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ITRANSACT ECONOMIC OUTLOOK

SOUTH AFRICA'S ECONOMY FURTHER DERAILED BY ESKOM IN 2019, BUT NEW DEVELOPMENTS IN ENERGY POLICY COULD REDUCE ESKOM'S NEGATIVE IMPACT

CONTENTS

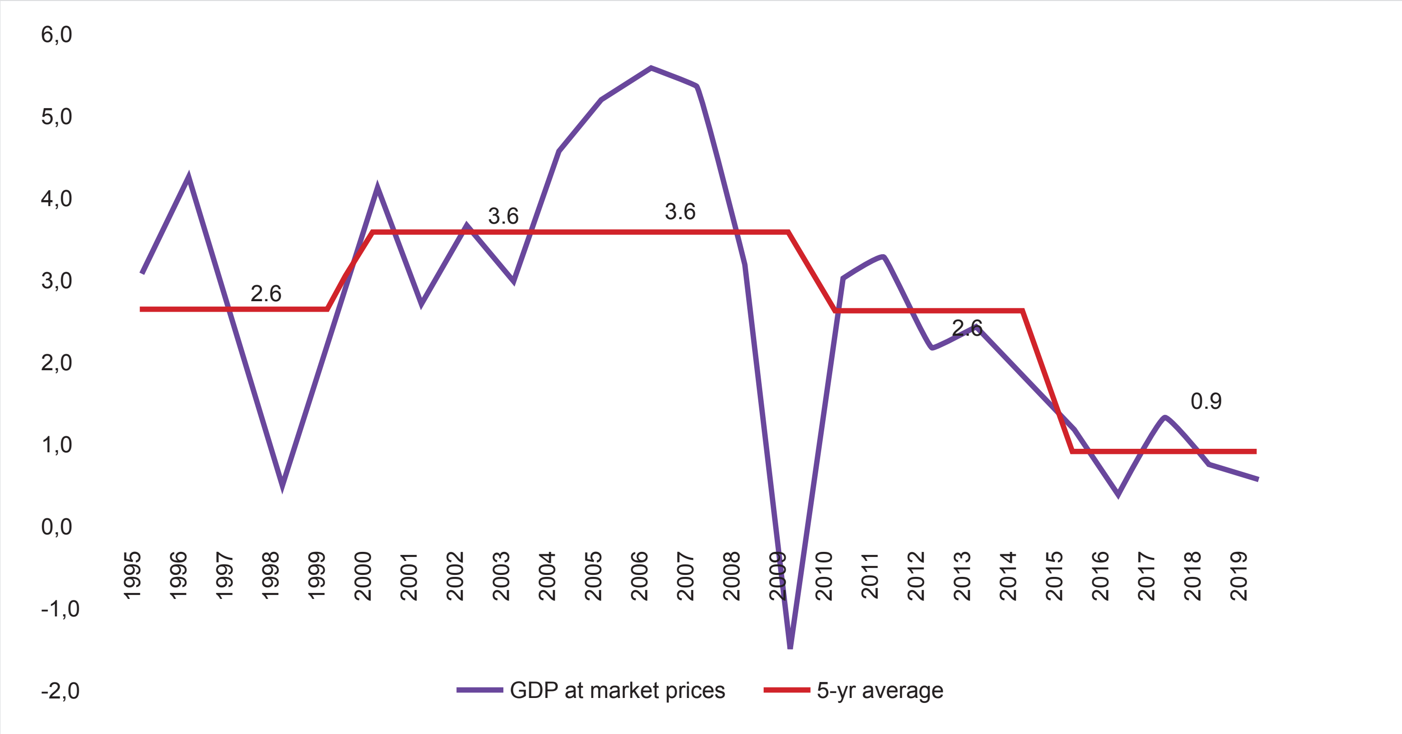
SUMMARY AND ASSUMPTIONS

- **South Africa's growth:** The last decade was very challenging for the South African economy in a myriad of ways, including growth. The mismanaged economy, along with the resultant insipid growth, lead to a deterioration of South Africa's macroeconomic fundamentals. What's more, both the supply side and demand side of the economy point to limited recovery of GDP growth momentum during the fourth quarter of 2019, and we expect GDP growth for 2019 as a whole to come in even lower than 2018's growth and to record only 0.4%.
- **Energy:** Eskom has played a major role in crippling the South African economy as its supply of electricity has often failed to meet the country's demands, while at the same time it has bled government finances. Nonetheless, there have been new developments in electricity policy, and these changes have the potential to alleviate some of the burden that has been placed on the South African economy by Eskom's rolling electricity cuts in the medium term. These are the possible creation of a new power generation entity separate from Eskom, as well as government permitting mining companies to produce energy for own use.
- **Investment:** Gross fixed capital formation somewhat showed signs of recovery in 2019, while President Ramaphosa's second investment drive was seen as a success. Even so, the country needs much more investment in order to exit its current growth slump, and for this to happen, there needs to be a marked improvement in confidence.
- **Unemployment:** Following a new high of 29% in the second quarter of 2019, South Africa's unemployment rate rose even higher and reached 29.1% during the third quarter, and the country's alarming unemployment rate is likely to worsen further until the economy starts growing meaningfully.
- **Interest rates:** The South African Reserve Bank cut the benchmark interest rate by another 25 basis points in January 2020, following the 25 bps cut of July 2019. We do not expect the Bank to cut rates during the Monetary Policy Committee's (MPC) forthcoming meeting from March 17th – 19th as this will be before Moody's next scheduled assessment of SA's sovereign credit on March 27th.
- **Fiscus:** Budget 2020 presentation will take place on Feb. 26th, and is expected to paint a picture of a fiscus that has deteriorated further, relative to Budget 2019.

The last decade was very challenging for the South African economy

There can be little disagreement that the last decade was very challenging for the South African economy in a myriad of ways, including growth. Graph 1 depicts GDP growth between 1995 (i.e. one year following democracy) and 2019, together with 5-year average growth rates. The Graph shows that the five-year average growth rate was 2.6% during 1995-1999, which improved to 3.6% for 2000-2004 and 2005-2009. But the five-year period following the great recession of 2008/09 saw the average growth rate moderating back to 2.6%, while the past five years saw the average growth in real GDP dipping to a meager 0.9% as the South African economy buckled under poor governance and policy uncertainty.

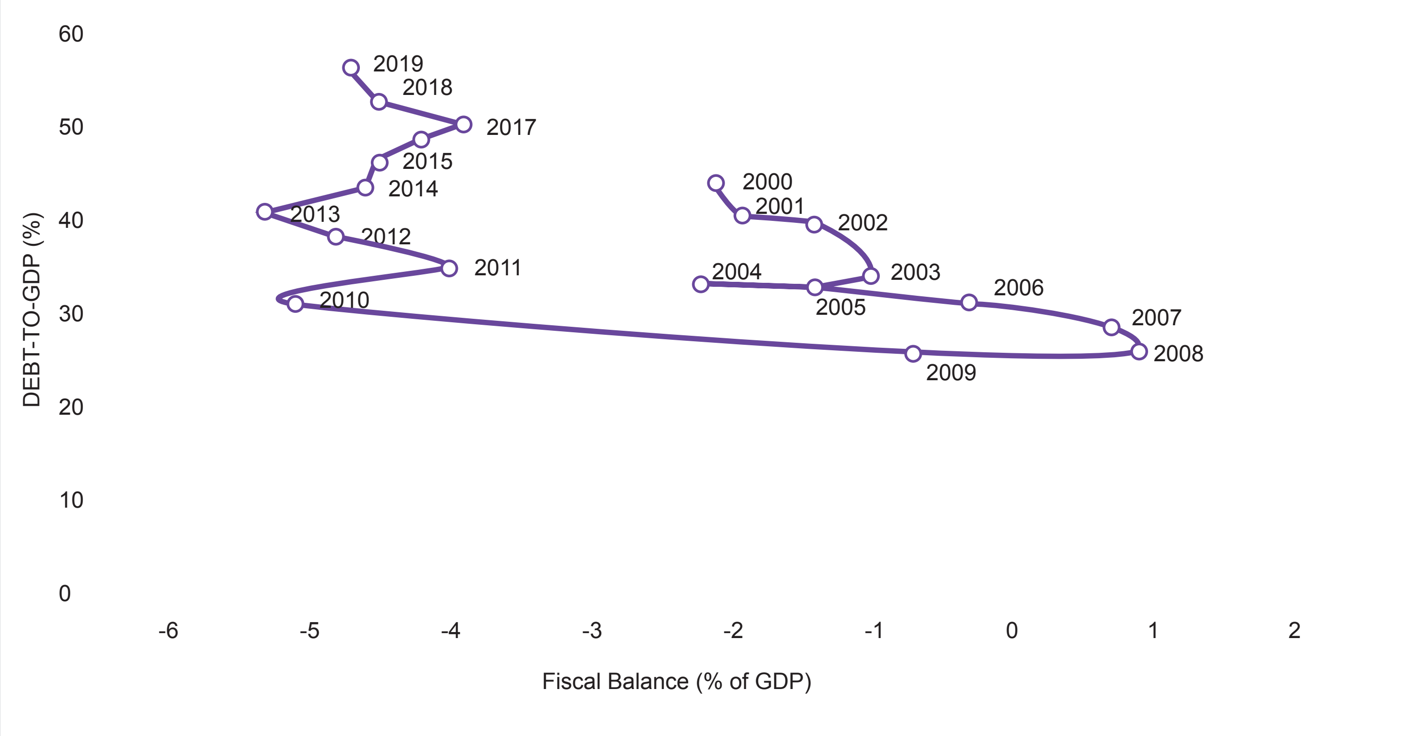
Graph 1: Real GDP growth, 1995 - 2019



Source: SARB and PAIRS
Note: * Estimate

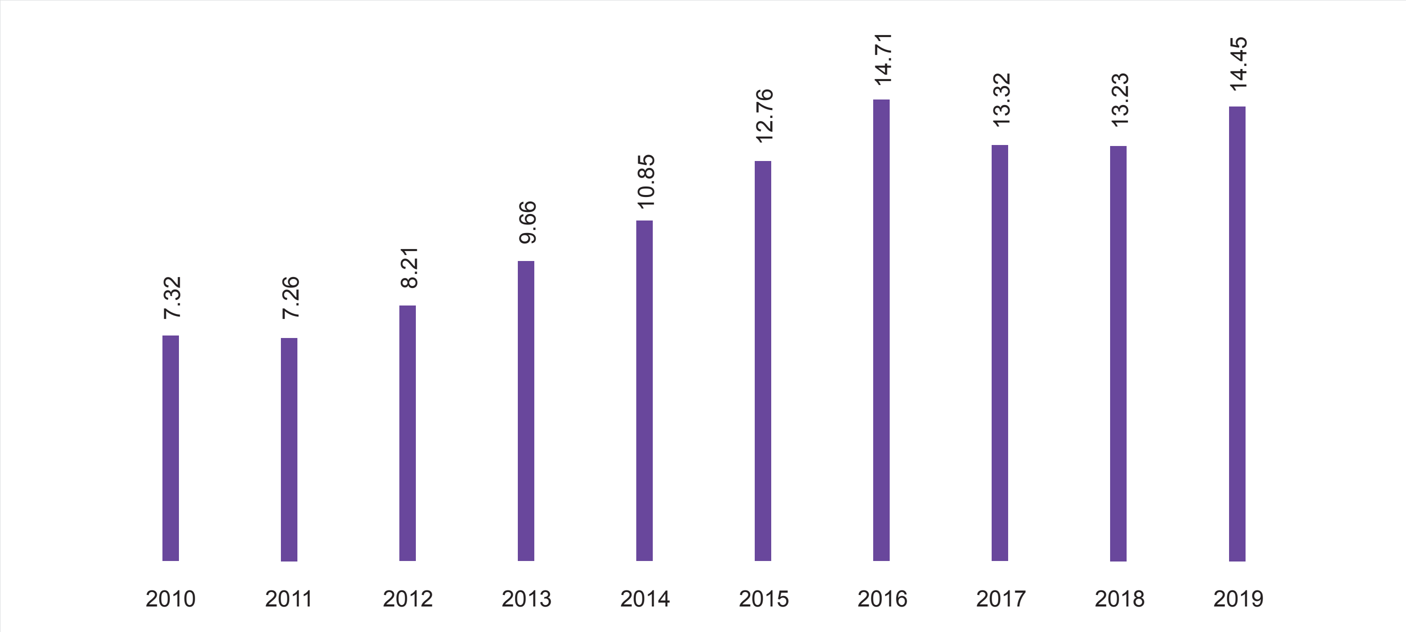
The mismanaged economy, along with the resultant insipid economic growth, lead to a deterioration of South Africa's macroeconomic fundamentals; government finance weakened leading to a compromised fiscal space, while there was also a significant depreciation of the South African currency. These are depicted in Graphs 2 and 3. Government deficit was only 0.7% of GDP and government debt-to-GDP ratio was just 26% in 2009, but these jumped to 5.1% and 31.6% in 2010, respectively, and by 2019 government deficit as a percentage of GDP was still high at 4.7% while government debt-to-GDP was at an astounding 56.7%. At the same time, the rand depreciated by approximately 49% against the US dollar, going from around 7.32 in 2010 to around 14.45 in 2019.

Graph 2: Fiscal space, 2000 - 2019



Source: SARB
Note: Fiscal years

Graph 3: South African exchange rate against the US dollar, 2010 - 2019



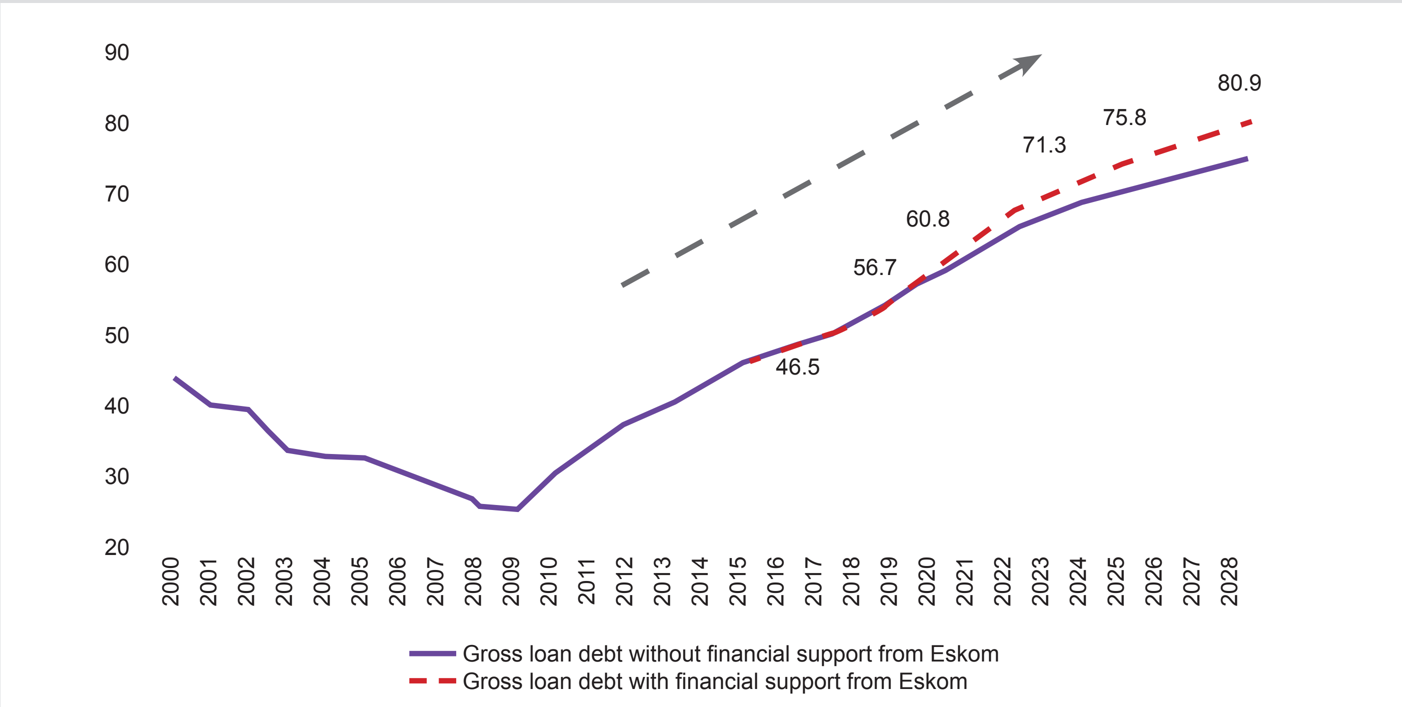
Source: IMF, SARB and PAIRS

The issues caused by state owned entities (SOEs), particularly Eskom, also escalated during the past decade. Eskom's financial, operational and governance problems intensified, which resulted in the entity becoming a major burden on the fiscus as well as the economy.

For starters, due to its financial paralysis, government has had to constantly bailout Eskom. Meanwhile it has played a major role in crippling the South African economy as its supply of electricity has often failed to meet the country's demands and has frequently implemented rolling power cuts notoriously known as "load shedding". It is important to note that Eskom still supplies the majority of the country's electricity; over 90%. It is therefore not surprising that the most 'Googled' word in South Africa in the last decade was 'load-shedding', testament to the profound impact it had on the entire economy during the period.

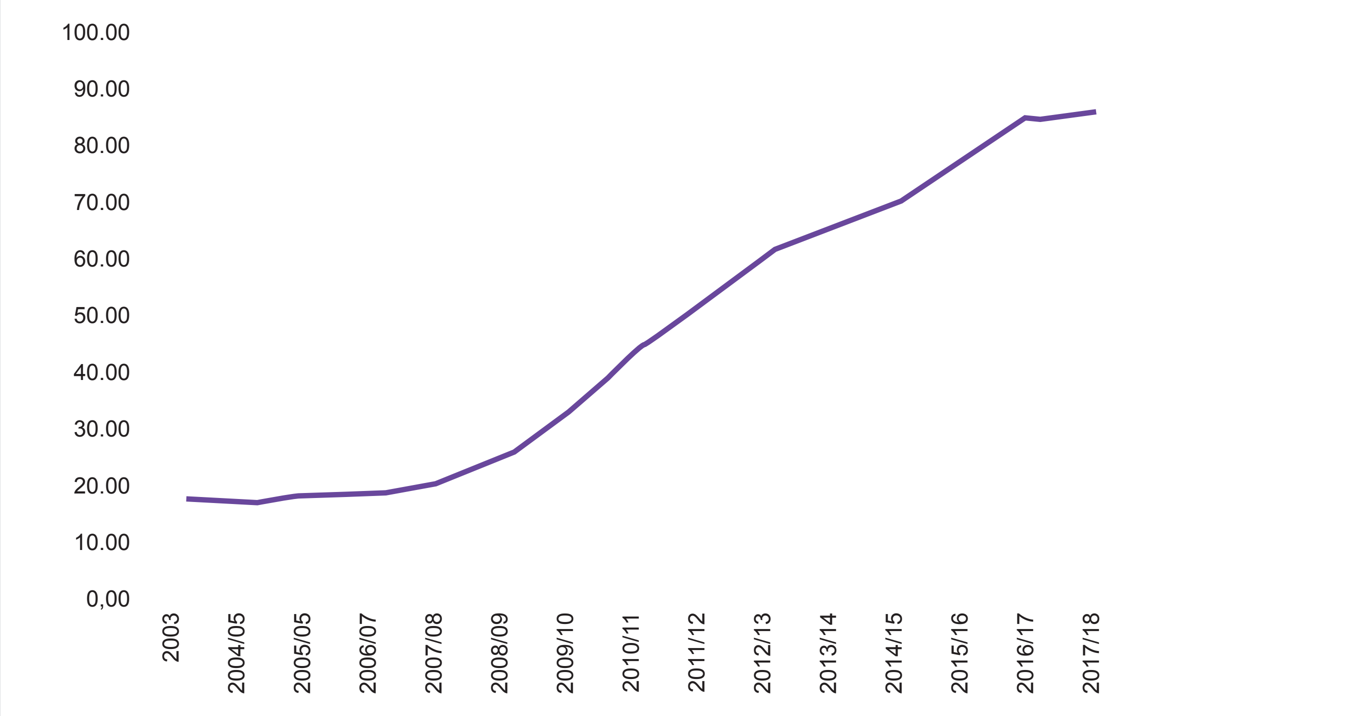
Graph 4 below shows South Africa's debt-to-GDP ratio, and it goes further by showing the projected debt trajectory with and without government support for the utility. In the coming fiscal year (2020/21) for instance, not only is the projected debt-to-GDP higher than Budget 2019 estimates, but support to Eskom takes up the debt-to-GDP ratio even higher by 2.1 percentage points. At the same time, electricity prices have increased steeply since the first electricity crisis that took place in late 2007, which has placed an added burden on both businesses and consumers. The periods 2008/09, 2009/10 and 2010/11 saw electricity tariffs increasing by approximately 29%, 30% and 32%, respectively. See Graph 5. Going forward, Eskom continues to pose major risks for the economy, even the World Bank has recently lowered South Africa's 2020 GDP growth forecast to 0.9% largely due to the electricity supply constraints .

Graph 4: Government debt as a percentage of GDP and outlook, 2000 – 2028



Source: National Treasury and PAIRS
Note: fiscal years

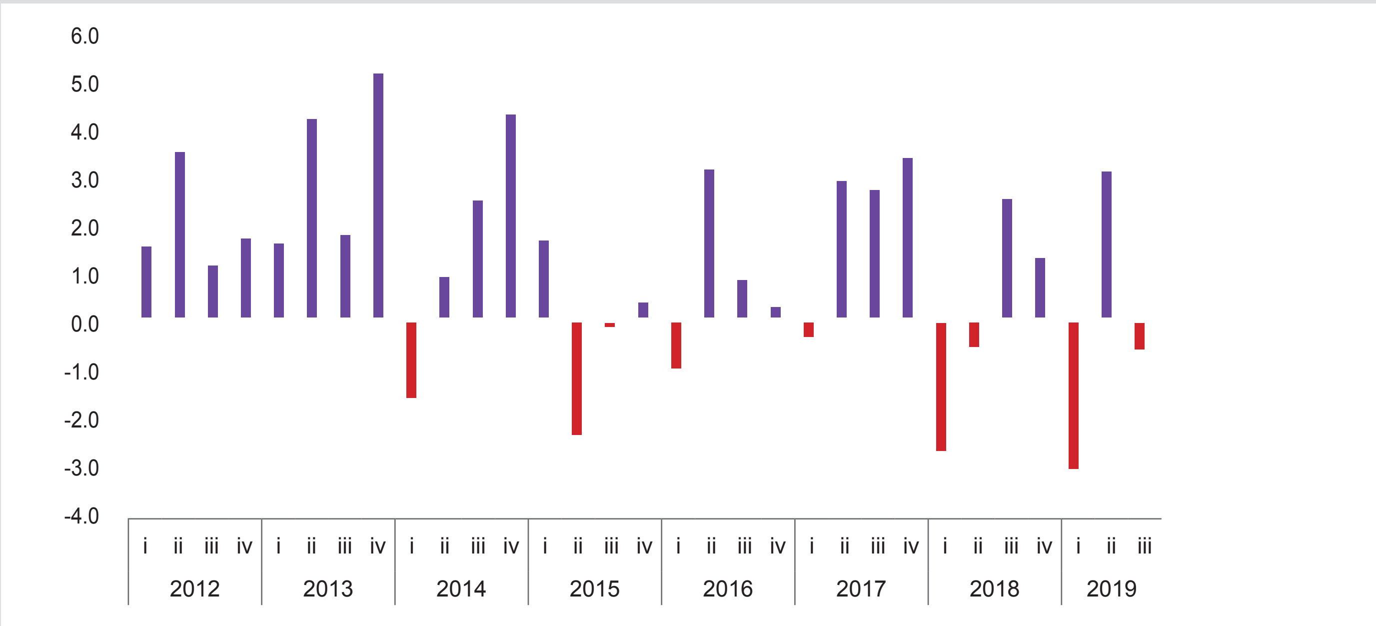
Graph 5: Eskom electricity average standard tariff price, 2003 – 2017/18



Source: Eskom and PAIRS
Note: Excludes negotiated pricing agreement and international customers

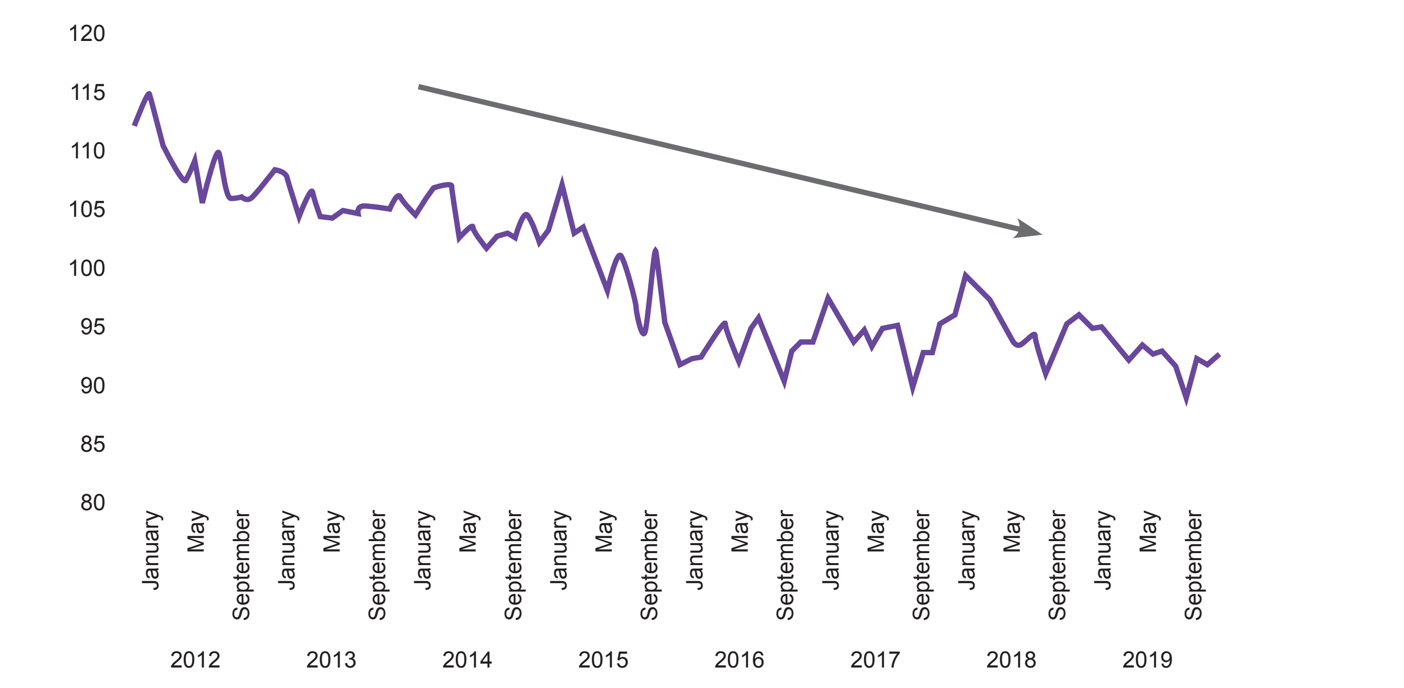
The South African economy's performance disappointed once again during the third quarter of 2019, with economic real GDP growth recording -0.6% q/q. This was following a rebound in economic growth of 3.2% after the first quarter contraction of 3.1% (Graph 6). The Q3 real GDP contraction took place amid persisting low confidence (Graph 7) in the economy, fueled largely by the inadequate and highly unreliable electricity supply by Eskom.

Graph 6: Real quarterly GDP growth, Q1 2012 – Q3 2019



Source: Stats SA
Note: saar

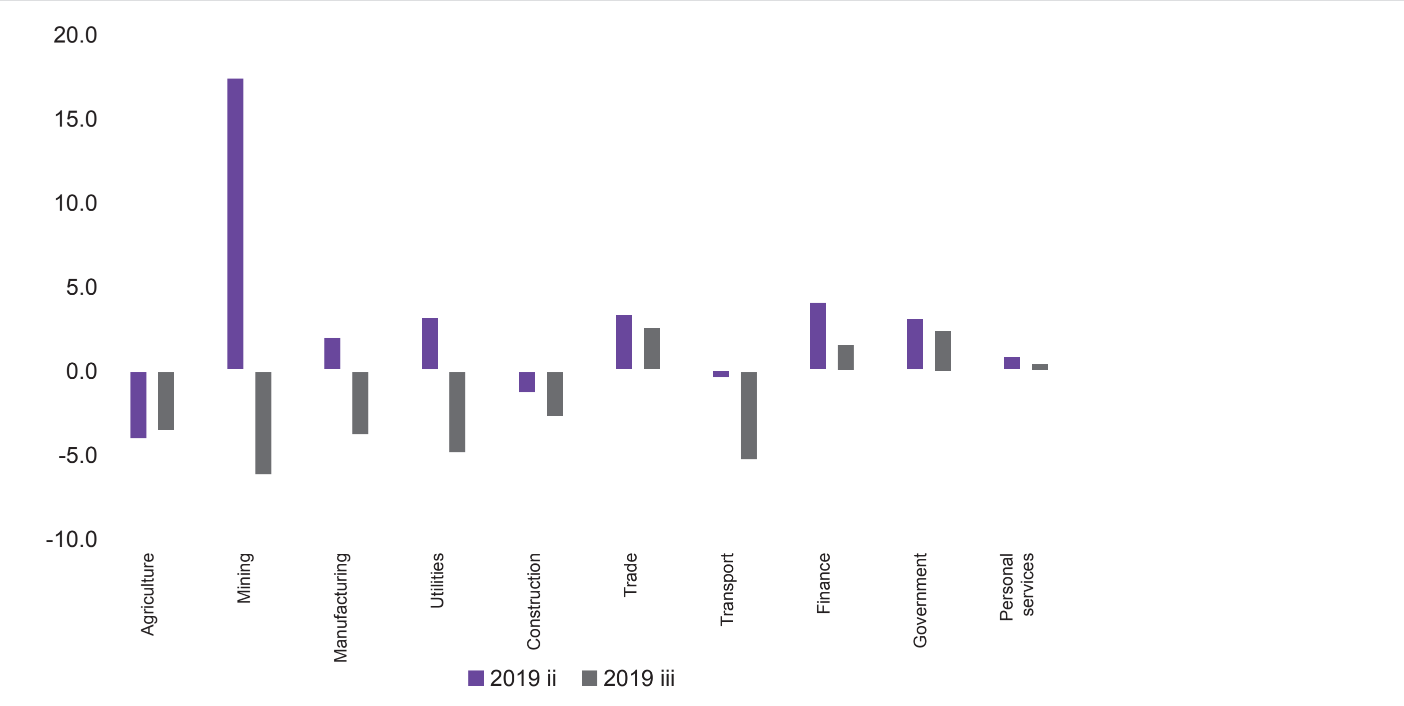
Graph 7: Business confidence index, 2012 - 2019



Source: SACCI

Activity was very much subdued throughout the economy during the third quarter of 2019, with only 4 out of 10 sectors having recorded positive growth rates, and these were all lower than their second quarter growth rates. These were trade (wholesale, retail and motor trade; catering and accommodation), finance (finance, real estate and business services), government and personal services, with trade registering the highest growth rate for the quarter at 2.6%. On the other hand, three of the main sectors have been in a technical recession for at least the second quarter as they have experienced contractions from at least Q1 2019, and these are agriculture (agriculture, forestry and fishing), construction and transport (transport, storage and communication).

Graph 8: Real quarterly GDP growth by industry, Q2 2019 – Q3 2019



Source: Stats SA and PAIRS
Note: saar

Since the beginning of 2018, the mining sector only grew positively during Q2 2019 by 17.4%, which was followed by a contraction of 6.1% in the third quarter. The overall decline was due mostly to contractions in the production of platinum group metals (PGMs), coal, iron ore and other metallic metals. The lackluster performance of the sector has been the result of rising operating costs including electricity costs (see Graph 5) as well as the decelerating global economic growth, along with declines in prices of a number of SA export commodities.

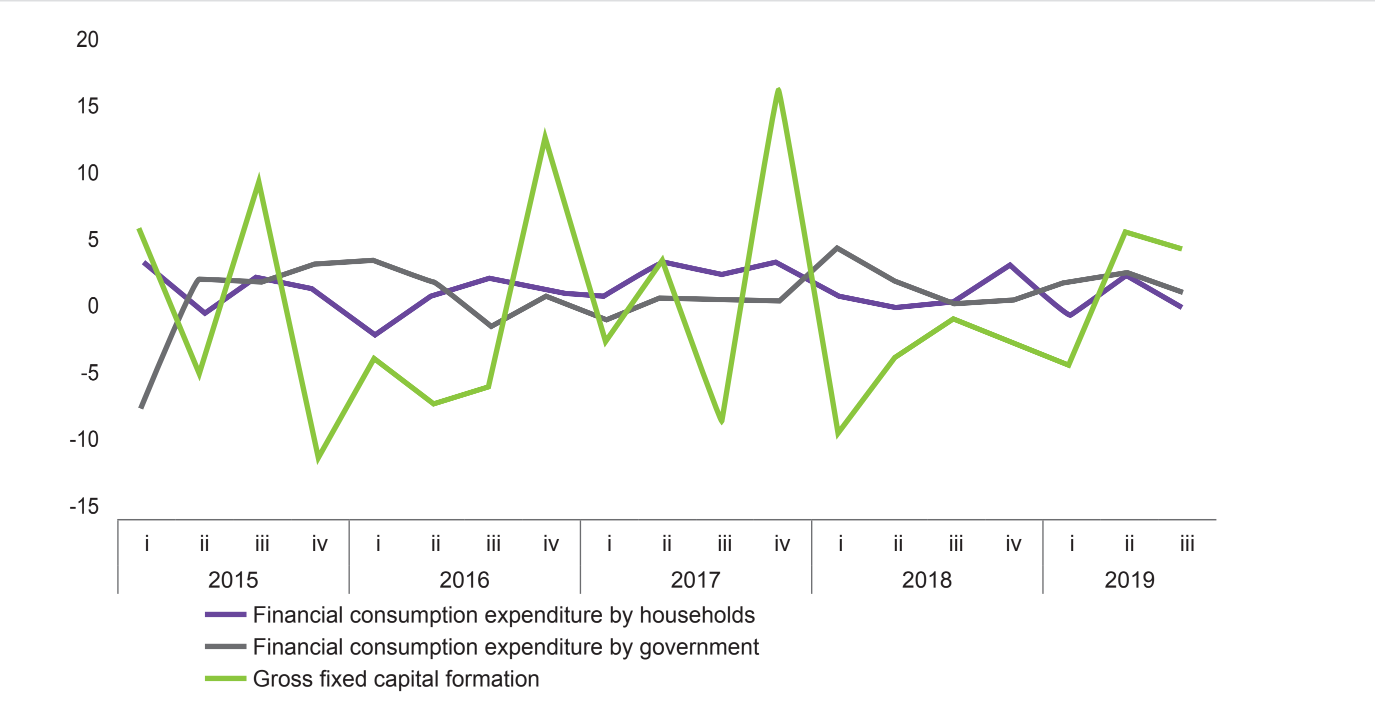
Nonetheless, production of gold, diamonds and other non-metallic minerals increased during the third quarter. The continued rise in gold production can be attributed to the further normalization of production following the end of the protracted industrial action at Sibanye-Stillwater's gold mines earlier in 2019. It is also worth noting that the Association of Mineworkers and Construction Union (Amcu) penned a three-year deal with the country's largest platinum producers towards end-2019 following lengthy negotiations, all without any industrial action. Still, intense load shedding that plagued the country during the fourth quarter negatively impacted the energy intensive mining sector. Following an increase of 1.7% m/m during October 2019, mining production contracted by 3.5% m/m in November 2019.

Production in the manufacturing sector declined by 3.9% during the third quarter of 2019 following an increase of 2.1% in the second quarter. Muted demand in the economy is largely to blame for the sector's poor performance. For one, the seasonally adjusted utilization of production capacity in the sector experienced a significant decline from 81.7% in February 2019 to 80.4% in August, with insufficient demand being the key reason for the underutilization.

High frequency manufacturing data does not suggest a much better outcome for the manufacturing sector for the fourth quarter of 2019. Despite recovering in October 2019 to record a growth rate of 2.5% m/m, production in the sector declined by 1.5% m/m in November 2019. Furthermore, PMI dipped further into the contractionary territory in December 2019 as it moderated to 47.1 index points from the 47.7 points recorded in November 2019. This then suggests that manufacturing's performance remained insipid during the last month of the year, and therefore for the fourth quarter as whole as well.

Domestic demand was also subdued during the third quarter of 2019 and it moderated to 1.2% from a growth rate of 3.2% in the second quarter. This was the result of final consumption expenditure by households declining from 2.6% to 0.2%, final consumption expenditure by general government decreasing from 2.8% to 1.3%, while gross fixed capital formation also moderated from 5.8% to 4.5%.

Graph 9: Quarterly growth in domestic demand, Q1 2015 – Q3 2019



Source: SARB and PAIRS

Retail sales made a fairly strong recovery during November 2019 as they recorded a growth rate of 3.1% m/m following the 0.1% m/m registered in October 2019. Looking at the historic data for retail sales, it appears that November tends to be a relatively strong month for retail sales. November, after all, is the month of 'Black Friday' deals. This effect is mostly apparent in the surge in sales of typically popular Black Friday retail items such as 'textiles and clothing', 'furniture and appliances', as well as items sold by 'general dealers' as indicated in Table 1 below. Following November Black Friday sales, the December retail sales in contrast have typically been weak, with these experiencing contractions since 2016. Monthly vehicle sales on the other hand only increased in October 2019 (5.7% m/m), and contracted in both November and December 2019, by 13.9% m/m and 6.8% m/m respectively. All these suggest that overall expenditure was still somewhat contained during the fourth quarter of 2019.

Table 1: Retail Sales, Nov 2018 – Nov 2019

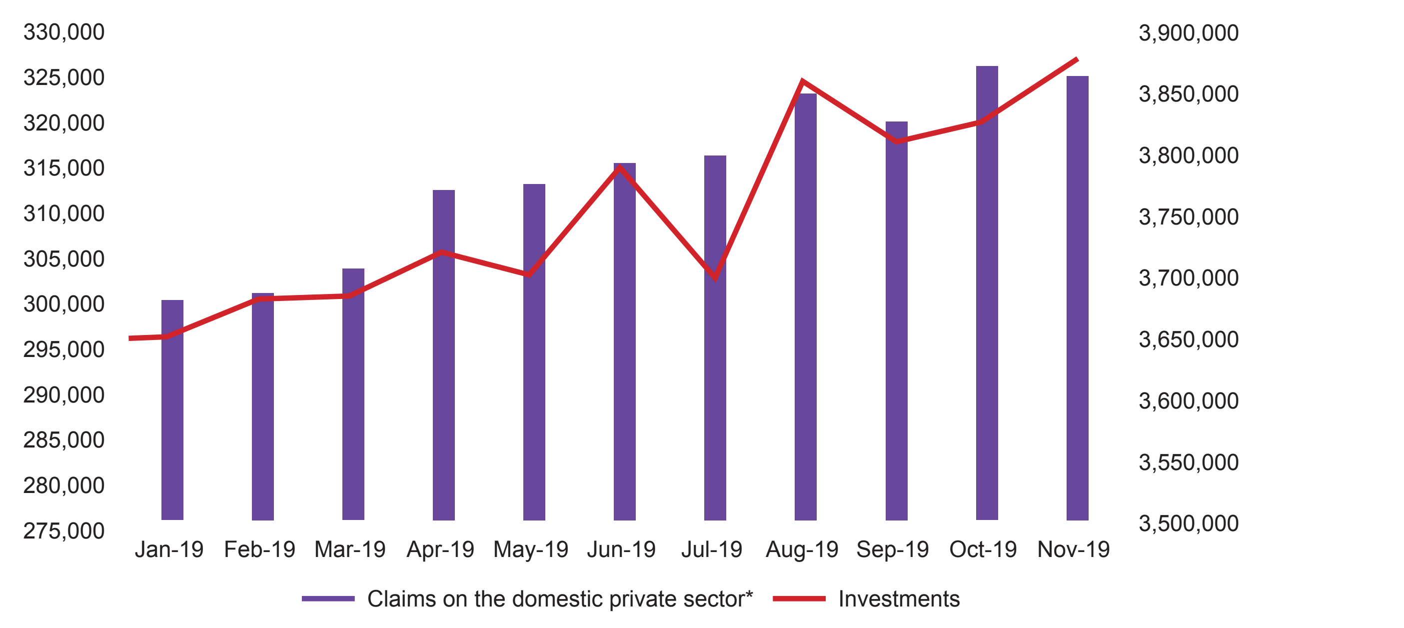
Retailer Type	Nov-18		Oct-19		Nov-19	
	Annual % change	Monthly % change	Annual % change	Monthly % change	Annual % change	Monthly % change
General dealers	2.2	20.9	0.7	-7.2	3.2	23.9
Specialised: Food, beverages, tobacco	-1.2	0.8	4.8	10.0	6.2	2.1
Pharmaceuticals, cosmetics, toiletries	2.2	-5.8	-0.6	8.2	-1.9	-7.0
Textiles, clothing	5.1	29.4	-0.6	9.9	2.7	33.7
Furniture, appliances	13.2	23.6	3.0	9.3	3.2	23.9
Hardware	-1.7	7.5	-2.8	9.4	0.4	11.0
Other	3.4	3.7	0.1	6.6	1.5	5.2
Total	2.8	2.8	0.4	0.1	2.6	3.1

Source: Stats SA

As for investments, although total credit to the private sector moderated slightly in November after increasing in October, credit for investment purposes increased in both October and November 2019. This suggests further positive growth in investment during the fourth quarter of 2019. Again, President Ramaphosa's second investment summit (that forms part of his investment drive) held in November 2019 was another success, with R363 billion confirmed investment pledges. These are likely to act as tailwinds to the ailing economy.

Still, both the supply and demand side of the economy point to limited recovery of GDP growth during the fourth quarter of 2019, and we expect GDP growth for 2019 as a whole to come in even lower than 2018's growth (0.8%) and to record only 0.4%.

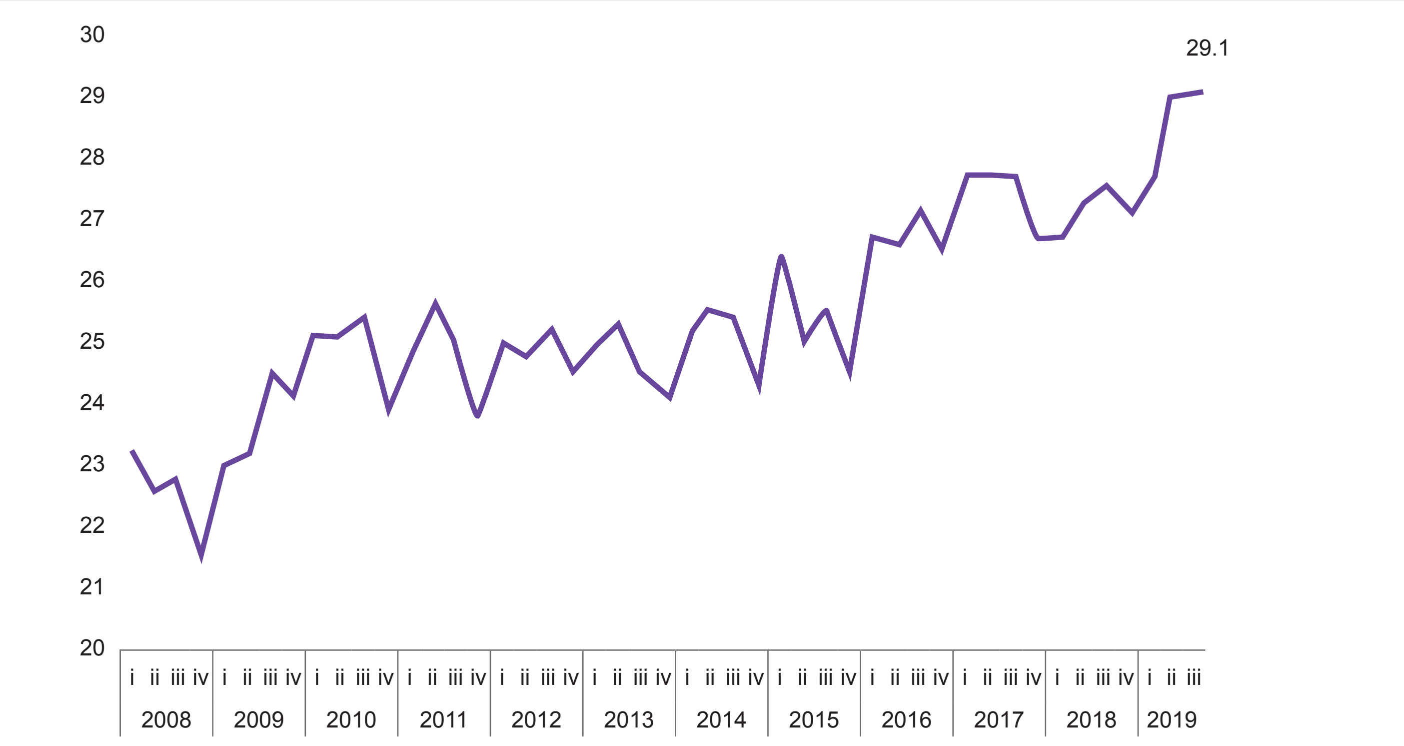
Graph 10: Credit to the private sector, 1994 - 2018



Source: SARB and PAIRS
Note: *seasonally adjusted

Following a new high of 29% in the second quarter of 2019, South Africa's unemployment rate increased further and reached 29.1% during the third quarter. The rise in the unemployment rate came about as the number of employed people went up by 62 000 while that of unemployed persons increased by 78 000. Despite their gross value added declining in the third quarter, both agriculture and mining each added 38 000 jobs, while manufacturing subtracted 30 000 jobs, and as can be expected in its current state. Construction too shed jobs amounting to 24 000 during the quarter. Ultimately, South Africa's unemployment rate is going to remain elevated until the economy starts growing meaningfully.

Graph 11: Unemployment rate, Q1 2008 – Q3 2019



Source: Stats SA and PAIRS

There have been new developments in electricity policy, and these changes have the potential to alleviate some of the burden that has been placed on the South African economy by Eskom's rolling electricity cuts in the medium term. The first major one is the announcement by Minister of Mineral Resources Gwede Mantashe that government has plans to create a new power generation entity separate from Eskom. He indicated that in order to establish the entity, government had invited investors to either partner with government, or otherwise invest on their own for its creation. Nonetheless, he indicated that ideally, the project should be a partnership between government and private investors. Furthermore, he communicated that the new entity should make use of a range of technologies, including solar, gas, as well as clean coal. Ultimately, Minister Mantashe indicated that the project will largely depend on the interest of investors.

The second announcement by Minister Mantashe during the annual Investing in Africa Mining Indaba is that government has conceded to allowing mining companies to produce energy for own use. And to do this, mining companies will not need licensing. He stated that the plan was to get the country back to having energy surpluses, that would also push down the price of electricity. The announcement has been welcomed by the mining sector, with the CEO of Minerals Council of South Africa also indicating that mining companies have approximately 1.5GW of projects that could be

operational in the coming three years. This is going to have significant positive impact on the mining sector, one that is highly energy intensive, and has been greatly constrained by Eskom's inability to supply adequate energy for its needs.

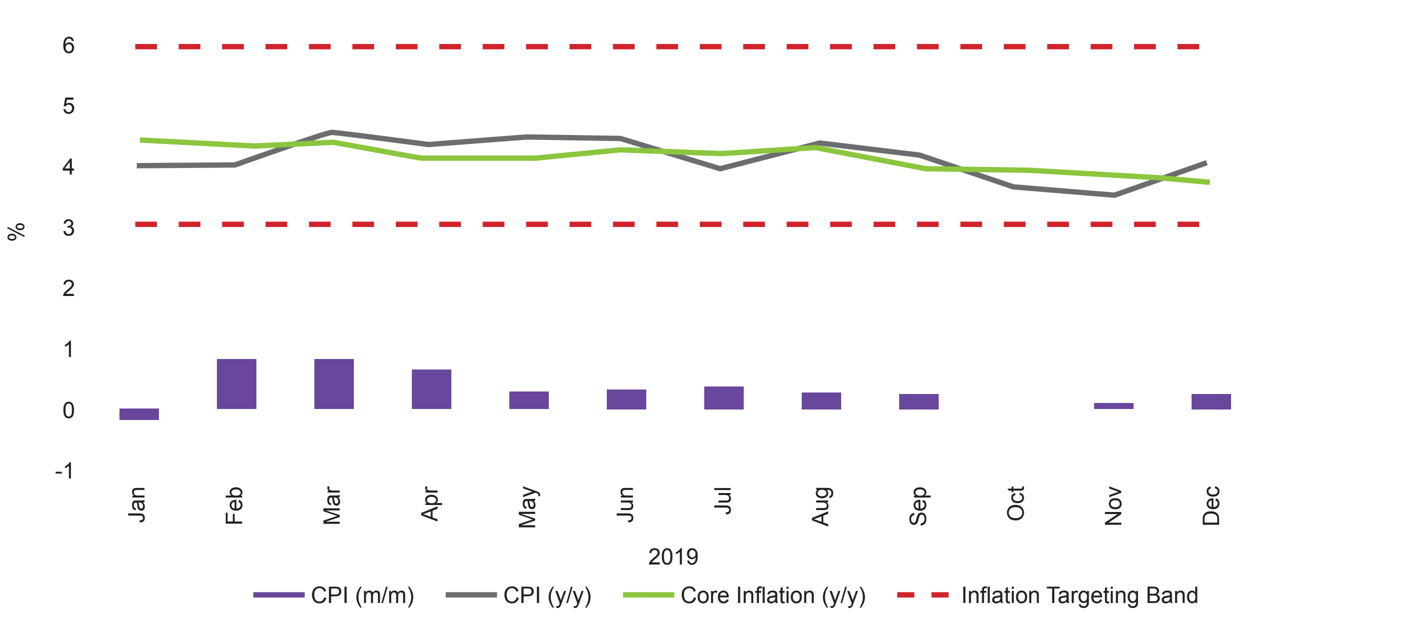
PRICES, INTEREST RATES AND EXCHANGE RATES

The South African Reserve Bank (SARB) cut the benchmark interest rate by another 25 basis points in January 2020, following the 25 bps cut of July 2019. The rate cut came on the back of a unanimous decision by the Bank's Monetary Policy Committee (MPC) amid months of contained inflation metrices.

Consumer inflation accelerated to 4% y/y in December 2019 after it reached a trough of 3.6% y/y for the year in November 2019. The Reserve Bank's target range for inflation is 3 – 6%, hence the range's mid-point is 4.5%, and Governor Kganyago has often communicated a preference to keeping the country's inflation rate around this mid-point. Indeed, the Bank managed this goal in 2019, with consumer inflation averaging 4.1% for 2019 as a whole (0.6 percentage points lower than it was in 2018), while the highest rate recorded for the year was 4.5%. We believe one of the key reasons the SARB was able to pull this off (i.e. on top of the low inflationary pressures) was the fact that the Reserve Bank's credibility still held following the political spat over its mandate as well as its independence (initiated by some within the ANC) seemingly came to an end during the 2019 State of the Nation address in June. The President put the matter to rest when he reaffirmed the Constitutional mandate of the SARB, saying the Bank should "pursue (its mandate) independently, without fear, favour or prejudice".

In 2019, demand-pull inflation remained muted as consumer spending was contained amid low domestic demand, while cost-push inflation mostly drove price increases throughout the year. For instance, Eskom managed to secure a 13.87% and a 15.63% average electricity price increase on its direct customers and on municipalities (both way above the inflation rate), respectively from the national energy regulator of South Africa (NERSA), that was implemented in April 2019. The compromised government revenue that has been the key factor in current poor government finances, are likely to result in increased taxes, particularly indirect taxes, during Budget 2020 to be presented on Feb. 26th.

Graph 12: CPI and core inflation, Jan 2019 – Dec 2019

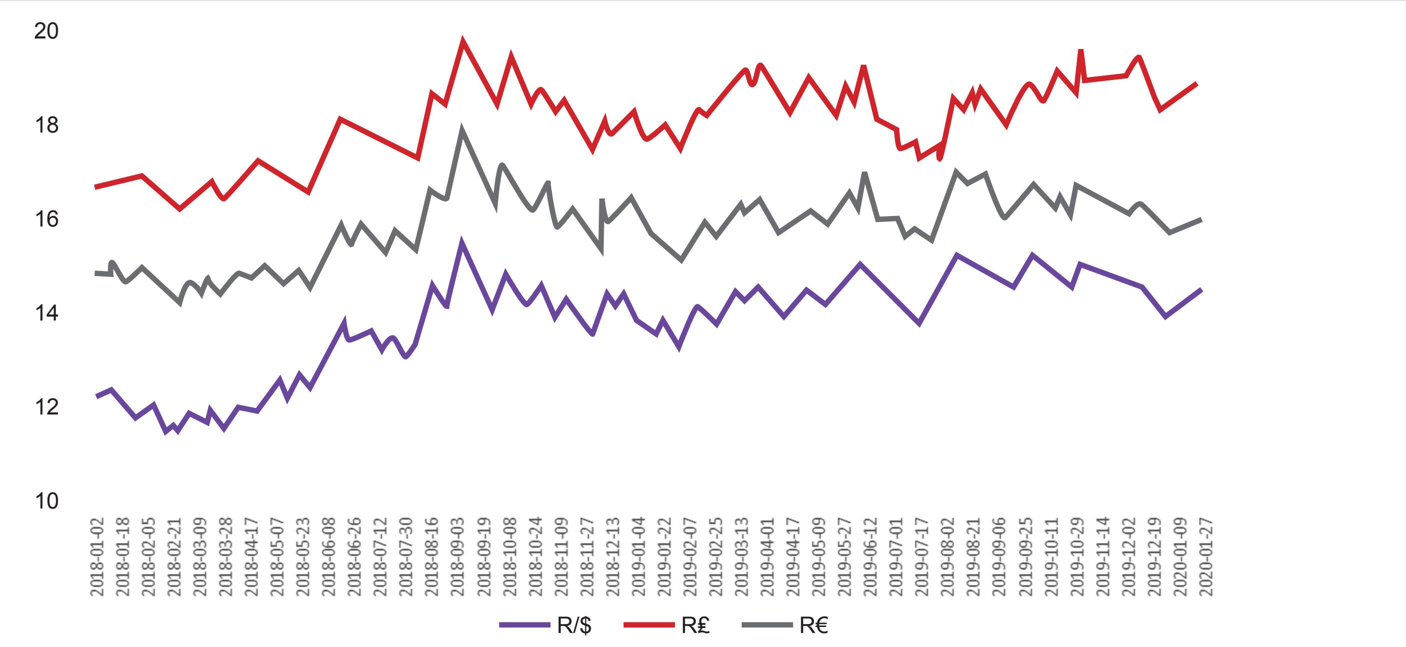


Source: Stats SA and PAIRS

Throughout 2019, the rand was mostly volatile as country specific factors such as low growth, the weak fiscus, policy uncertainty, and the uncertainty brought on by general elections took their toll on the South African exchange rate. In addition to the intrinsic factors, external influences, particularly those affecting emerging markets, also had an impact on the rand. In particular, the rand weakened significantly around August 2019 as the trade disputes between the US and China continued to weigh on sentiment and trade, while at the same time global activity waned – these caused marked depreciation in a number of emerging market currencies including the rand. Nonetheless, the US Fed cut rates thrice during the year that saw more monetary policy accommodation by most major developed economies' central banks, keeping some pressure off emerging markets as they benefited from the search for yield.

The greatest upside risk to the inflation outlook arises from Moody's upcoming assessments of the country's credit in March and November 2020. The probability of Moody's downgrading SA's sovereign credit rating to junk status is elevated, and should this be the outcome, large amounts of capital outflows are likely to hit the rand hard, depending on the pace of capital outflows.

Graph 13: The South African exchange rate, Jan 2018 – Jan 2020



Source: SARB and PAIRS

Baring strong shocks (such as the capital outflow shocks in the possible event of a credit rating downgrade by Moody's), South Africa's inflation will remain relatively muted. The SARB has indicated that it has revised down its medium-term inflation outlook compared to end-2019, with inflation forecast generated by its Quarterly Projection Model (QPM) averaging 4.7% for 2020, a downward revision from 5.1%, and averaging 4.6% for 2021. Even inflation expectations have been moderating, with expectations for 2020 averaging 4.8% from 5.0%, according to Bureau for Economic Research (BER) fourth quarter survey. At the same time, the SARB communicated that (as it was announcing the latest rate cut), although it would like to see inflation expectations anchored closer to 4.5%, i.e. the inflation target range mid-point, the lower inflation forecast together with the improved risk profile opened space for further monetary policy accommodation. Hence, without significant shocks to inflation, we see another interest cut before the end of 2020, especially given the country's persistent low growth environment.

FISCAL AND EXTERNAL ACCOUNTS

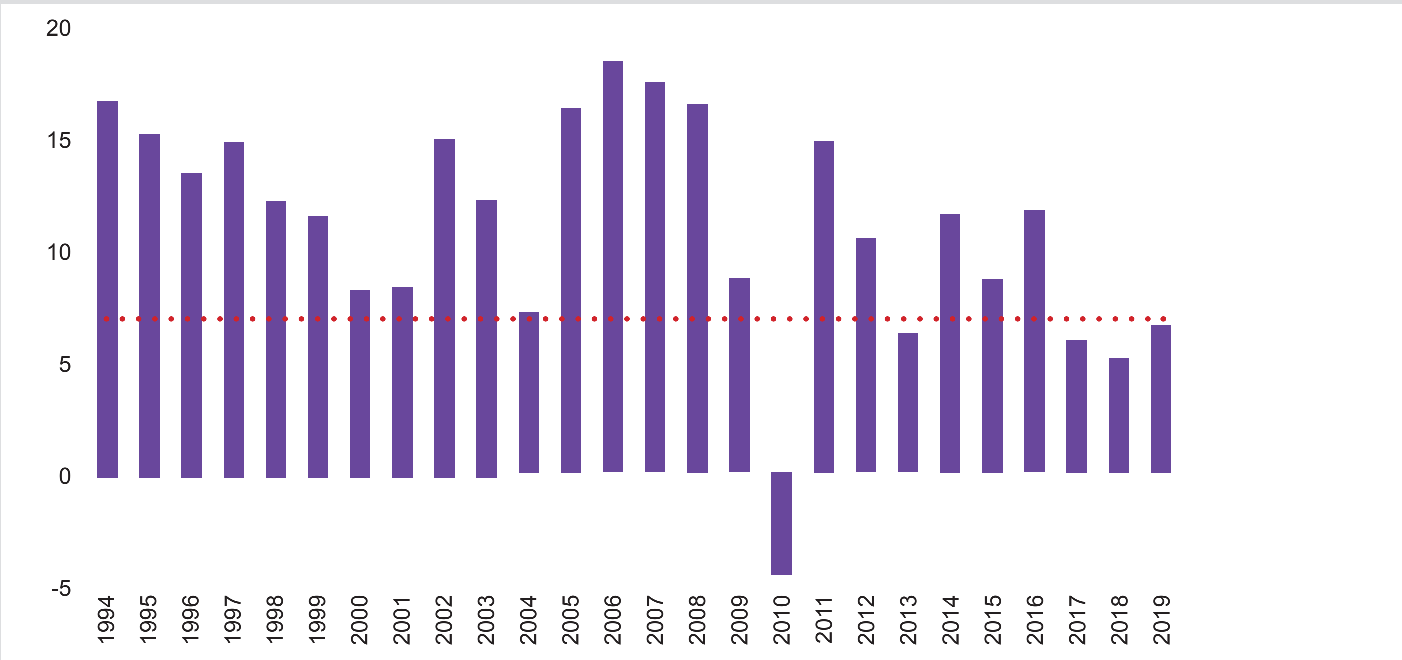
The Fiscus

Budget 2020 presentation is less than a month away (Feb. 26th) and is expected to paint a picture of a fiscus that has deteriorated further relative to Budget 2019. On top of the financial pressures emanating from SOEs, the other key factor in South Africa's strained government finances has been government's inability to collect adequate revenue, while simultaneously struggling to contain expenditure.

The Medium Term Budget Policy Statement (MTBPS) (Oct. 2019) revised the consolidated government revenue down by R46 billion for fiscal year 2019/20, and by R231 billion in the medium term - all relative to Budget 2019. The downward revisions mainly come on the back of downwardly adjusted estimates for GDP growth. During Budget 2019, GDP growth for 2019 was expected to rise from 2018's growth (0.8%) to 1.5%, but this forecast was downgraded to 0.5% during the MTBPS. Similarly, 2020's GDP growth forecast was adjusted downwards from 2.1% to 1.2%. Furthermore, the South African Revenue Service (SARS), indicated that largely due to the lackluster economic growth, in 2017, almost 50% (48.3%) of SA companies had taxable income equaling zero, while 27.4% reported a loss, and only 24.3% had positive taxable income.

Inefficiencies as well as structural weaknesses have also been reported as also playing a large role in revenue under collection. With the changes in management in 2019 aimed at improving governance, it is likely that SARS will, in time become more efficient and effective in collecting tax revenue. For instance, the Davis tax committee that is also investigating the country's tax gap has indicated that it is estimated the country lost over $3 billion in tax revenue related to exports and imports in 2016, while around R7 billion is lost annually on account of base erosion as well as profit shifting, whereas VAT (value added tax) fraud and tax evasion by high net worth individuals is also costing SA billions in revenue. Nonetheless, the committee has communicated that SARS is making a turnaround.

Graph 14: Growth in total national government revenue, 1994 – 2019



Source: SARB
Note: fiscal years

In contrast, consolidated government expenditure is expected to further increase, with an upward adjustment of R17.5 billion for the 2019/20 fiscal year. This upward revision to the expenditure can largely be attributed to the additional support for Eskom of R26 billion, as well as R11 billion to other SOEs. A consequence of the lower revenue and higher expenditure is a widening deficit. Government's consolidated budget deficit too was revised up to 5.9% of GDP during MTBPS 2019 from 4.5% of GDP in Budget 2019.

As mentioned before, there is an increased risk that South Africa's sovereign credit rating could wholly become sub-investment grade in 2020 following the outcomes of end-2019 assessments by the three major rating agencies, particularly Moody's. This outcome could lead to increased cost of borrowing, which would put further pressure on government expenditure, and lead to even larger deficits. The reason we say 'could' lead to increased cost of borrowing is because it appears that the market has already priced in a downgrade to sub-investment grade, but the extent of this is unknown. Since sovereign spreads encompass both the expected loss from default as well as the risk premium, it appears South Africa's government bonds are already at the levels of sub-investment grading.

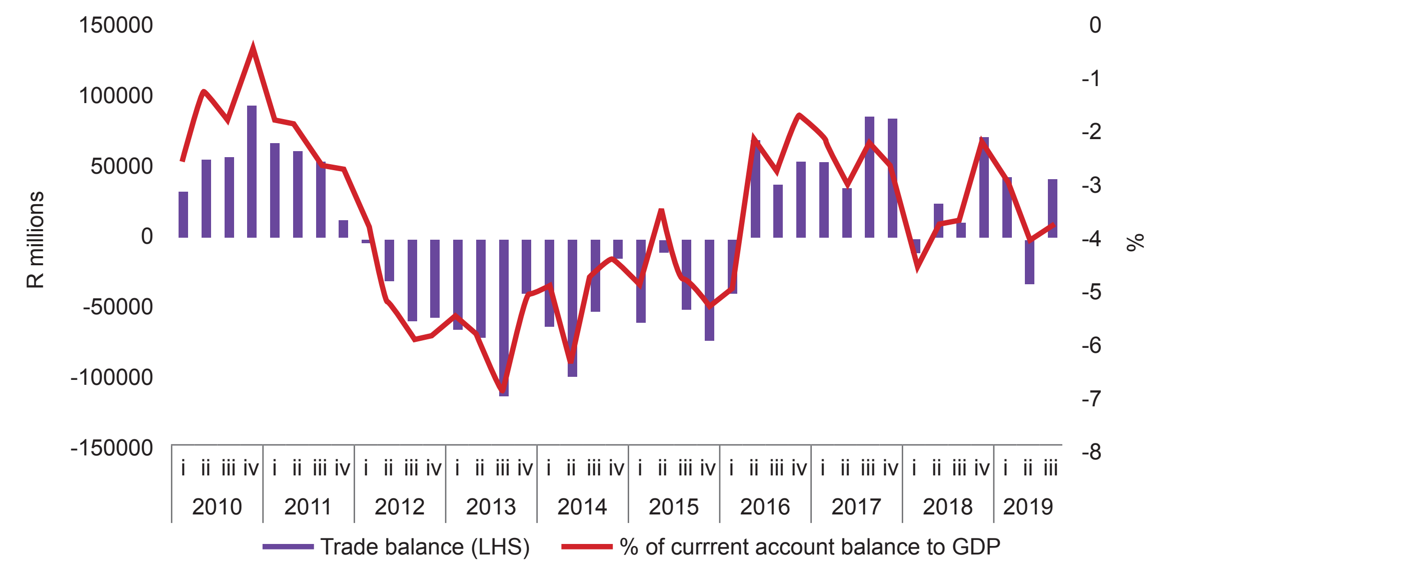
As an illustration, at the time of writing, the spread between SA's 10-year bond yield and the US 10-year treasury yield was 736.9 bp, while that between Brazil's 10-year bond yield and the 10-year treasury yield was 512.6 bp. The spread for South Africa's 10-year bond is markedly larger despite the fact that Brazil is wholly junk-graded by the three major rating agencies, while SA still has an investment credit rating from Moody's. It therefore appears that South Africa's sovereign credit is already downgraded to junk by the market, and therefore there might not be a significant change in SA bond yields even if Moody's was to execute the dreaded downgrade from Baa3.

EXTERNAL ACCOUNTS

South Africa's current account recorded a deficit of R190 billion during the third quarter of 2019, a narrowing from R209 billion in the second quarter of 2019. As a ratio of GDP, the current account deficit narrowed from 4.1% to 3.7%.

The narrowing of the current account deficit came on the back of South Africa's trade balance switching from a deficit of R31.8 billion in the second quarter of 2019 to a surplus of R41.1 billion in the third quarter. This was due to the value of merchandise and net gold exports increasing, while the value of merchandise imports declined. The value of merchandise exports increased on account of both higher volumes as well as prices. Overall, the value of merchandise exports increased by 2.1% as increases in agricultural and manufactured exports offset the decline in non-gold mining exports. Mining exports were weighed down largely by shutdowns due to scheduled maintenance work; this was in the production of ferro-alloys, while there was a closure of a coal export railway line. All in all, the volume of merchandise exports increased only slightly by 0.3% in the third quarter, while the rand price of merchandise exports went up by 1.8% during the third quarter after an increase of 3.5% in the second quarter.

Graph 15: Balance of Payments: trade balance and current account deficit as % of GDP, Q1 2010 – Q3 2019



Source: SARB and PAIRS

On the contrary, the rand price of South African imports declined during the third quarter, which lead to an increase in South Africa's terms of trade. The value of merchandise imports declined by 2.1% in the third quarter after an increase of 8.9% in the second quarter of 2019. The decline was mostly driven by a marked decrease in the value of mineral products, driven largely by lower crude oil imports resulting from amongst other factors: the high rand price of crude oil, a shutdown of an oil refinery for maintenance, as well as base effects following a significant Q2 build-up of stocks due to a planned 20-day single-point mooring facility shutdown.

The services, income and current transfer account widened to its largest ever deficit in the third quarter of 2019 at R231 billion from a deficit of R177 billion in the second quarter. As a percentage of GDP, the account's deficit went from 3.5% in the second quarter to 4.5% in the third quarter. The larger shortfall was due to the significantly large deficit on the income account as there was a marked increase in net income payments, following four consecutive quarterly declines. The increase can be attributed to a substantial increase in gross dividend payments originating from companies with a direct investment relationship with foreign shareholders. On the contrary, subsequent to quarterly increases during H1 2019, gross interest payments contracted slightly during Q3 2019, which somewhat contained the deficit on the income account.

Monthly trade data indicates that South Africa's trade account recorded surpluses of R2.75 billion, R5.64 billion and R14.85 billion in October, November and December 2019, respectively. Hence the trade account recorded another surplus during the fourth quarter of 2019. This should lead to a contained current account deficit, the outcome of which will depend on the size of the deficit on the services, income and current transfer account.

FORECAST TABLE

Variable	Unit	2017	2018	2019f	2020f
Population	Million	56.5	57.7	58.8	59.5
Real GDP	Per cent, growth	1.3	0.8	0.4	1.0%
Unemployment	Per cent of labour force	27.5	27.1	28.7	29.0
Headline Inflation	Per cent (avg)	5.3	4.6	4.1*	4.8
Repurchase (repo) rate	Per cent (avg)	6.9	6.6	6.6*	6.1
Current Account Deficit	Per cent of GDP	2.5	3.5	3.4	3.4
National Government Deficit	Per cent of GDP	4.4	3.9	5.9	5.8

Source: PAIRS, SARB, Stats SA
Note: "avg": average
* outcome

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