Economic overview:
Recent developments in the Global and South African economies
August 2019
Department of Research and Information
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The world economy is facing significant threats that are undermining its expansion momentum. The US-China trade war has escalated and may turn out to be protracted. The risk of a currency war is also emerging, while a no-deal Brexit is becoming a distinct possibility. Geo-political tensions, in turn, have intensified in various parts of the world. The confluence of such adverse developments is threatening to derail global growth, potentially even taking the world economy towards its first recession in a decade.

Various central banks around the globe have been responding to these adverse developments by lowering interest rates, indicating that accommodative monetary policy stances may prevail for some time. The US Federal Reserve’s reference to a “mid-cycle adjustment” as it recently lowered its policy rate by 25 basis points - the first cut since 2008 - was not well received by the markets. The Fed’s stance has also met with sharp criticism from the US President, unsettling markets further as it is being perceived as interference in monetary policy.

Financial markets have been reacting strongly to the increased risk levels, with investment capital fleeing towards assets deemed to be safer such as the government bonds of specific advanced economies, gold and hard-currencies. Equity markets have tumbled in the process, and emerging market currencies have been weakening due to capital outflows.

Sub-Saharan Africa’s economic performance has been expected to improve at the aggregate level, albeit varying considerably across its sub-regions, with southern Africa projected to post the weakest outcomes. However, rising risks globally are presenting powerful headwinds as they affect world demand for the region’s commodities, export and import trade in other merchandise, fixed direct investment activity and capital flows.

The South African economy, in turn, is struggling to recover in an increasingly difficult global environment. The second quarter of 2019 is likely to have seen a return to positive growth, considering the recovery in manufacturing and mining output, as well as in consumer-related segments such as retail trade and new passenger vehicle sales. Despite such a turnaround, for the year as a whole, the economy may struggle to achieve the lacklustre growth rate of 0.8% recorded in 2018.

The operating environment remains challenging for many South African manufacturing enterprises, with manufacturers having expressed concerns over the outlook for business conditions. They have become more pessimistic regarding future investment in plant and equipment, as well as export sales. This does not bode well for a speedy and lasting recovery of this important sector of the economy.

Although South Africa’s exports recovered in nominal value terms in the second quarter of the year, strong headwinds globally may compromise world demand going forward. The domestic export sector is highly reliant on other African economies, the European Union, China, the US and Japan as markets for its products.

Although consumer spending is showing signs of improving, households continue facing significant challenges, including high debt levels, rising living costs, difficulty in accessing new credit, as well as uncertainty on the employment front. These are limiting their ability and willingness to spend.

The principal credit rating agencies – Standard & Poor’s, Moody’s and Fitch – are increasingly concerned with the lack of progress in addressing the enormous challenges facing key state-owned enterprises and in the implementation of essential
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structural reforms. Government’s adherence to its fiscal consolidation and debt sustainability commitments are consequently being questioned. It is expected that Moody’s will alter its outlook for the sovereign from “stable” to “negative”, perhaps even sooner than its scheduled review in November 2019, while a ratings downgrade into sub-investment territory should not be ruled out. This would have serious consequences for the South African economy.

Implications for South African businesses

• With the outlook for global growth deteriorating, import demand in key destinations for South Africa’s exports (such as China, Germany, the US and UK) is likely to come under pressure, potentially impacting on the performance of externally-oriented businesses.

• Global value chains are being affected by ongoing disruptions to world trade flows and investment activity, and evidence of trade diversion is emerging. This is resulting in increased competition from foreign producers in traditional external markets for South African exports, as well as in the local market. The ability of business enterprises to offset domestic demand weakness by expanding into global markets may be somewhat constrained in the current international environment, although select opportunities may emerge, especially in other African markets.

• Renewed risk-aversion towards global equities, particularly emerging market stocks in general, is likely to persist until markets are confident that there will be a constructive and sustainable resolution to the ongoing trade and investment protection disputes between the US and China. In the interim, sharp sell-offs may occur from time to time due to investor concerns with the growth trajectory, both internationally and domestically.

• Weaker growth prospects globally, especially in China, are likely to affect industrial commodity markets negatively, both in terms of volume demand and prices. The adverse impact on the performance of businesses in the mining and minerals beneficiation segments could be significant.

• The easing of monetary policy across the world provided a window of opportunity for the Monetary Policy Committee of the SA Reserve Bank to lower the repo rate in support of the domestic economic recovery. However, with renewed turmoil in global financial and currency markets, and the rand amongst the worst performing emerging market currencies, the room for further monetary policy accommodation may be limited.

• Despite the recent 25 basis points cut in South Africa’s repurchase rate, current conditions in the household and business sectors do not bode well for this to translate into significant increases in consumption spending or investment activity. Although businesses may not necessarily experience an improvement in sales on the back of the interest rate cut, the latter should alleviate debt-servicing costs.

• Weak prospects for domestic economic growth in the short- to medium-term, alongside significant spare production capacity across many industries, point to continued restraint in fixed investment spending by businesses enterprises.

• Although the outlook for fixed investment over the short-term is weak, anticipated improvements in South Africa’s regulatory framework as well as improved coordination and alignment of policies, in line with Government’s commitments, should contribute towards restoring business and investor confidence. This will be
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gradual though, with the resultant progressive improvement in sentiment levels translating into higher levels of fixed investment activity. This is likely to be initially directed towards the upgrading of equipment, with expansionary investments ensuing as the economy’s growth momentum accelerates.

- Government’s fiscal position has weakened considerably, while the financial standing of key SOEs has deteriorated. Consequently, both capital and operational spending by the public sector is expected to be highly constrained, with adverse implications for supplying industries and service providers. Nevertheless, a more focused and effective approach to localisation, alongside an efficient monitoring of product designations, would go a long way in stimulating economic activity.

- At this stage, it is expected that Moody’s will alter its outlook for the sovereign from “stable” to “negative”. However, the risk of further downgrades to South Africa’s sovereign risk ratings, including Moody’s placing the sovereign in a sub-investment grade, should not be overlooked. Should this materialise, there would be adverse implications for the cost of and access to foreign capital by public and private sector entities. Furthermore, this would unleash a chain of negative developments, including large capital outflows, a depreciating currency, rising inflationary pressures and domestic interest rate hikes, all of which would affect the business and investment environment to a considerable extent.
Risks to the global economic environment increasing

Global growth is under serious threat. Major forces remain unabatedly at play, slowing the world economy’s expansion momentum and raising the risks of its potential derailment. Such forces range from popular discontent with rising levels of inequality to the rise of populism in several countries; from heightened geopolitical tensions to increasingly nationalistic and separatist tendencies; from rising protectionism to a de facto trade war between the United States (US) and China, and, more recently, the spectre of currency wars.

The trade war between the US and China has escalated, with no signs of a truce on the horizon. Despite the protectionist measures imposed by both sides since 2018 (see Figure 1), the surplus on China’s balance of trade with the US remains little changed. It totalled USD28 billion in July 2019, marginally lower than the recent historical peak of above USD30 billion.

On August 1st, President Trump ratched-up the confrontation by threatening to impose, as from September (subsequently altered to two phases), 10% tariffs on the remaining USD300 billion of US imports from China yet unaffected by higher trade barriers. China’s initial response was to suspend imports of US agricultural goods by its state agencies, along with a potential increase in tariffs on imports sourced from the US.

China’s central bank then allowed the renminbi to weaken against the US dollar beyond the psychological level of 7 RMB per USD. The US saw such a move as an attempt by China to regain part of the price competitiveness that its exports had lost in US markets due to higher tariffs. This led the US Treasury to designate China a “currency manipulator”, raising the possibility of the US-China trade war morphing into a broader economic war between the two countries.

A UBS study has indicated that the new set of US tariffs could shave 0.3 of a percentage point off the country’s economic growth in 2020. With China’s production base well integrated within global supply chains, the weakening of its currency

Economic and geopolitical risks have increased across the globe

Figure 1: Timeline of the US-China trade war

A weaker currency could be detrimental to China’s growth prospects
may provide some benefits on the export side, but it would also raise the cost of imported inputs and drive up domestic prices. This could slow consumption expenditure in the process and underscore capital outflows. These are risks that the Chinese authorities may not be keen on taking given the socio-economic imperatives and long-term goals.

A protracted trade war between the US and China could necessitate an intensification of China’s domestic stimulus measures to support economic growth, but these have limits. Various monetary policy measures to boost liquidity have already been implemented, and further targeted easing could raise the risk of asset bubbles and stoke financial systemic risks. The effectiveness of recent tax cuts has reportedly been limited and the implementation of additional fiscal stimulus and/or subsidies for consumption may have adverse ramifications for the sustainability of aggregate demand over the long-term.

Expectations are that the trade war between the US and China will be protracted, with adverse consequences for world trade, investment and economic growth. Rising risks to global growth have been evident in recent movements in key financial and commodity markets, as well as several economic indicators.

The rate of increase in global trade volumes weakened to a mere 0.15% (y-o-y) in the first 5 months of 2019, significantly lower than the 3.4% growth recorded in 2018 (see Figure 2a). However, the emerging economies as a group recorded a 0.5% (y-o-y) drop in their volume of trade over the first 5 months of the year, compared to a 4.8% increase in 2018.

Nevertheless, other recently released economic data from across the world still point to a moderation in output growth, and not the sharp deceleration or even the possibility of a recession as flagged by several analysts and commentators. Expectations of future economic performance remain positive, albeit marginally, with the composite Purchasing Managers Indices (PMIs) still above the 50-point mark in the US, China, the Eurozone and Japan. Labour market data in these countries still reflect very low levels of unemployment, which is supportive of consumption spending, while inflationary pressures are not yet evident. However, the manufacturing PMIs for the abovementioned countries, except for the US, are below the 50-point level. This indicates that the trade war, in conjunction with other global risk factors are weighing on global manufacturing activity, which, if sustained, could have negative implications for overall economic growth.

**Figure 2:** The volume of global trade has slowed in recent months in reaction to the ongoing US-China trade war, and declined significantly in the case of the emerging economies, while lower PMIs point to a moderation in growth.

Indications of economic weakness are emanating from the Eurozone, whose economy expanded by a mere 0.2% (quarter-on-quarter) in the second quarter of 2019. Germany’s GDP declined by 0.1% (q-o-q), triggered by lower exports and weaker construction activity, and its industrial production fell by 5.2% in July, on a year-on-year basis. The German
industrial base is highly reliant on China, the US and the UK as export markets. Recent developments have thus raised fears that the German economy, which is the largest in Europe, might be heading for a recession. The EU is not only being affected by the fall-out between the US and China, but also by the prolonged uncertainty surrounding Brexit. The new British prime minister, Boris Johnson, has indicated a willingness to lead the UK out of the EU with or without a deal. He has stated that the scrapping of the Irish border backstop would be a precondition for further negotiations with the EU, a demand which the latter is unlikely to accept. With the October 31st deadline for Brexit fast-approaching, a no-deal outcome is becoming increasingly likely.

Financial markets have been reacting strongly to rising risks in the world economy. Investment capital has been shifting away from riskier assets such as equities, particularly emerging market equities (see Figure 3d), and towards perceived safer assets such as government bonds of so-called safe-haven countries, pushing yields on these securities lower (Figure 3b). Capital has also been moving towards gold, raising its price from below USD1 300/oz to above USD1 500/oz (see the trend illustrated in Figure 3a), as well as hard-currencies, particularly the US dollar, the Swiss franc and the Japanese yen, resulting in their strengthening (Figure 3c).

There are indications that the Swiss National Bank is intervening to limit the extent of the franc’s appreciation. In contrast, it would appear that the Bank of Japan has not yet intervened, allowing the USD/JPY exchange rate to move below the 105 level, which previously prompted intervention to protect Japanese exporters.

**Figure 3: Financial and commodity markets have been reacting strongly to elevated global risks**

In the oil market, fears of a faster than anticipated deceleration in world growth are outweighing the recent build-up of US inventories and the risk of oil supply disruptions due to the military tensions in the Strait of Hormuz. The price of Brent crude declined from over

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*The outcome of Brexit is still uncertain, with a no-deal exit an increasingly distinct possibility.*

*Investment capital moving away from equities towards treasuries, gold and hard currencies.*

*Oil prices are reflecting concerns over the future trajectory of world demand.*
USD70 per barrel in May to below USD60 per barrel in August (see the trend illustrated in Figure 3a above).

US economic data still reflect a relatively strong economic performance of the American economy. However, its growth momentum is expected to slow due to a softening of domestic demand, with the unwinding of the fiscal stimulus playing a role in this regard. Moreover, domestic production, consumption and investment activity is likely to be adversely impacted by higher import tariffs, while US exports not only face retaliatory import duties in key external markets such as China, but also the negative impact of a strong dollar.

Several analysts and commentators see the US economy moving towards its first recession in a decade. As shown in Figure 4a, the differential between the 10-year and 3-month Treasury notes has moved into negative territory. Furthermore, its inversion has steepened the most since 2007, the year preceding the financial crisis in the US and subsequent recession. Such trends are deemed to be indicative of forthcoming weakness and, potentially, recessionary conditions.

Concerned with the potential impact of recent developments in the global trading arena on the American economy, while inflationary pressures remain quite subdued, the US Federal Reserve (Fed) lowered the policy rate by 25 basis points on July 31st. It indicated, however, that such a move was a mid-cycle adjustment and not the start of a downward cycle. Nonetheless, financial markets are still anticipating a further rate cut in September, with the implied rates (see Figure 4b) reflecting expectations that, by December 2020, the US Fed will have lowered rates by a total of 125 basis points (including the 25bps cut in July).

Monetary policy has also been eased in several other countries, with the central banks of India, Thailand, New Zealand, Brazil and South Africa, among others, having recently cut policy rates. The European Central Bank (ECB) and the Bank of Japan (BoJ), in turn, have limited room to lower interest rates further, for these are already in negative territory. The ECB has, however, announced that it is considering reactivating its quantitative easing programme, while the BoJ will continue with the programme already underway.

The outlook for the global economy has clearly deteriorated. The International Monetary Fund (IMF) has accordingly lowered its forecasts for world growth to 3.2% in 2019 (2018: 3.6%) and to 3.5% in 2020. However, should the trade war between the US and China escalate further and/or persist over a prolonged period, the ramifications could result in even lower growth rates than those currently projected, potentially even taking the world economy towards its first recession in a decade.
Sub-Saharan Africa is particularly vulnerable to global developments

Rapidly changing dynamics and intensifying risks in the world economy suggest that the growth momentum in Sub-Saharan African (SSA) is likely to remain relatively modest and below long-term averages. Escalating tensions and policy uncertainty in the global trading arena are impacting on trade flows, production activity and global value chains. Commodity markets are being affected in the process and global business is reassessing investment plans.

The SSA region is projected to register growth of 3.4% and 3.6% in 2019 and 2020, respectively, according to the latest IMF forecasts. This will be largely driven by robust growth in several of its non-resource intensive economies, as the economic performance of larger economies is expected to remain weak over this period.

The projected performance of the various sub-regions is illustrated in Figure 5. In the case of Southern Africa, several countries are anticipated to record weak growth. The Angolan economy continues struggling to come out of recession amid declining domestic oil production and relatively low crude oil prices, while the economies of Zimbabwe and eSwatini are projected to contract in 2019. Zambia, in turn, is facing heightened external debt vulnerabilities, an uncertain policy and regulatory environment (particularly with respect to mining), as well as recurrent drought conditions. Accordingly, its growth forecasts have been significantly reduced to just under the medium-term annual average of 2%.

In sharp contrast, economic growth rates of close to 6% and over are projected by the IMF for Rwanda, Ethiopia, Côte d’Ivoire, Uganda, Ghana and Kenya, supported by continued investment spending on public infrastructure and/or new minerals capacity coming on stream over the period.

Figure 5: Growth in Sub-Saharan Africa set to remain relatively modest

Source: IDC, compiled using IMF World Economic Outlook databases, April 2019

With the fortunes of the SSA region closely linked to those of its key trading partners, a stronger-than-anticipated deceleration in economic activity in these economies could weigh on its expansion momentum. Combined, China, the US and the Eurozone are estimated to have accounted for around 43% of the total exports of SSA, excluding South Africa, in 2018. Furthermore, China and the US together held more than 10% of the overall stock of foreign direct investment (FDI) in Africa in 2017, while some of the key Eurozone economies, such as France, the Netherlands and Italy feature among the continent’s top inward investors.
Adverse developments in these key trading and investment partners therefore present significant risks to the economic outlook for SSA. A substantial slowdown of the Chinese economy, which accounts for more than half of the global demand for metals, would likely translate into weaker demand for commodities, affecting SSA’s commodity producers both in terms of export volumes and prices. Zambia, the Democratic Republic of the Congo and Guinea are likely to be amongst the economies most affected by slower than anticipated growth in China in the face of a prolonged trade war with the US.

Domestic risks to the outlook of several SSA economies include debt sustainability issues, weather-related disruptions to economic activity, a slow pace of structural reforms, political developments and policy uncertainty, as well as security challenges.

**South Africa’s tentative economic recovery beset by challenges**

**Economic activity recovered in key sectors**

Levels of economic activity in South Africa are likely to have recovered in the second quarter of 2019, considering the preliminary data for select key economic variables (refer to Figure 6 below). This follows the economy’s shocking contraction in the opening quarter of the year, when real GDP fell by 3.2% (q-o-q, seasonally-adjusted and annualised rate).

**Figure 6: Economic activity has rebounded, but unlikely to be sustained**

Manufacturing output rebounded in Q2 2019, expanding by 2.1% (saar) relative to the previous quarter (see Figure 7). Nevertheless, overall manufacturing output during the first six months of the year was only 0.5% higher than in the corresponding period of 2018. The recovery momentum is, however, unlikely to be sustained through the remainder of 2019, for the manufacturing sector is facing numerous challenges, particularly the persistently weak levels of domestic demand, while slower growth in global demand could aggravate the situation.

According to the latest survey of the Bureau for Economic Research, manufacturers are expecting business conditions to remain largely unfavourable over the next 12 months, and have become more pessimistic over exports and levels of fixed investment activity. Their expectations regarding investment in machinery and equipment in about 12 months’ time are weakest since the 2009 recession. This does not bode well for a swift and sustained recovery of South Africa’s manufacturing sector.
Figure 7: Manufacturing output increased in Q2 2019, but the outlook remains challenging

Mining output recorded a substantial turnaround in the second quarter of the year, having increased by 14.6% (q-o-q) compared to the 12.1% decline in the first quarter. Furthermore, as illustrated in Figure 8, most mining sub-sectors reported higher output volumes, including the larger segments such as those mining iron ore, coal and, to a much lesser extent, platinum group metals (PGMs).

Despite this recovery in production activity, total mining output during the first six months of 2019 was still 3.2% lower than in the corresponding period last year. Weaker global demand for commodities, especially from China, alongside rising operational costs (particularly the recent hike in electricity tariffs), labour-related challenges and low confidence levels continue to weigh on mining activity in South Africa. These factors are particularly problematic for marginal/loss-making mining operations.

Figure 8: Mining activity recovered, but operating environment still difficult

Mining sector still facing a difficult operating and trading environment
As indicated by the recovery in retail trade sales in the second quarter of 2019 (+4.3% in real terms, q-o-q, saar) and by the strong rebound in sales of new passenger vehicles (refer to Figure 6 above), household consumption spending is showing signs of improvement. However, the consumer environment remains challenging, considering the high levels of household indebtedness, cost of living pressures and uncertain employment prospects. These factors underpin low consumer confidence levels and continue to affect the ability and willingness of households to raise spending in a meaningful manner. The recent 25 basis points cut in the repurchase (repo) rate by the Monetary Policy Committee of the SA Reserve Bank should provide limited relief to debt-ridden households, but is not expected to raise consumer expenditure significantly.

Rebound in exports may prove difficult to sustain in the current global environment

On the external front, merchandise exports also experienced a substantial turnaround in the second quarter of 2019, having risen by 10.9% (q-o-q) in nominal value terms, compared to the 14.8% drop recorded in the first quarter of the year. This rebound could, however, be short-lived, bearing in mind the rising risks to the world economic outlook. Trade tensions not only have a bearing on global trade flows, but also affect production activity and investment decisions. They are also leading to trade diversion, thereby intensifying competitive forces within the global marketplace.

Slower growth in a number of external markets is a matter of concern for South Africa’s open economy. Developments in the European Union (EU), the rest of the African continent, China, the US and Japan are particularly important, for these trading partners accounted for 73% of South Africa’s total merchandise exports in the first six months of 2019, as illustrated in Figure 9.

Figure 9: South Africa’s export sector is highly reliant on specific external markets

<table>
<thead>
<tr>
<th>Export destinations of overall SA merchandise goods in 2019 (January - June)</th>
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<tbody>
<tr>
<td>Europe, 24.1%</td>
</tr>
<tr>
<td>Africa, 26.3%</td>
</tr>
<tr>
<td>China, 10.7%</td>
</tr>
<tr>
<td>United States, 6.8%</td>
</tr>
<tr>
<td>Japan, 5.0%</td>
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<tr>
<td>Rest of the world, 27.1%</td>
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</table>

Source: IDC, compiled using SARS data

South Africa’s top four export product categories are:

- Motor vehicles, parts and accessories, which accounted for 14.3% of the entire merchandise export basket (in nominal terms) in the first half of 2019;
- Platinum group metals (8.3%);
- Basic iron and steel products (7.2%); and
- Iron ore, with a 6.3% share.

The combined share of these product categories within South Africa’s overall merchandise export basket stood at 36% over the period January to June 2019. The four charts included in Figure 10 illustrate the trends in South Africa’s exports of such products on a quarterly basis and in real terms (i.e. at constant 2010 prices) since 2010.
In real terms, exports of motor vehicles, parts and accessories increased sharply in recent years. Growth in exports to the EU was particularly strong at 26.6% and 44.6% in 2014 and 2015, respectively. Moreover, real export growth to the EU averaged 19.9% per year over the period 2014 to 2018, followed by a sharp rise in the first half of 2019. This confirms the importance of this market as the key destination for the South African automotive industry.

Demand for motor vehicles, parts and accessories by countries elsewhere in Africa, the second largest export destination for the local automotive industry, disappointed with a contraction of 6% per annum, on average, over the past five years. As far as the US is concerned, a decline was observed in real exports for each of the past three years, with a 53% drop in real exports in 2018, whilst sharply lower exports were also recorded over the first six months of 2019. This reflects strategic changes in South Africa’s automotive production, as OEMs reoriented their supply chains.

The rest of the African continent is the largest market for South African exports of basic iron and steel products. After falling by 18.8% in real terms in 2015, a gradual recovery ensued in subsequent years, with exports of basic iron and steel products to other African countries having increased by 17.7% in 2018. However, the first half of 2019 saw a marginal contraction (-0.1%) on a year-on-year basis.

Basic iron and steel exports to China were under pressure in 2017 (-39.7%) and 2018 (-11.1%), but recovered strongly (+32.1%) on a year-on-year basis over the first six months of 2019. Demand from the EU has been lacklustre in recent years, with the value of exports of basic iron and steel virtually unchanged in real terms (growth of 0.1% per annum, on average) over the period 2014 to 2018, and having declined to some extent in the first semester of 2019.
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**Exports of platinum group metals** (PGMs) are predominantly destined for the EU, Japan and the US. Although PGM exports to the EU and the US recorded robust growth in recent years, averaging 16.1% and 12.4% per year, respectively, over the period 2014 to 2018, demand from Japan was quite subdued, as real exports increased at an average annual rate of just 0.7% over this period.

Developments in Europe’s automotive market, with sales of new passenger vehicles under pressure, are weighing on demand for PGMs. This was clearly reflected in the sharp drop of PGM exports to the EU over the first half of 2019 (on a year-on-year basis), although some recovery could be observed in the second quarter. However, demand conditions in Japan and the US appear to have improved since the start of 2019, considering the spike in PGM exports in the first half of the year compared to the same period in 2018.

**Exports of iron ore** were under pressure from 2016 to 2018, declining at an average rate of 5.8% per year in real terms. Real exports to China fell by 7.4% on an average annual basis, whereas those to Japan tumbled by 15.2% per year, on average, over the same period. Iron ore exports to the EU, however, remained resilient as growth averaged 11.5% per year in real terms from 2016 to 2018.

Although iron ore exports have recovered since the start of 2019, the momentum may not be sustained in light of a worsening global economic environment, which could affect demand conditions in some of South Africa’s key export destinations for this mineral. The downturn in the European steel market, for example, is of concern. Steel production in China, on the other hand, recently reached new record highs, with demand underpinned by fixed investment activity benefitting the construction industry. Should this trend continue, it will likely have positive implications for the iron ore market.

*The unemployment challenge is likely to deteriorate in a low-growth environment*

South Africa’s growth prospects are expected to remain relatively weak over the short-term, further limiting its labour absorption capacity.

According to the latest Quarterly Labour Force Survey of Stats SA, the South African economy created 21 300 additional employment opportunities in the second quarter of 2019, compared to the previous quarter, with the trade and community services sectors as the key contributors. Nevertheless, the level of total employment in June 2019 was almost 216 000 lower than in December 2018.

*Figure 11: Employment levels rising gradually, but insufficiently for an expanding labour force*

![Employment trends: Overall and in select sectors](image-url)
Net job creation over time has not been sufficient to absorb new entrants into the labour market. Accordingly, the unemployment rate increased sharply to 29% in the second quarter of 2019, from 27.6% in the preceding quarter, with 6.7 million people currently finding themselves without a job (see Figure 12).

*Figure 12: South Africa’s unemployment rate rose sharply in the second quarter of 2019*

South Africa’s fiscal metrics are deteriorating rapidly, risking further downgrades of sovereign credit ratings

The economy’s performance in the current fiscal year will be significantly weaker than projected in the National Budget 2019. This will result in lower than anticipated tax revenues which, coupled with the financial constraints of key state-owned companies (principally Eskom, but also South African Airways, Denel and the SABC, among others) will worsen South Africa’s fiscal metrics.

The deterioration of South Africa’s fiscal metrics has been considerable, with the budget deficit anticipated to represent around 6% of GDP in the 2019/20 financial year. Overall government debt, in turn, is spiralling out of control and could exceed the 65% of GDP ratio much sooner than projected in the 2019 Budget.

Eskom is faltering under an enormous and still rising debt burden of about R440 billion, having recorded a financial loss of R20.7 billion in its 2019 financial year. The utility could not generate enough income to cover its operating costs and interest payments. Due to the severity of the debt crisis at Eskom, the utility is seeking to transfer the bulk of its debt to government, having indicated that it is only able to sustain a debt burden of about R160 billion on its own balance sheet. Bold, decisive and urgent action is needed to address...
Eskom’s financial plight as a prerequisite to stabilise government finances and demonstrate its commitment to sound fiscal discipline. The broad restructuring plans announced for the utility in the State of the Nation Address last February have yet to evolve into specifics. However, the Minister of Public Enterprises recently stated that a “paper” outlining the roadmap for Eskom’s unbundling process will be ready by mid-September.

The principal credit rating agencies – Standard & Poor’s, Moody’s and Fitch – are increasingly concerned with the lack of progress in addressing the enormous challenges facing key state-owned enterprises and in the implementation of essential structural reforms. Government’s adherence to its fiscal consolidation and debt sustainability commitments are consequently being questioned.

On July 26th, Fitch altered the outlook for South Africa to “negative”, thus suggesting a further downgrade within its non-investment grade territory could ensue. However, the agency kept South Africa’s long-term foreign and local currency debt ratings at BB+, one notch below investment grade.

Table 1: SA’s sovereign credit ratings

<table>
<thead>
<tr>
<th>Ratings category</th>
<th>Foreign currency denominated debt</th>
<th>Local currency (Rand) denominated debt</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Moody’s</td>
<td>S&amp;P</td>
</tr>
<tr>
<td>Investment grade</td>
<td>A3</td>
<td>A-</td>
</tr>
<tr>
<td></td>
<td>Baa1</td>
<td>BBB+</td>
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<tr>
<td></td>
<td>Baa2</td>
<td>BBB</td>
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<tr>
<td></td>
<td>Baa3</td>
<td>BBB-</td>
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<tr>
<td>Sub-investment grade</td>
<td>Ba1</td>
<td>BB+</td>
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<td></td>
<td>Ba2</td>
<td>BB</td>
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<td></td>
<td>Ba3</td>
<td>BB-</td>
</tr>
</tbody>
</table>

Source: Moody’s, S&P and Fitch Ratings

Moody’s, which has been keeping South Africa’s sovereign rating one notch above investment grade, has cautioned that the deteriorating fiscal metrics and the front-loading of government’s financial support package for Eskom are credit negative. It is expected that Moody’s will alter its outlook for the sovereign from “stable” to “negative”, perhaps even sooner than its scheduled review in November 2019, while a ratings downgrade into sub-investment territory should not be ruled out.

A downgrading of the sovereign by Moody’s to a sub-investment rating would trigger a sizeable forced selling of local government bonds as South Africa would drop out of the CitiGroup World Government Bond Index. Considering the recent sell-off of South African bonds by foreigners and the sharp depreciation of the rand well in excess of most emerging market peers, it would appear that market players are anticipating a downgrade to “junk”.

This would have serious consequences for the country, as it relies heavily on foreign capital inflows to finance its deficits on the current account of the balance of payments and fiscal balance. A substantial premium would have to be paid to attract investor interest in local bonds, in the process not only raising debt-servicing costs with the corresponding opportunity costs, but also unleashing a wide range of adverse developments through the economy at large. The rand would come under immense pressure due to substantial net capital outflows. This would result in considerably higher inflationary pressures, with consequences for monetary policy.
Higher interest rates and a more fragile operating environment would affect investment decisions, leading business enterprises to reconsider their capital expenditure plans. Government and the public sector at large would also be forced to reduce spending on infrastructure development and to cut-back on non-essential consumption expenditure, in the process aggravating the economy’s performance. Weaker rates of economic growth over a prolonged period of time would have dire socio-economic consequences that South Africa can ill afford.

The challenges facing the South African economy at present are enormous, and call for immediate and decisive action. Much is being said about a potential bail-out from the International Monetary Fund should South Africa’s fiscal situation not improve. Such an option could be avoided if the appropriate steps are taken timeously, even if accompanied by considerable societal pain in the short- to medium-term, for the alternative is likely to prove significantly more detrimental.