South African Economic **Outlook 2019**

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South Africa: a year of two halves

We expect two distinct parts to the SA economy this year. In H1:19, the economy will likely remain in wait-and-see mode, with pre-election policy and political uncertainty still weighing on growth. The only support is expected to come from low oil prices (even if they should rise modestly), base effects[1] and stronger support from household credit growth. In H2:19, premised on sufficient ANC electoral support to allow for deeper economic reforms, clear signals about the ANC's policy agenda, and pragmatic expropriation without compensation-related constitutional change, private sector employment and fixed investment could begin to show signs of life after protracted stagnation. Unfortunately, the risks are still biased downwards, as we remain concerned about downside risks to the decelerating global economy as well as the risks of electricity load-shedding and negative credit rating action by Moody's.

Likewise, the rand and local bonds will likely remain on the back foot early in the year, awaiting clarity on the global economic trajectory as well as the national election outcome and credible policy reform interventions. Both these assets are in our view undervalued, and we see scope for them to gain once there are credible policy reform (premised on a reasonably benign global economic outlook). But for now, the elevated risks keep us cautious.

Growth hinges on politics and policy

Consumer spending should again be the key growth driver in 2019. Consumer balance sheets seem in good enough shape (except for the low-income groups) – but discrepancies among data series create uncertainty about the strength of income growth; this is a significant forecast risk. Our inventory and capital stock analyses suggest that the case for imminent rebounds is not as strong as commonly assumed, until political perceptions and demand improve. A rebound in gross fixed capital formation (GFCF) will ultimately be a key medium-term growth driver – but we don't expect this to be imminent. **We forecast growth of 1.3% in 2019.**

The forecast global growth deceleration is unhelpful, though the global backdrop is expected to remain benign without material downward pressure on SA's key export commodities' prices, though this is a key forecast risk. A slight improvement in SA growth amid a global deceleration is not unprecedented, though we are concerned about the weakness in the composite leading business cycle indicator[2]; and our econometric business cycle model, based on it, points to weak H1 growth.

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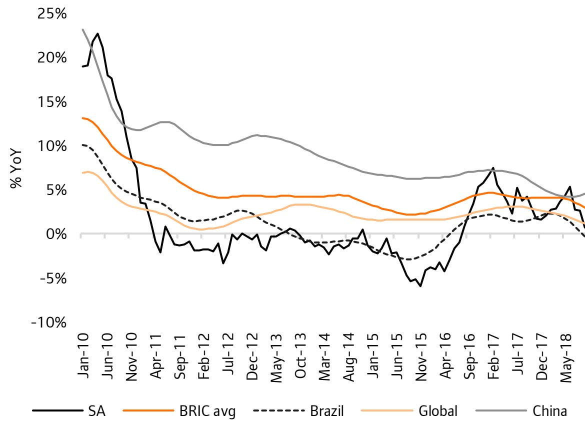
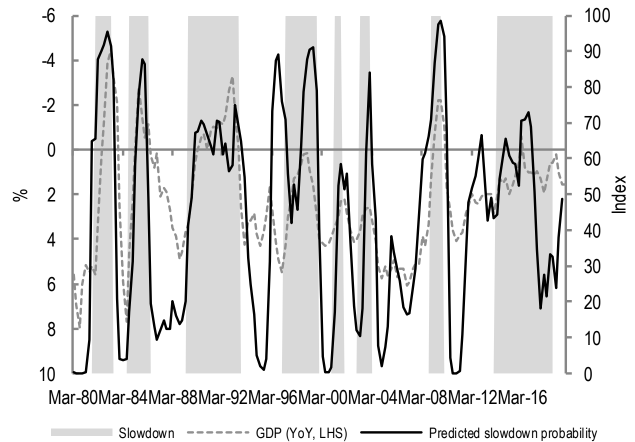
[1] Including a reversal of the impact of the Western Cape drought, though deteriorating rainfall forecasts weigh on the national agricultural prospects[1].
[2] In relative and absolute terms.

Figure 1: Global leading indicators – not supporting SA growth outperformance



Source: SARB

Figure 2: Econometric business cycle model giving worrying signals

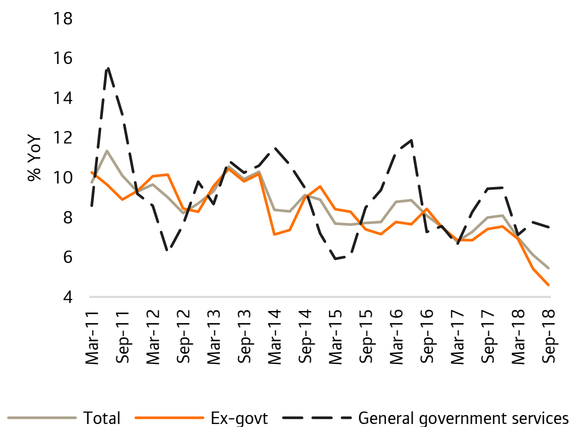


Source: SARB, Standard Bank Research

Consumers: supported by benign inflation and credit growth

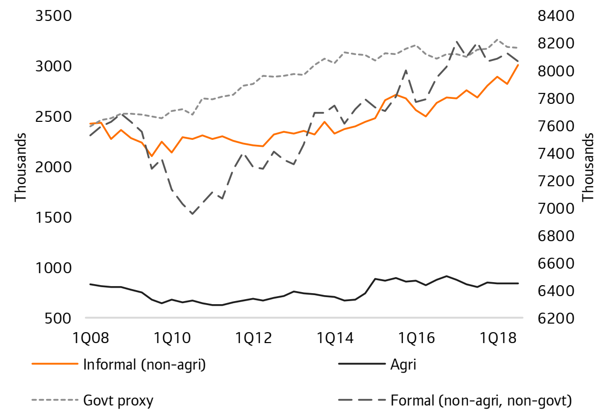
The main driver of consumer spending growth in 2019 is likely to be real wages again, although accelerating credit growth also provides growing support. Unfortunately, the wide discrepancies among the various official measures of income growth that concerned us during 2018 (see our report The state of the consumer of 3 December 2018) seem to have been resolved with a convergence towards the lower measures. This is a significant risk to consumer spending growth and, in turn, economic growth, in 2019.

Figure 3: Compensation of employees slowed



Source: Stats SA

Figure 4: Employment stagnating, with downside risk

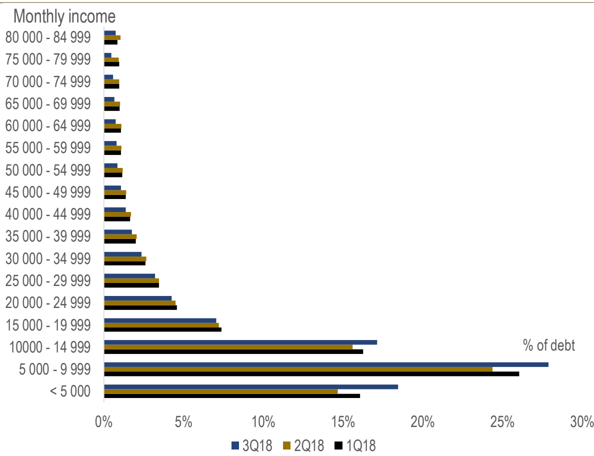


Source: Stats SA, Standard Bank Research

Total private sector employment has essentially been trending sideways although this seems to mask a shift from formal to informal employment. As with most of our recent structural analyses (see our 2019 SA macro outlook report for detail), the manufacturing, mining and construction sectors have been the weakest. Government employment seems to be gradually grinding lower. We assume that total employment will trend sideways in 2019, though the risks are modestly biased downwards. The relatively low ratio of employment to GDP is encouraging insofar as it should limit the downside risks (to employment) to a large extent.

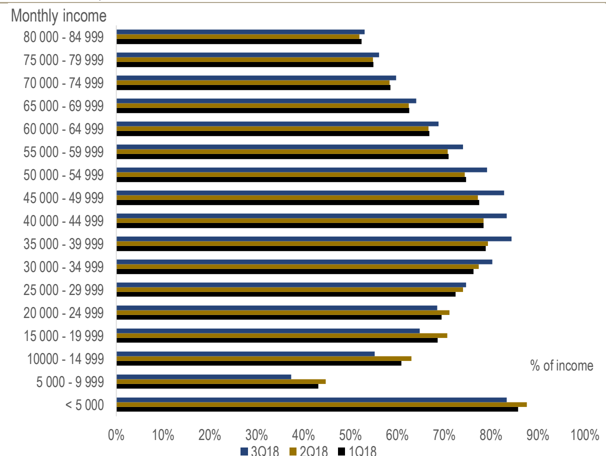
There should be some support for consumer spending growth from the ongoing (albeit moderate) acceleration in credit growth. **All types of households' bank credit have been accelerating, with asset-backed credit responsible for more than 76% of the credit growth in the last six months**[3]. This should counteract the impact of slowing wage growth. If the recent growth in households' bank credit persists, the additional spending power that this provides to households (in rand terms) exceed that provided by the growth in the total private sector wage bill. The data from one of the credit bureaus (which is not as robust as official data, and need to be used with circumspection) suggests that this stronger credit uptake has generally been by the middle- to higher income groups. Their arrears have been reasonably low and declining, suggesting that this is not distressed borrowing[4].

Figure 5: Arrears across income groups – lower end under pressure



Source: SARB, Treasury, XDS, Eighty20, Standard Bank Research

Figure 6: Debt-income ratios across income groups – lower end can't yet afford more debt

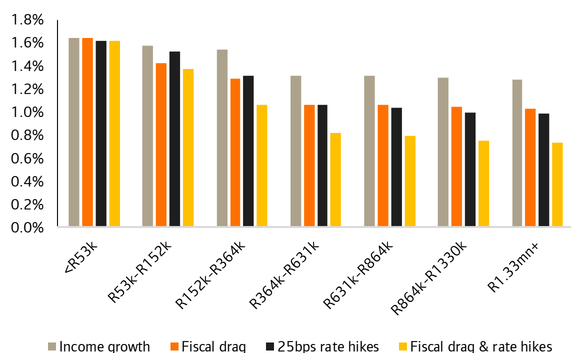


Source: SARB, Treasury, XDS, Eighty20, Standard Bank Research

Assuming 6.5% (nominal) income growth, we estimate that **real income growth should remain positive across the income spectrum, even once the impact of modest fiscal drag[5] and the usual "sin" tax increases[6] are taken into account,** alongside the November 2018 interest rate hike. With just some fiscal drag and no monetary tightening, real income growth after tax and interest costs are around 0.7% for the higher-income groups and around 1.6% for the lower-income groups. The risk is that income growth may be below the 6.5% assumed in these estimates, given the recent deceleration, weakness and discrepancies among different datasets.

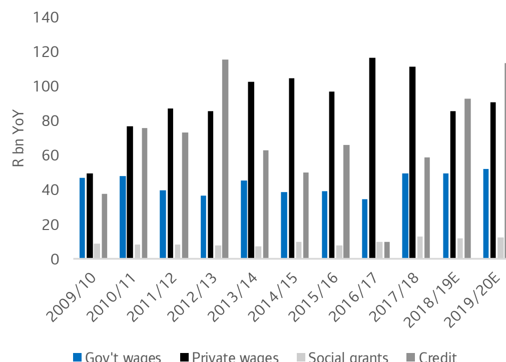
[3] *Though the year-on-year growth rates are strongest in their unsecured credit.*
[4] *This is supported by the aforementioned bias of the bank credit towards asset-backed credit.*
[5] *Tax brackets not adjusted for inflation.*
[6] *These are here incorporated into our inflation forecasts.*

Figure 7: Real spending power growth impact of inflation, with/out fiscal drag and monetary tightening



Source: SARB, Treasury, XDS, Eighty20, Standard Bank Research

Figure 8: Gov't vs private wage bill, social grants and credit growth



Source: SARB, Treasury, XDS, Eighty20, Standard Bank Research

Fixed investment: not resurging yet

We expect very weak public-sector infrastructure spending growth in the short-to medium term, given the generally precarious SOE financial positions and limited fiscal space. Total public-sector infrastructure spending forecasts will likely be cut again in Budget 2019 given savings and delays announced by the SOEs. It is more difficult to judge the likely momentum in government infrastructure spending.

Ultimately, capital expansion is one of the areas in which there is the most upside potential in a benign political/policy setting, and we are optimistic about a possible increase in private sector participation in infrastructure construction (and potentially maintenance and operations). This was strongly echoed in the October 2018 Medium-Term Bu MTBPS. It is, however, still unclear exactly how the proposed Infrastructure Fund will work, and we suspect that this may take some time to finalise so that it is unlikely to start making a difference in 2019 yet.

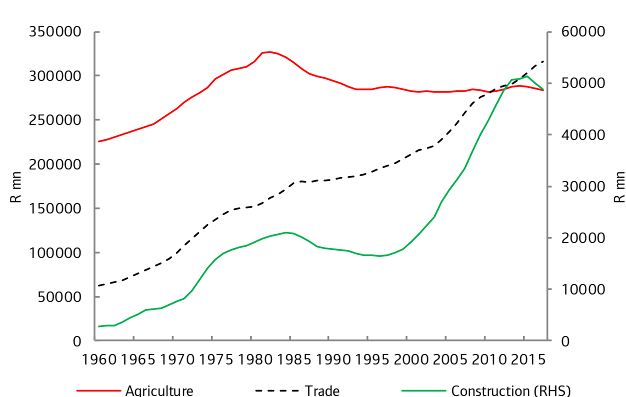
There should be some lift to private sector gross fixed capital formation (GFCF) from the new round of contracts signed as part of the renewable energy independent power producer (REIPP) programme at the beginning of 2018. However, in general, **private sector gross fixed capital formation (GFCF) is likely to remain subdued in the near term given policy and political uncertainty** despite some improvement in company profitability and incremental progress with policy reform. This is echoed in surveys of manufacturing firms which indicate that they are not yet increasing fixed investment despite rather high capacity utilisation.

While there was a lack of growth in aggregate private sector gross fixed capital formation over the past two to three years, **capital stock levels continued rising in most sectors bar manufacturing and construction**. In other words, on aggregate, firms' fixed investment continued to exceed depreciation. There is thus no general backlog in "replacement" investment. However, over the past decade, the ratio of capital stock to output has declined somewhat in the manufacturing, construction and financial services sectors.

It is noteworthy that the contraction in the manufacturing sector's capital stock started around a decade ago – well ahead of firms perceiving the political climate (and policy uncertainty) to be particularly problematic. The stagnation in the agricultural sector's capital stock began even earlier. The weakness in the construction sector, in contrast, is more recent, and partly reflective of fiscal constraints. The weakness in real private sector fixed investment in 2016-2017, when the political climate perceptions deteriorated sharply following the quick succession of Finance Ministers in December 2015 and

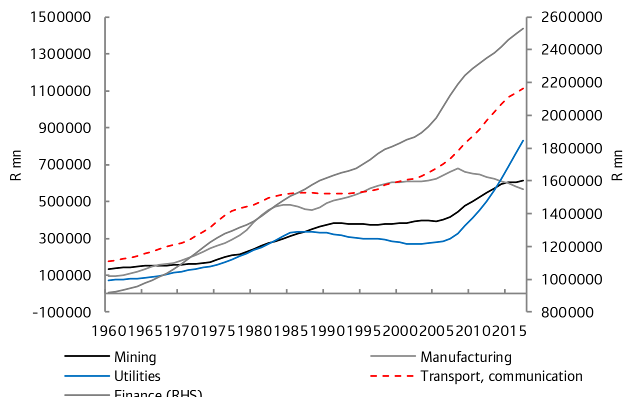
heightened uncertainty about unaffordable nuclear procurement and sovereign credit rating downgrades, was broad-based across sectors. However, in most sectors (bar some of the services sectors) the weakness started earlier.

Figure 9: Sectoral capital stock (1) – construction falls, agriculture stagnates, trade rises



Source: Stats SA, SARB, Quantec

Figure 10: Sectoral capital stock (2) – generally rising, except for manufacturing decline



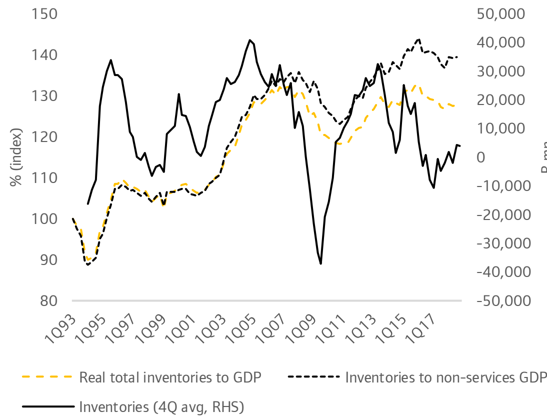
Source: Stats SA, SARB, Quantec

Inventories: case for restocking not obvious yet

Despite a decline in inventories during the latest economic downturn, a more certain improvement in the economic prognosis might be required to trigger a material rebound in stocks. **Surveyed firms do not at this stage regard inventory levels as particularly low relative to demand**, supporting our view that an economic growth boost from restocking is not imminent. While the low ratio of commercial and industrial inventories to GDP published by the SARB is commonly interpreted as a signal that restocking is imminent, real inventories to GDP (total or non-services GDP, as services sectors generally carry lower inventories) are not as convincingly low enough to compel a restocking boost to economic growth yet. Our estimates suggest that **aggregate inventory volumes are below their recent peak (relative to GDP), but well above previous troughs that were followed by restocking cycles**.

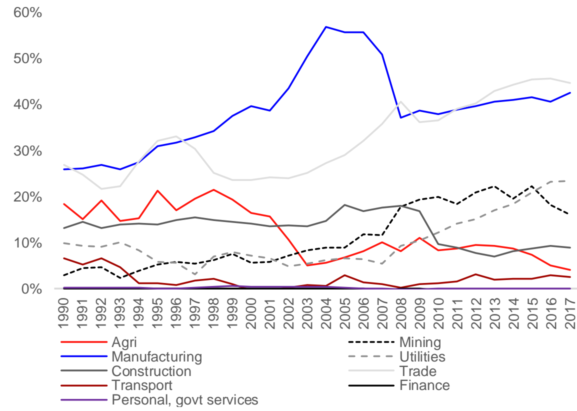
However, trends differ across sectors. In 2017 (the latest data available), real inventories (relative to the sector's output) were near peak levels in the wholesale and retail trade, leisure and catering sector, as well as the transport and communication sector, and at a new peak in the utilities sector. In the construction sector, real inventories (relative to the sector's output) were at the highest since their global financial crisis (GFC) plunge. Real inventories (relative to output) seemed somewhat low in the agricultural sector. Manufacturing stocks have been rising (as percentage of the sector's output) and are at the highest since the GFC, though still well below the pre-GFC spike in the mid-2000s.

Figure 11: Inventories lower, but not necessarily low enough to compel material restocking yet



Source: SARB, Stats SA, Standard Bank Research

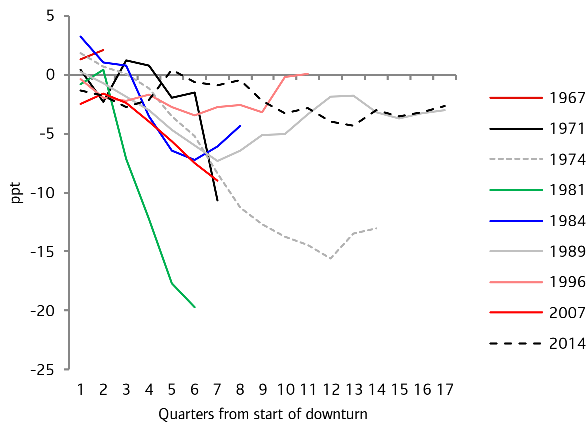
Figure 12: Real inventories low vs GDP in mining and agriculture, high in trade, rising in manufacturing



Source: Stats SA, SARB, Standard Bank Research

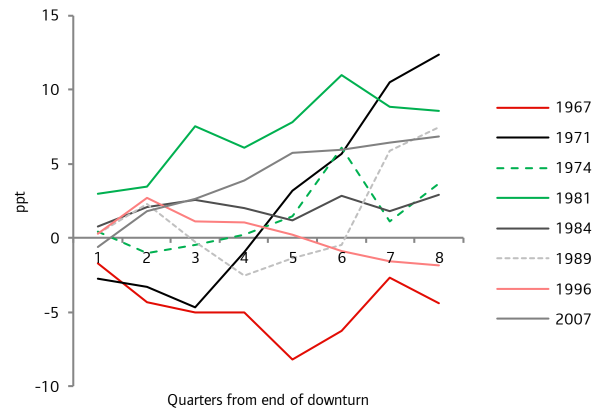
The key sectors, in terms of the magnitude of their inventories, are the trade, catering and accommodation sector as well as manufacturing (we estimate that they constitute around 50-60% of total inventories, depending on the measure used), followed by the mining and agricultural sectors. **Real inventories are not particularly low in either of the two key sectors in terms of the magnitude of inventories** (trade and manufacturing). The latest inventory destocking cycle has been rather shallow; we thus expect the restocking cycle to make a reasonably modest contribution to GDP growth once the economy recovers. We assume modest inventory restocking in 2019, that is unlikely to have a material impact on GDP growth.

Figure 13: Cumulative contribution of change in inventories to GDP growth from start of each downturn[7]



Source: Stats SA, Standard Bank Research

Figure 14: Change in inventories' cumulative contribution to GDP growth from end of downturn



Source: Stats SA, Standard Bank Research

Government consumption: modest contribution to GDP growth

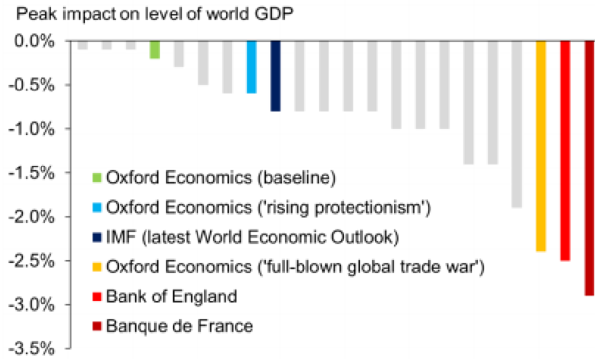
Our assumptions for the growth in real government consumption expenditure are slightly higher than those in the MTBPS. This is partly owing to our lower inflation projections.

[7] *The date in the legend refers to the beginning of the downturn.*

Net exports: could modestly support economic growth

We expect a small positive (real) economic growth contribution from net exports in 2019, from a negative contribution in 2018. A flare-up in global trade tension is a pertinent risk to this reasonably benign assessment, with SA's trade and current account balances some of the most vulnerable among EM.

Figure 15: Trade war growth impact – wide range of estimates reflect uncertainty about the end-game



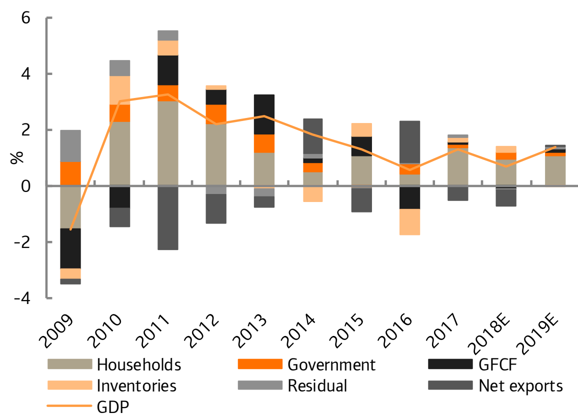
Source: Oxford Global Economic Model, Standard Bank Research

Figure 16: US-China very aggressive tariff war estimated impact – SA CAD more vulnerable than peers, SA GDP not

% avg	2019	2020
World GDP	-0.18	-0.39
SA GDP	-0.06	-0.24
China GDP	-0.55	-1.10
Russia GDP	-0.28	-0.72
India GDP	-0.05	-0.00
Indonesia GDP	-0.12	-0.26
SA CAD	-0.25	-0.32
Brazil CAD	-0.15	-0.17
Australia CAD	-0.03	-0.10
Chile CAD	-0.60	-0.70
Russia CAD	-0.60	-0.90
India CAD	0.08	0.09
Indonesia CAD	-0.03	-0.06

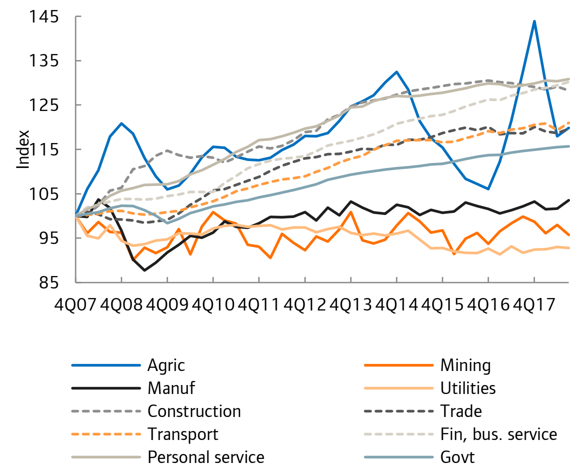
Source: Oxford Global Economic Model, Standard Bank Research

Figure 17: Growth composition – near-term growth still dependent on consumers



Source: Stats SA, Standard Bank Research

Figure 18: Sectoral GDP trends – mining, manufacturing, utilities sectors the post-crisis laggards



Source: SARB, Standard Bank Research

CAD fundamentally fragile

We expect the CAD to compress from an estimated 3.6% of GDP in 2018 to around 3.3% in 2019, but it may then expand to around 3.8% in 2020 if the economy recovers as expected

We expect the current account deficit (CAD) to remain at levels (particularly when SACU payments are excluded) that are typically not hard to fund. There should be some CAD support from a reasonably competitive (real trade-weighted) rand, a reversal of the Western Cape drought impact, and strong (albeit sub-peak) terms of trade. However, along with the fiscal deficit, the total funding requirements still make it one of the more vulnerable among EM to changes in actual or expected global liquidity conditions. The still-sizeable CAD despite the terms of trade only 4% below an all-time high[8] and still

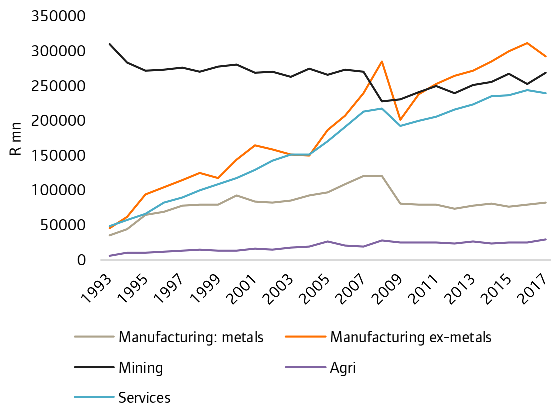
[8] In 3Q18, the latest data available.

14% above the 20-year average (amid sluggish domestic demand) reflects structural economic constraints. Our analysis highlights two key constraints.

It is very worrying that the CAD is at current levels despite the terms of trade only 4% below the all-time high

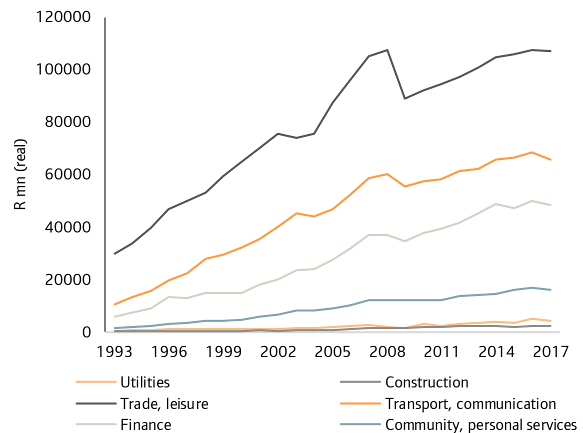
First, there is a clear constraint from stagnating mining export volumes, using either the strict technical classification or expanding it to include processed metals (from the manufacturing sector). If (the latter broad definition of) mining (related) export volumes had since the global financial crisis grown in line with non-mining exports, total exports would have been around 0.5% of GDP higher in 2017 (*ceteris paribus*). The importance of the mining sector for the trade balance is fading, with (a very broad classification of) mining and metals now only around 38% of total real exports (in 2010-rands) from 53% in 2004 and 60% in 1999. [9]

Figure 19: Real exports – mining and metals a key weakness



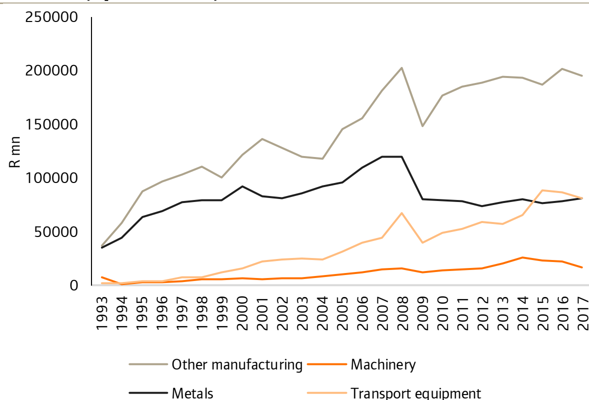
Source: Quantec

Figure 20: Real sectoral exports (excluding mining, agri and manufacturing)



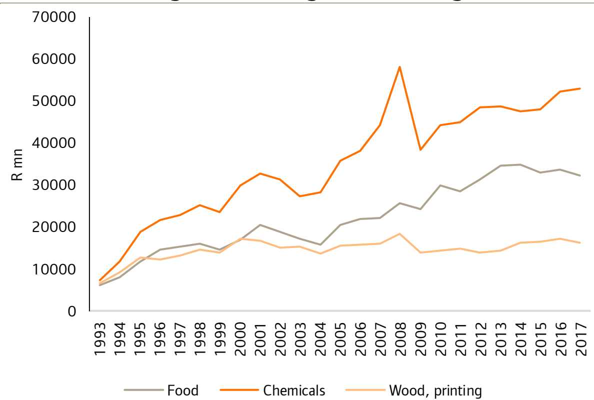
Source: Quantec, Standard Bank Research

Figure 21: Real manufacturing exports – metals and machinery particularly weak



Source: Quantec, Standard Bank Research

Figure 22: Select manufacturing industries' real exports – chemicals[10] strong, food strong till the drought



Source: Quantec, Standard Bank Research

Second, import intensity of domestic demand reached record-high levels Our analysis suggests that it is mainly in the manufacturing sector that imports have been

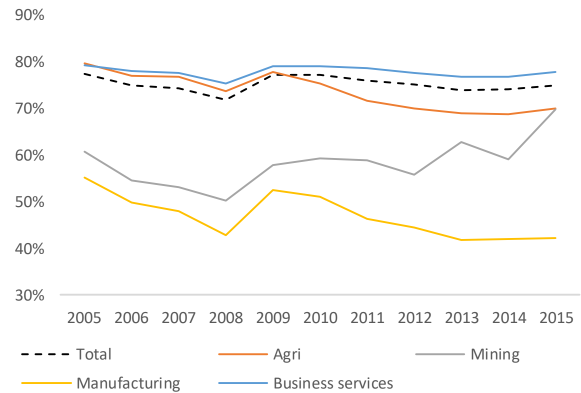
[9] *In the manufacturing sector, export volumes outside of (the aforementioned) metals are around 2.6% above their pre-GFC peak and now bigger than the (narrowly defined) mining export volumes (though still smaller than the joint mining and manufactured-metals exports). Within the manufacturing sector though, industries' performances varied markedly. Metals exports have been generally flat, while chemicals, transport equipment, and (until recently) food and beverages exports have been rather strong.*
[10] *Petroleum products, chemicals, rubber and plastic.*

rising relative to the size of the sector's output; this has been quite broad-based across many manufacturing industries[11].

Figure 23: Record-high imports vs demand a concern

Source: SARB, Standard Bank Research

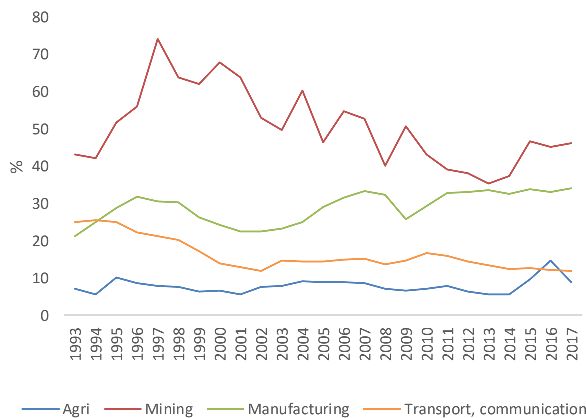
Figure 24: Local value added in final domestic demand (select sectors)



Source: SARB, Standard Bank Research

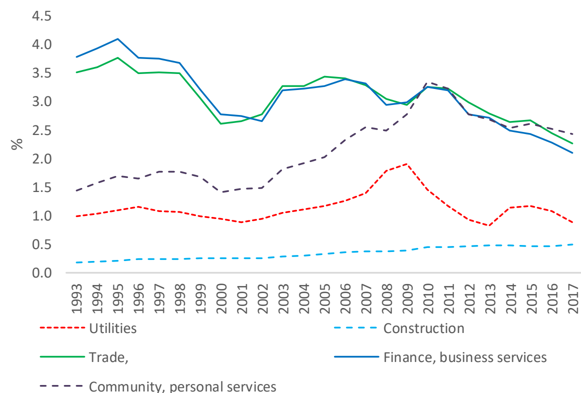
Import-leakage charts portray a similar general picture. **The manufacturing sector is again the main culprit in driving up the aggregate import leakage**. Similarly, the deeper analysis by the OECD into the local value added in final domestic demand and/or exports also point to an aggregate deterioration that is driven mainly by the manufacturing sector (this weakness is broad-based).

Figure 25: Domestic demand satisfied by imports – general manufacturing uptrend, drought-spike in agriculture



Source: Quantec, Standard Bank Research

Figure 26: Domestic demand satisfied by imports – services sectors generally declining



Source: Quantec, Standard Bank Research

Bar some weakness during the GFC, **the services portion of the CAD has generally been balanced**. Tourism receipts have generally been on an uptrend; a counteracting rise in tourism payments has been partly offset by a decline in other service imports[12]. **Services imports and exports are on average more rand sensitive than goods**, and

[11] Part of the rise in imports relates to the expansion in exports, though our analysis suggests that this is not a critical driver.
[12] Services sectors' export volumes have grown 2.8% on average per year over the post-GFC period, and they were by 2017 (the latest data available) nearly 10% higher since the GFC (this compares with 2.2% for goods). Generally, services are also bucking the goods sectors' rise in import intensity.

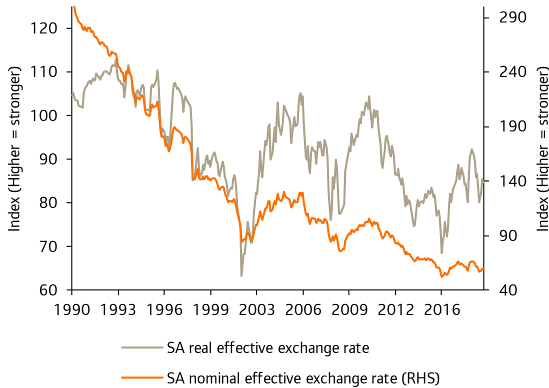
to the extent that the real rand remains competitively valued, it should provide a boost to this portion of the CAD.

Rand: undervalued yet vulnerable

Like the economy, **the rand will likely be weaker early this year**, with a possible rebound later in the year. The rand is still relatively weak according to our valuation models, but pre-election uncertainty and renewed load-shedding risks from Eskom (alongside global headwinds and risks) are expected to keep it weak and vulnerable in 1H19. A pragmatic budget that doesn't trigger negative sovereign credit rating action might be an initial catalyst for some appreciation, though more political certainty and concrete policy reform actions will be required for a significant rerating. There is a risk that, like early in 2018, rand strength will overshoot once optimism about policy and political reform is revived. Purchasing-power parity (PPP) estimates are unsustainably strong, in our view, but are so widely followed that they may become self-fulfilling if policy reform is convincing.

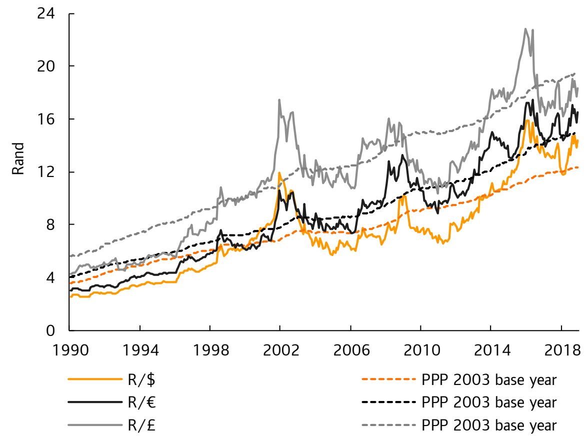
We expect the rand to strengthen to R13.40/$ by end-2019, remaining there in 2020, before declining to R13.50 by end-2021.

Figure 27: Trade-weighted rand – marginally weak vs historical benchmarks



Source: Bloomberg

Figure 28: PPP estimates – suggest the rand is generally materially undervalued



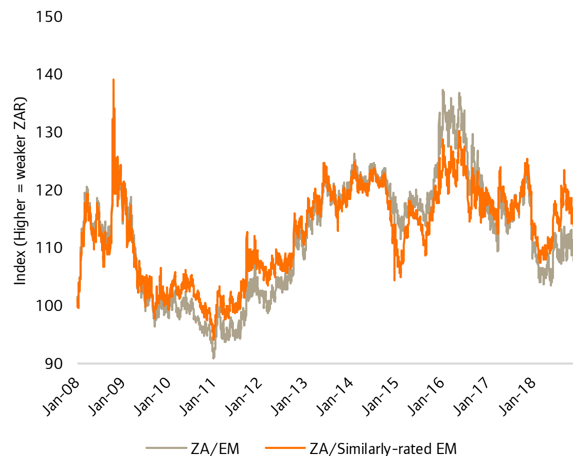
Source: Bloomberg, Standard Bank Research

Our reasonably constructive rand forecasts are premised on a relatively benign global economic outlook despite tightening global liquidity conditions and a marginal growth slowdown. The risks to the global economic assumptions are decidedly biased to the negative side. A key negative risk is the expected global growth deceleration to which a possible resurgence in trade friction and an uncertain Brexit pose further downside risks. This, in turn, underscores downside risks to commodities – the biggest risk to our forecasts for 2019. We also acknowledge the risk that we might be underestimating the impact of rising US rates on the rand. Positive global risks include the possibility that oil prices may remain low, and probable dollar weakness.

Figure 29: Econometric rand model suggests marginal undervaluation (against weak AUD)

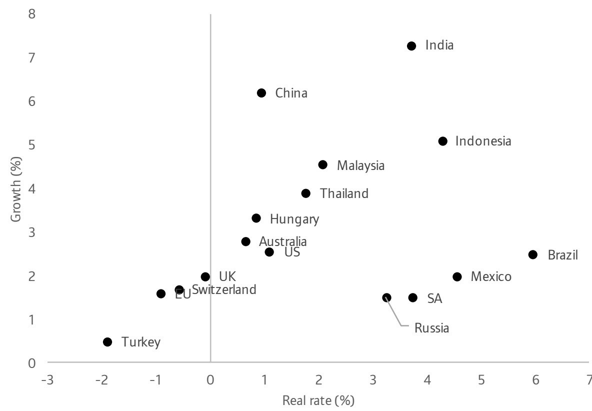
Source: Bloomberg

Figure 30: Rand vs EM currencies – risk premium back at 3Q17 levels



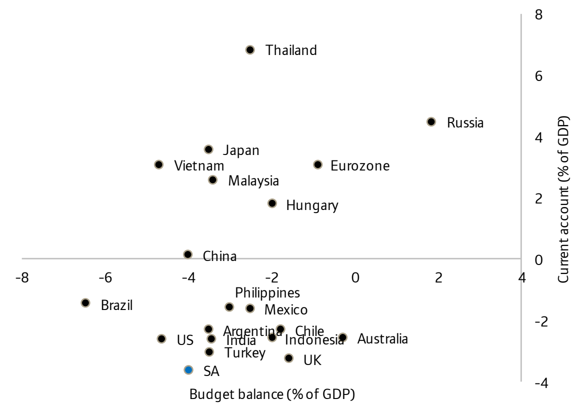
Source: Bloomberg, Standard Bank Research

Figure 31: SA growth and interest rates in context



Source: Bloomberg, Standard Bank Research

Figure 32: SA twin deficits (2019) in context



Source: Bloomberg, Standard Bank Research

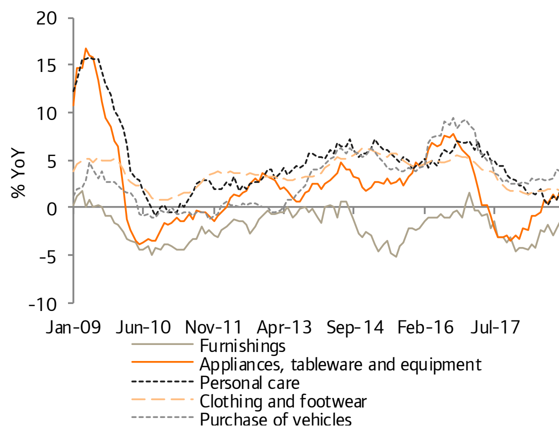
Inflation and interest rates: benign

Our 5.1% average inflation forecast for 2019 is below the consensus

Specific factors – including the fading disinflation of early-2018 rand strength, rising food inflation (from low levels, and owing to a weaker rand and global price pressure) and still-elevated administered tariff increases (including a double-digit forecast electricity tariff increase) – will put upward pressure on consumer inflation in 2019. However, subdued exchange rate pass-through, low oil prices, weak wage growth and generally subdued global inflation should help to keep inflation contained in 2019. Our 5.1% average 2019 forecast is below the consensus; our in-target inflation forecasts support our view that the SARB will not hike interest rates again in 2019 (though we tentatively pencil in another hike in 2020), particularly given our concerns around downside risks to near-term economic growth.

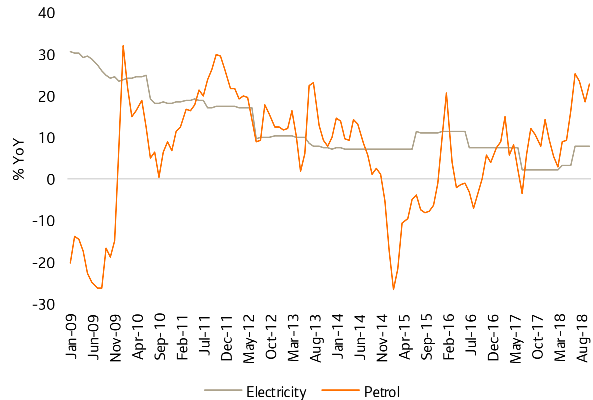
While the domestic economic outlook and risks clearly do not require imminent monetary tightening, the risks are in our view still biased towards slightly earlier tightening than we currently forecast, given the negative rand risks and the SARB's desire to anchor inflation expectations lower. Investors would have to be nimble this year, as rate expectations will likely be particularly data-dependent.

Figure 33: Rand-sensitive categories – benefit of early-2018 appreciation is fading



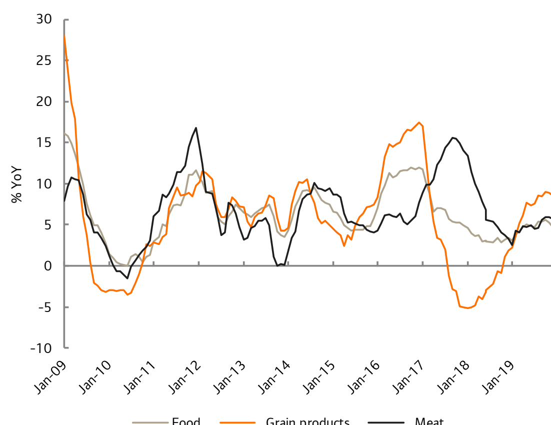
Source: Stats SA

Figure 34: Energy costs a significant inflation forecast risk for 2019



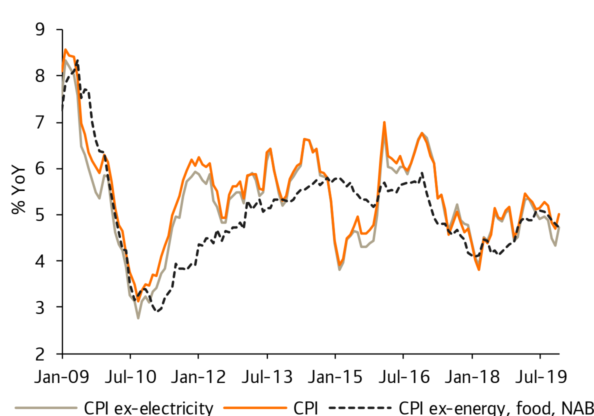
Source: Stats SA

Figure 35: Food inflation – cycle should be reasonably modest, but risks have increased



Source: Stats SA, Standard Bank Research

Figure 36: CPI forecasts – comfortably inside the target range



Source: Bloomberg, Standard Bank Research

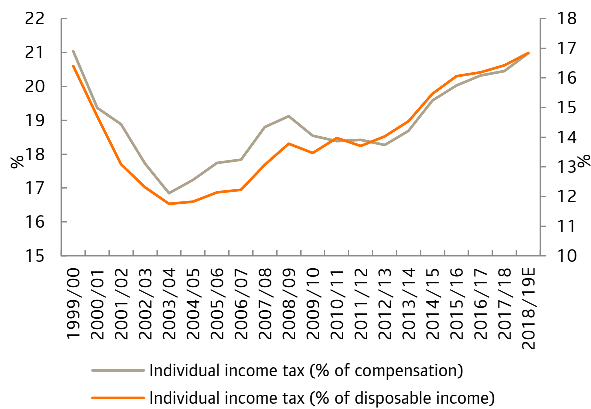
Fiscal policy and ratings: legacy risks

The fiscal deficit trajectory should not change much in the 2019 budget; Eskom's need for fiscal support is a major risk

We expect the 2019 fiscal trajectory to broadly match that of the October 2018 Medium-Term Budget Policy Statement (MTBPS). Revenues for FY18/19 may slightly under-perform the latest forecasts, and there are obvious further economic growth and in turn tax revenue risks. We do not expect tax hikes, apart from modest fiscal drag and inflation-related increased in consumption taxes; government and the ANC are very cognisant of the sharp rise in households' tax burden over the past 15 years, to the highest in two decades. Treasury is optimistic that an improvement in SARS's efficacy may ultimately significantly boost tax revenues.

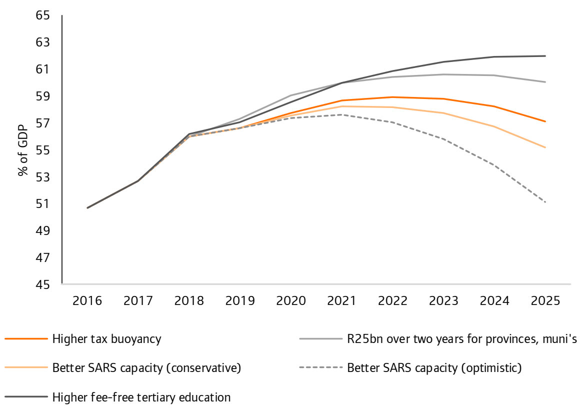
We expect the expenditure ceiling and deficit-neutral SOE support pillars of fiscal consolidation to be preserved. Eskom's funding requirements – a key risk – are not imminent, and at this stage we assume the budget will only pencil in a modest fiscal injection for FY19/20 – perhaps enough to service the R100bn of debt that Eskom has asked government to assume. This can be deficit-neutral (if funded, for example, via the mooted sale or leasing of unused properties identified in 2018 by the Department of Public Works, a spectrum auction, the recovery of identified overdue tax receipts and/or modest fiscal drag). Additional government spending (including spending related to president Ramaphosa's stimulus and recovery plan announced in 2H18 and the above-budget wage increase granted in 2018) gets accommodated within the expenditure ceiling and the risk is that other spending will be crowded out rather than the expenditure ceiling breached. According to our detailed analysis, negative credit rating action (by Moody's in particular) is only likely if there is a deterioration in key relevant metrics (see our reports Eskom and the economy: Some thoughts and Fiscal sustainability and Moody's for more detail). This remains a risk, but not our base case at this stage.

Figure 37: Households' tax burden – highest in decades



Source: Treasury, SARB, Standard Bank Research

Figure 38: Debt scenarios – material two-sided risks



Source: Treasury, IMF, Standard Bank Research

Figure 39: Macroeconomics forecasts

Growth data (% y/y, seasonally adjusted & annualised)	Q1:18	Q2:18	Q3:18	Q4:18	Q1:19	Q2:19	Q3:19	Q4:19	2018F	2019F
Expenditure on GDP	1,3	1,5	1,4	1,1	1,5	1,8	2,0	2,1	1,3	1,9
Household consumption expenditure (HCE)	1,0	1,7	1,8	1,8	1,9	2,0	2,0	2,0	1,6	2,0
Gross fixed capital formation (GFCF)	-0,8	-0,5	1,7	2,1	3,0	3,8	4,0	4,0	0,6	3,7
Exports	8,8	5,8	0,7	0,7	1,9	2,2	2,5	2,7	4,0	2,3
Imports	7,1	6,4	0,7	1,5	1,9	2,2	2,4	2,5	3,9	2,2
Current Account Balance (CAD) % of GDP	-3,8	-3,0	-3,5	-2,7	-4,4	-3,7	-4,2	-3,3	-3,3	-3,9
Prices										
Inflation (average)	4,9	5,1	5,3	4,9	5,3	5,0	5,0	5,2	5.1	5.1
Interest rates (%)										
Prime lending rate (end period)	10,25	10,25	10,25	10,25	10,50	10,50	10,50	10,50	10.25	10.50

Source: SARB, Standard Bank Research

Elna Moolman

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