South Africa Economic Update, December 2019

Structural challenges, subdued demand a slowing global economy, weigh on SA's economic performance

Executive Summary:

- ***Economy facing renewed challenges***
- ***Eskom remains the single largest risk factor***
- ***Fiscal metrics worsened substantially***
- ***Insufficient employment creation***
- ***Sovereign ratings under considerable threat***

1. Overall Macro-Economic Highlights

The global economy is in a synchronized slowdown, with advanced, emerging and developing economies generally experiencing a moderation in their growth performances. The International Monetary Fund[1] (IMF) has again revised its forecast for world growth down to 3% for 2019, from 3.2% previously. This will be the worst performance since 2009. The Sub-Saharan Africa region is also facing a slight moderation of its growth prospects. The South African economy finds itself under renewed pressure. Growth is estimated to have moderated in Q3 2019[2], based on preliminary data for several key economic variables. The output of the manufacturing and mining sectors has fallen, while retail trade sales are exhibiting modest growth.

South Africa looks increasingly likely to miss its projections for GDP (gross domestic product) growth and faces a potential "junk" credit rating from all three major ratings agencies, as domestic and international pressures weigh on Africa's second-largest economy. The Absa Manufacturing Purchasing Managers Index[3] dipped to 41.6 in September from 25.7 in August, the second consecutive sharp decline in factory activity and South Africa's largest in a decade.

South Africa's budget deficit could reach -5.4 to -5.6% of GDP, an overshoot of between 0.9 and 1.1 percentage points, based on fiscal pressures building on both the revenue and spending side of the budget[4]. Tax revenues are clearly underperforming the targets, mainly corporate and personal income taxes and domestic VAT receipts.

The bounce back that was seen in the second quarter GDP wasn't sustained, and growth was very weak in the third quarter. The World Bank[5] has cut South Africa's growth forecast for 2019 through to 2021, citing weak investor sentiment and lingering policy uncertainty. Growth for 2019 is now projected at 0.8%, half a percentage point lower than April's forecast and unchanged from 2018, according to the bank's October Africa's Pulse report.

In October the Finance Minister delivered his Medium Term Budget Policy Statement (MTBPS) in which he attempted to reconcile the substantial bailout packages given to the state owned power utility- Eskom, with the slow growth the country is experiencing and falling tax revenue. There have also been some widespread strikes in mining and a few other sectors, so there isn't one massive factor contributing to the weak economic data- there are a lot of different things going wrong all at once. The October 2019 Medium Term Budget Policy Statement (MTBPS) estimates the budget deficit for the current fiscal year at R306.2 billion, or 5.9% of GDP, compared to the 4.5% deficit projected in the National Budget 2019 released in February.

[1] IMF World Economic Outlook. 2019
[2] Statistics South Africa. 2019
[3] Absa PMI September. 2019
[4] Budget Review.2019. National Treasury.
[5] World Bank Africa Pulse Report. 2019

A key obstacle to reform is also the fact that South African President Cyril Ramaphosa has faced deep internal divisions within his governing ANC (African National Congress) party. Finance Minister Mboweni's[6] recent growth plan for the South African economy proposed increased private sector participation in the energy, telecoms and transportation sectors, entering previously uncharted policy waters and surprisingly gained the support of the ANC's National Executive Committee.

There was an expectation that the country would see a modest pickup in growth as reforms got underway after the national elections. The recovery was expected to be driven by a rebound in household consumption and private investment. However, signs of improving business and investor confidence are emerging as evidenced by the commitments made by both local and foreign entities at the second South Africa Investment Conference hosted by President Cyril Ramaphosa on 6 November 2019. Investment pledges totalling ZAR371 billion were made, potentially creating around 412 000 direct employment opportunities over the next five years in various sectors of the economy.

2. Currency

The South Africa Rand (ZAR) has not been to immune to the global market shifts in 2019. Brexit, the China-US trade war and a weaker global environment have all impacted emerging market currencies, and the ZAR in particular. The biggest risks however have been domestic, in other words the countries troubles have resulted in historic lows for the Rand in 2019. The South African Rand is prone to large scale swings over very short periods of time, and in a lot of the cases it seems to be reactive to market news which sees reversals after a short period of time. Since the global picture is an ongoing saga, suffice it to say the Rand volatility will continue to be exacerbated by the country's financial situation and weakening global demand.

3. Trade and Investment

In constant rand terms, South African exports have increased slightly since 2014, while imports are lower than they were five years ago despite some increases in the past two years[7]. In dollar terms, trade has been more volatile, with a sharp fall in imports and exports from 2014 to 2015 followed by a near-recovery. Exports declined slightly from the third quarter of 2018 to the third quarter of 2019 in both constant rand and dollars for agriculture, mining and manufacturing. A trade surplus supports the rand, but has a minimal impact in the face of financial outflows.

Private investment recovered over the year to September 2019, with a particularly sharp increase in the second to third quarter 2019[8]. This growth reversed a decline over the previous three years. In contrast, both the government and state-owned enterprises saw a fall in investment. This suggests that the government's efforts to promote private investment had enjoyed at least some initial success.

4. Sectorial and specific developments

4.1 Agriculture, Mining and Manufacturing

On the production front, lower output from mining and manufacturing bears testimony to difficult operating and trading conditions facing these two important sectors of the economy. Weak demand conditions domestically and increasingly challenging global markets, accompanied by higher costs of doing business (particularly due to electricity tariffs, among others) and, among other factors, policy-related concerns, have been affecting their production activity. Manufacturing output dropped by 3.8% in Q3 2019, implying a contraction of 0.2% (year-on-year) for the period January to September 2019.

The outlook for the manufacturing sector has also worsened, as evidenced by the decline in business confidence[9] to a reading of 16 points in Q3 – the lowest in 20 years. Manufacturers anticipate to invest less in machinery and equipment over the next 12 months, while worsening conditions globally underpin lower expectations regarding export sales. The poor performance of the mining sector has considerable implications for many supplying and supporting industries across the South African economy.

The production in South Africa's agricultural sector contracted by 3.6% quarter-on-quarter seasonally adjusted, which marks the third consecutive quarterly contraction. Indeed this would confirm much suspicion that the farming economy is in recession. In December 2019, the task team appointed by President Ramaphosa in 2018 to make recommendations around land reform, presented its report to

[6] Economic transformation, inclusive growth, and competitiveness: Towards an Economic Strategy for South Africa. 2019. National Treasury.
[7] Merchandise Trade Statistics. 2019. South African Revenue Services
[8] TIPS FDI Tracker. 2019
[9] Rand Merchant Bank Business Confidence Index. 2019

Parliament. The Presidential Advisory Panel on Land Reform and Agriculture came up with 73 recommendations on how to proceed, and in the end Cabinet adopted 60 of these recommendations. Land expropriation and restitution was one of the biggest election promises made by political parties. The next step is for an amendment to the property clause (Section 25) in the Bill of Rights, in the Constitution, so as to authorise 'expropriation without compensation' (EWC). What will emerge at a later stage is the Panel's inability to address the growing top of Climate Change and its meaning for land reform in South Africa.

4.2 Employment

The unemployment rate rose to an 11 year high- a new record of 29.1%, with 6.7 million people unable to find work in Q3 of 2019. All in all total employment remained virtually unchanged over the past year. The economy's labour-absorption capacity has declined over time. Contributing factors have included competitiveness pressures; skills shortages; technological change and other factors leading to increased mechanisation; and, among others, labour market related matters.

4.3 State Owned Enterprises (SOE's)

Eskom:

Eskom supplies 95% of the nation's power and has been without a permanent CEO since July, while failing to generate enough revenue to cover costs. The company has been allocated bailouts totaling 128 billion rand ($8.46 billion) over three years. Time proportionate government spending is running at the fastest rate in recent years – which in part reflects advance payments to Eskom.

Operational challenges and financial constraints at Eskom, higher electricity tariffs and declining demand in a low-growth environment have been affecting the performance of the electricity sector. The recently gazetted Integrated Resource Plan (IRP) 2019 provides clarity on South Africa's electricity requirements and how it will be supplied over the period up to 2030, indicating a more diversified energy mix with increasing contributions from renewable energy sources. Sustained, reliable and cost-effective energy supply is crucial for business planning, fixed investment decisions and overall economic growth.

The immediate priority is to stabilise the financial situation at Eskom, government has also been focusing on the structural reforms needed to ensure the long-term sustainability of this critical SOE. Key amongst these is the segmentation of Eskom into three different entities, namely power generation, transmission and distribution. With limited progress to date, the urgency of such reforms were spelled out in the MTBPS.

South African Airways (SAA):

In the first week of December 2019, South African Airways (SAA) was put into business rescue. Since 2017 the national carrier has not published its financial statements, however it is clear that the airline has struggled to keep its finances under constrain. The immediate reason for SAA's declining assets and rising liabilities was its failure to make a profit since 2011. While its costs were rising steadily, SAA's ability to attract passengers proved limited and therefore as part of the business rescue process, the budget will provide another ZAR4 billion to SAA in 2019. Ultimately, SAA exemplified a central problem with many of South Africa's SOE's.

5. Rating agencies' assessments

Ratings agencies have become increasingly concerned with South Africa's worsening fiscal metrics and poor growth performance, as well as with enormous risks posed by Eskom.

Two days after Finance Minister Mboweni unveiled his budget policy, Moody's made a call on South Africa's credit rating. The two big concerns for Moody's were slow growth, which has been causing debt to rise, and the power sector. Markets have largely priced in a downgrade, meaning that any short-term market move will most likely not cause sustained economic impact.

Both S&P Global Ratings and Fitch already have South African debt at sub-investment grade, colloquially labelled "junk," with Moody's the only major ratings agency yet to downgrade, with its rating currently sitting at "stable. In its most recent published note, Fitch decided to affirm South Africa's long-term foreign and local currency debt ratings at 'BB+' and maintain the negative outlook. Moody's kept the sovereign rating unchanged at Baa3 on 1 November 2019, as anticipated, it altered the outlook from "stable" to "negative". The agency has indicated that it requires more clarity on how government plans to address the widening budget deficit and the steep rise in debt.

6. International Economic Relations

6.1 Free Trade negotiations

SACU-EFTA

The 6th round of EFTA-SACU negotiations recently concluded in Botswana in December 2019. Prior to the meeting, the EFTA countries had reached out to their missions in SACU countries to assist in clarifying the deadlock around the chapter on sustainable development. The discussions allowed important clarifications in this area. The SACU countries for example, have made it clear that the current mandate does not allow them to fulfill the commitments requested by EFTA. In principle, they were open to trying to obtain an extension of the current mandate for the next meeting.

6.2 AfCFTA

The Agreement Establishing the African Continental Free Trade Agreement (AfCFTA) entered into force on 30 May 2019. The 22-country threshold in conformity with legal provisions was reached on 29 April 2019 when Sierra Leone and the Saharawi Republic deposited their instruments of ratification with the depositary. To date, 29 countries have both signed and ratified the AfCFTA Agreement. Of the 55 AU member states, only Eritrea has yet to sign. The operational phase of the AfCFTA was subsequently launched during the 12th Extraordinary Session of the Assembly of the African Union in Niamey, Niger on 7 July 2019. It has been indicated that the start of trading under the AfCFTA Agreement will begin on 1 July 2020.

7. Implications for Switzerland

The relatively weak outlook for South Africa's economic performance, especially over the short-term, is of concern. The economic downturn has been very prolonged and the signs of recovery in domestic demand (which affects investment decisions, production activity and job creation) are still quite weak. Over the short-term, companies that rely on the investment cycle for product off-take may find it challenging to sustain sales to public sector entities in light of cutbacks. The private sector is facing its own challenges due to weak demand, spare production capacity and low confidence. However, growth prospects should improve gradually on the back of structural reforms/initiatives led by government, including major reforms at key state-owned enterprises (SOEs). Business confidence should improve in the process, eventually translating into increased fixed investment spending. This should result in increased business opportunities over time. Some of these opportunities include: The recently released master plans for the automotive sector, the poultry industry and the clothing, textiles, leather and footwear industries; The recently gazetted Integrated Resource Plan 2019, which will open the way for considerable investments in renewable energy generation (particularly wind power) and related components manufacturing; The pipeline of fixed investment projects announced at the South Africa Investment Conference hosted by President Ramaphosa in November 2019; The imminent release of high-demand broadband spectrum, which will lower data costs and attract investment activity; and, among others.