 3 rate cuts).

**Figure 10:** Market expectations tilted toward a lowering of US policy rates by 50-75 bps

In a seemingly pre-emptive move, the SARB’s MPC raised the repo rate by 25 basis points in November 2018 as the inflation outlook deteriorated and in anticipation of a further increase in the US policy rate by the Federal Reserve, which did not materialise. The SARB is currently forecasting average inflation for 2019 at the target mid-point of 4.5%, increasing to 5.1% in 2020.

Difficult economic conditions locally, as shown by the shocking GDP growth data for the first quarter of the year, along with indications of a more accommodative monetary policy stance in the US, may prompt the MPC to lower the repo rate by 25 basis points either in July or September to support the domestic economic recovery, potentially followed by a further 25 bps cut in November. However, on its own this will not be sufficient to re-ignite growth in a domestic economic environment characterised by low business, investor and consumer confidence due to a myriad of factors. Crucial amongst these are policy coherence and certainty, and the independence of key institutions such as the SARB.
The markets were recently perturbed by statements challenging the SARB’s mandate, its approach to monetary policy and ownership status. Concerns thus resurfaced that the central bank’s independence would be compromised, potentially leading to misguided and risky monetary policy actions. Shortly thereafter, however, President Ramaphosa asserted that “It is our desire for the South African Reserve Bank to be publicly owned. However, we recognise that this will come at a cost, which, given our current economic and fiscal situation, is simply not prudent.”

In his State of the Nation Address on June 20, the President confirmed the SARB’s mandate as enshrined in the Constitution, specifically: “The primary object of the South African Reserve Bank is to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic”. Accordingly, the SARB “must pursue (this mandate) independently, without fear, favour or prejudice”, stated the President. However, this must be done in consultation with the Minister of Finance to ensure macroeconomic coordination, as constitutionally mandated.

**Highly constrained fiscal space, debt sustainability concerns**

A persistently weak economic environment has been impacting negatively on government finances. The space for counter-cyclical fiscal intervention in support of the economic recovery has thus been drastically reduced.

During the 2018/19 fiscal year, total revenue collected amounted to R1.29 trillion, a shortfall of R14.6 billion from the estimates published by National Treasury in the 2019 Budget. Government expenditure, in turn, was reasonably in line with projections. The overall deficit thus widened to R232.9 billion, taking the main budget deficit for 2018/19 to 4.9% of GDP, significantly higher than the ratio of 4.4% estimated in the 2019 Budget.

A weaker than anticipated economic performance in 2019/20 is likely to result in a further deterioration of the fiscal metrics beyond the projections published last February. The possibility of a large fiscal stimulus being provided is thus basically ruled out, although spending allocations could be somewhat reprioritised towards growth-inducing categories.

The three major international rating agencies have continuously expressed their concern over South Africa’s deteriorating fiscal performance. Moody’s, the only one out of the three to have kept the sovereign rating in investment grade territory, recently indicated that the economy’s poor performance is credit negative. Importantly, this agency announced in May that government guarantees issued to Eskom would henceforth be included in overall government debt when assessing South Africa’s creditworthiness, for the power utility will not be able to meet its debt obligations without governmental assistance.

**Figure 11: Arresting the upward trend in government debt is imperative**

![Graph showing government debt as a percentage of GDP](source: IDC, compiled using SARB and Stats SA data; IDC forecasts)
Recent developments thus raise the probability of Moody's altering its outlook for South Africa from "stable" to "negative", possibly in November. In the absence of tangible progress towards fiscal consolidation and debt sustainability, the possibility of a downgrade to sub-investment will increase substantially.

According to Moody's, arresting and ultimately reversing the long-term decline in the economy's growth potential and the rising debt trend, will be crucial. Other imperatives include "(overcoming) spending pressures relating to interest and wages", addressing the tax collection challenges associated with a diminished institutional capacity at the South African Revenue Services (SARS), as well as the financial sustainability of state-owned companies (SOCs), especially Eskom, South African Airways (SAA) and Transnet.

In his State of the Nation Address (SONA), President Ramaphosa asserted government’s commitment to a confidence- and investment-boosting macroeconomic and fiscal policy framework, underpinned by "prudent borrowing and stringent expenditure management to stabilise our public finances and lower the debt trajectory".

Given the critical role played by Eskom in the economy at large, the President indicated that a Special Appropriation Bill will be urgently tabled to frontload a significant portion of the R230 billion in fiscal support planned for Eskom over the next 10 years, to alleviate the power utility's near- to medium-term financial constraints. This is likely to worsen government’s debt ratios over the Medium-Term Expenditure Framework period. Besides indicating that a chief restructuring officer will soon be appointed "to reposition Eskom financially with careful attention to the mix between revenue, debt and cost structure of the company", no further detail was provided on its unbundling process. Moreover, no reference was made in the SONA to SAA or the South African Broadcasting Corporation (SABC).

**Public sector spending on infrastructure development declining in real terms**

The public sector plays a key role in economic development by facilitating and propelling the investment process through the provision of economic and social infrastructure. This tends to crowd-in private sector investment, which in turn enhances the economy’s productive capacity.

Hamstrung by financial constraints and operational challenges, as well as facing reduced demand in a subdued economic environment, capital spending on infrastructure development by South Africa’s public sector (i.e. public corporations and general government) has been declining in real terms since 2016.

**Figure 12: Public sector spend on infrastructure has been falling in real terms**

![Graph showing public sector spend on infrastructure has been falling in real terms](image)

*Public corporations
General government

**Note:** Confined to economic and social infrastructure, thus excluding spending on economic services.

Source: IDC, compiled using SARB data
Economic overview

Given the strong linkages between the public sector’s capital expenditure programmes and many suppliers of goods and services across the economy, lower spending on infrastructure development has far-reaching implications. Among the most affected are the construction industry; manufacturers of key material inputs such as machinery and equipment, building materials (e.g. fabricated steel, cement, bricks) and transport equipment (e.g. motor vehicles, locomotives and rolling stock); as well as engineering, transport and business services.

According to National Treasury’s Budget Review 2019, public sector spending on infrastructure development over the next three fiscal years (2019/20 to 2021/22) is projected to total R865 billion at current prices. This translates into R248.3 billion per year, on average, at constant 2017 prices. Our analysis of the potential impact of such expenditure revealed the following developmental outcomes: the combined direct and indirect impact on GDP is estimated at R258.7 billion per annum, again at constant 2017 prices, while almost 740 000 jobs could be created or maintained in the process.

However, in a scenario where such public sector expenditure on infrastructure is reduced by 5% in real terms relative to the above plan, the positive impact on GDP would be lowered by almost R13 billion (at constant 2017 prices), on average per year, while 37 000 fewer jobs would be created/maintained in the process.

Maximise localisation to counter the downward trend in infrastructure development

However, by ensuring a more effective implementation of their localisation strategies and the product designations associated with public sector procurement, government and SOCs can counter-act to a significant extent the adverse repercussions of reduced public sector spend on infrastructure due to financial constraints.

In order to determine the potential impact of enhanced localisation efforts on the domestic economy, specifically by procuring more from local suppliers instead of relying on imports, our analysis assumed a 10% reduction in the import leakage associated with the public sector spend over the fiscal years 2019/20 to 2021/22 as outlined in the Budget Review.

Should this be achieved, the positive impact on GDP is estimated to be about R4.5 billion higher on an annual basis (refer to Table 2), while an additional 12 800 jobs could be either created or sustained across several sectors of the economy. These outcomes pertain to both direct and indirect impacts on GDP and employment through the multiplier effects associated with increased spending on local goods and services, as opposed to imports.

Table 2: Estimated impact of enhanced localisation (reduced import leakage) associated with public sector infrastructure expenditure on the South African economy

<table>
<thead>
<tr>
<th>Economic variable</th>
<th>2019/20</th>
<th>2020/21</th>
<th>2021/22</th>
<th>Average over MTEF period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Imports (at constant 2017 prices)</td>
<td>36.8</td>
<td>36.0</td>
<td>36.9</td>
<td>36.6</td>
</tr>
<tr>
<td>Reduced import leakage of 10%: R billion (at constant 2017 prices)</td>
<td>3.7</td>
<td>3.6</td>
<td>3.7</td>
<td>3.7</td>
</tr>
<tr>
<td>Development impact: GDP in R billion (at constant 2017 prices)</td>
<td>4.5</td>
<td>4.4</td>
<td>4.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Employment (number)</td>
<td>12 858</td>
<td>12 574</td>
<td>12 874</td>
<td>12 769</td>
</tr>
</tbody>
</table>

Source: IDC calculations, based on Budget Review 2019 data

An effective roll-out of localisation plans and proper monitoring of actual expenditure and respective developmental outcomes would go a long way towards supporting several supplier industries, including many small- to medium-sized enterprises whose activities are highly reliant on the public sector’s procurement system.
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**Crowding-in private sector funding for infrastructure development**

The economic stimulus and recovery plan announced by President Ramaphosa in September 2018 included the establishment of an Infrastructure Fund by means of which government aimed to crowd-in other funders and investors for the expansion and improvement of the country’s infrastructure.

The Infrastructure Fund would comprise a contribution from government of more than R400 billion over the next three years, which would be used to leverage funding from developmental finance institutions, multilateral development banks, as well as private lenders and investors.

To ensure that infrastructure projects are implemented in a swifter, more cost-effective and developmental manner, particularly in terms of employment creation and localisation, the fund would be supported by a strong technical team in the Presidency.

In the SONA on June 20, President Ramaphosa recalled that R100 billion had been set aside by government as seed capital for the Infrastructure Fund. The President also indicated that the consultative process towards the fund’s institutionalisation was proceeding with private sector investors such as pension funds.

The fund will be managed by the Development Bank of Southern Africa, with oversight from the reconfigured Department of Public Works and Infrastructure. However, private sector investors may insist on playing some oversight role within the fund’s governing structure. A clearly-defined project pipeline may also be a precondition for attracting long-term capital investment commitments, ensuring alignment with private funders’ investment strategies and risk appetite.

**Revitalising the productive sectors of the economy and investment**

With the aim of revitalising and expanding the productive sectors of the economy, boosting private sector investment and creating a more inclusive economy, the SONA outlined several initiatives.

These include the development of master plans in industries such as clothing and textiles, chemicals and plastics, gas, renewables, steel and metals fabrication, as well as priority attention on the development of agricultural and agro-processing value chains and targeted minerals beneficiation.

Government will fulfil its role as an enabler by providing critical infrastructure and through spatial interventions such as the development of special economic zones, the revitalisation of local industrial parks and the establishment of digital hubs. SME development is also a key focal point, while township and village enterprises will contribute to local economic development.

Policy direction to initiate the spectrum licensing process will be issued by the Minister of Communications to the Independent Communications Authority of South Africa (ICASA) within a month. This long-awaited step, which will include measures to enhance competition in the sector, transformation and universal access, is expected to reduce data costs in South Africa.

The importance of the tourism sector was highlighted, with the aim being to attract more than double the number international tourist arrivals by 2030. Introducing a world-class visa system, revamping the country’s brand, making concerted efforts to attract more visitors from China and India, and providing a safer environment for tourists form part of the plan in this regard.

Substantially higher levels of fixed investment are required to elevate and sustain the economy’s expansion momentum. By addressing bottlenecks hindering investment activity...
and working towards a clear revival in business and investor sentiment, government aims to attract substantial contributions from the private sector.

Improved efficiencies and better planning and implementation of the public sector’s infrastructure build programme will be highly beneficial to the local construction sector, which is under severe pressure at present. Furthermore, measures are to be put in place to reduce the cost of doing business, including electricity prices, port and harbour charges, as well as by ensuring a more affordable and efficient transport and logistics system.

Regional integration will be enhanced to expand trade and investment with the rest of the African continent, with the African Continental Free Trade Area being key in this regard. Particular focus will be paid to the development of select value chains within the SADC region.

Concluding remarks

The outlook for the South African economy has dimmed significantly. Households still find themselves in a difficult environment, which is affecting their ability and willingness to spend, at least in the short-term.

Limited fiscal space in a low-growth environment will not only impact on government’s consumption expenditure, but also on its investment in infrastructure. Financial and operational challenges at key SOCs are expected to constrain their capital expenditure for quite some time.

Capital outlays by the private sector, in turn, are likely to remain subdued in the shorter term as weak demand, excess production capacity and a degree of policy uncertainty keep business sentiment at low levels, weighing on investment decisions.

Globally, strong headwinds may result in a weaker than anticipated expansion momentum for the world economy, with the deterioration in trade relations between the US and China playing a key role in this regard. Lower economic growth in some of the principal external markets for South Africa’s exports is a matter of concern, while FDI inflows may be also affected in a more challenging global environment.

Against such a background, it is imperative that all social partners commit to and collaborate in restoring confidence and investing in South Africa’s future, for its economy and people present enormous potential. Steps are being taken in this direction, as highlighted by President Ramaphosa in his State of the Nation Address, but time is of the essence.

Department of Research and Information

21 June 2019
Economic overview

Annexure

Figure A1: Real GDP growth and contributions by expenditure item

Figure A2: Real GDP growth and contributions by the broad economic sectors

Source: IDC, compiled using Stats SA data