Special Report

South Africa – Higher real GDP growth required to alleviate longer-term pressures

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1. Introduction

South African growth has been weaker since the Global Financial Crisis (GFC), averaging 1.6% (2009-2017) versus 3.7% in the ten years before the crisis (1998-2007). Over the same period, GDP per capita in USD purchasing power parity (PPP) terms has remained flat. Social pressures have been increasing. The unemployment rate increased to 27.2% in 2Q 2018 from 23.2% in 1Q 2008, with long term unemployment rising by 1.7 million people. Youth unemployment remains very high, with the rate for '15-24 year-olds' standing at 52% in 1Q 2018, and youth unemployment comprising 63.5% of total unemployed.

Room for manoeuvre has diminished. Since 2008, gross general government debt has doubled, increasing by 26 percentage points of GDP to 52.6% of GDP in 2017 with South Africa running fiscal deficits averaging 4.5% of GDP from 2009 to 2017. A smooth political transition from former President Zuma to President Ramaphosa in 2017 has eased pressures and opened up the opportunity for deeper reforms to boost growth, but challenges remain and recent quarterly GDP statistics have disappointed.

2. Challenges

The South African economy appears well placed to benefit from the political transition and global growth prospects, however, it faces a number of challenges. Potential growth estimated at 2% is low, with high unemployment and deteriorating public finances. South Africa also has a current account deficit largely funded by volatile portfolio inflows exposed to global financing conditions. The exchange rate, ZAR vs USD, has fallen by around 14% since Jan 1st 2018.

(1) Weak Growth

Growth was higher before the Global Financial Crisis (GFC) with purchasing power parity (PPP) GDP per capita on an upward trajectory, but has since remained flat (Chart 1). The South African economy has historically been driven by domestic consumption as shown in Chart 2; however, consumption has been weaker since the crisis contributing an average of 1.6 percentage points of GDP per year to real GDP growth (2009-2017).

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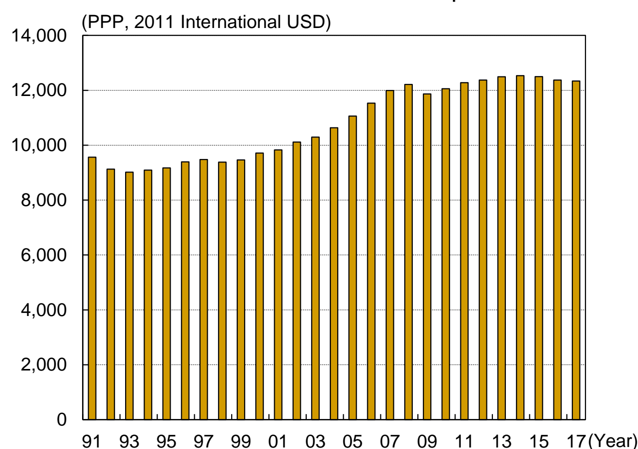
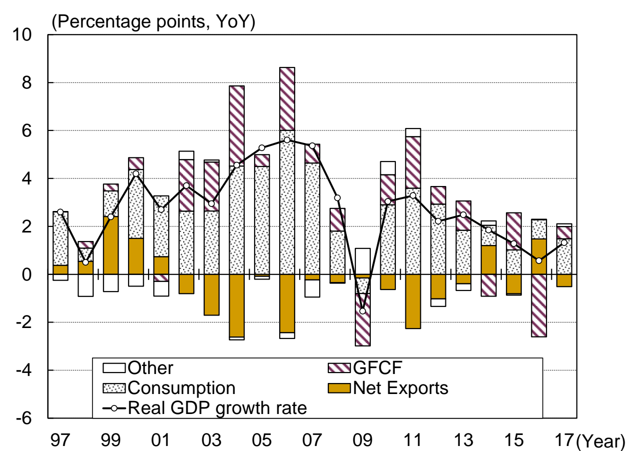
Over the last four years, consumption has contributed an average of just 1 percentage point to real GDP growth. Weak consumption has been due to a combination of factors. These include high unemployment, weak productivity growth and the political backdrop all feeding into the low confidence environment. This has in turn fed into weak investment environment and together with weaker commodity prices has affected gross fixed capital formation (GFCF).

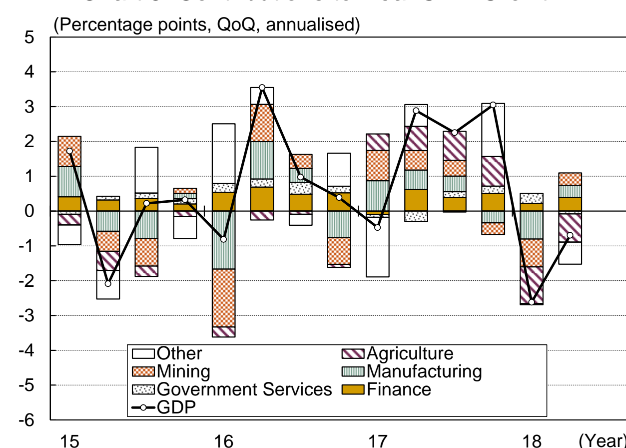


Source: IMF, MUFG Bank Economic Research Office

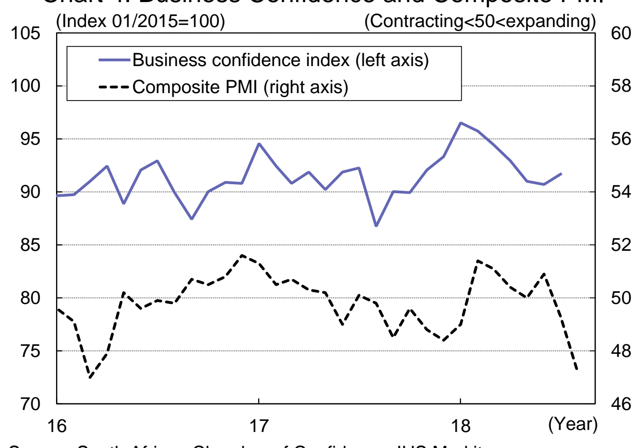


Source: Stat SA, IMF, MUFG Bank Economic Research Office

Latest quarterly figures have disappointed but growth is expected to pick-up over 2H 2018. The recent contraction of 2.2% in 1Q 2018 decreasing to 0.7% in 2Q 2018, QoQ and annualised, (Chart 3) came about due to contraction in the manufacturing, mining and agricultural sectors. However, despite composite PMI readings highlighting further weakness (Chart 4), growth turned positive in the mining and manufacturing sector in 2Q 2018.



Source: Stat SA, MUFG Bank Economic Research Office



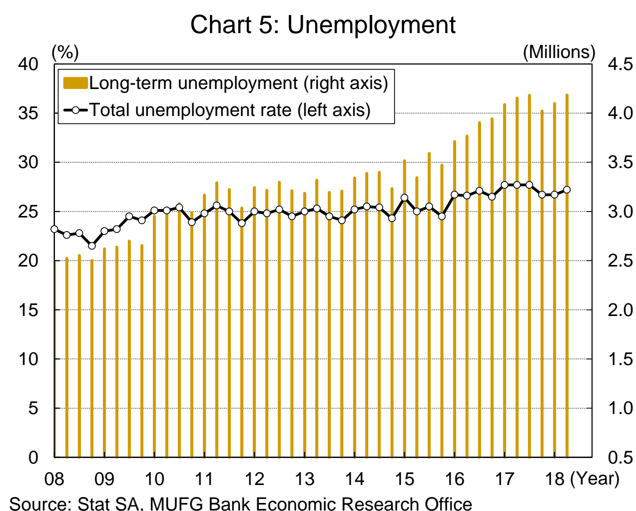
Source: South African Chamber of Confidence, IHS Markit, MUFG Bank Economic Research Office

Growth is expected to pick-up over 2H 2018 as agriculture normalises reducing its negative contribution to GDP, but is likely to remain weak. The main drivers will be consumption, supported by rising wages, and higher investment, supported by improved commodity prices. Investment is also expected to catch-up after years of under-investment as companies take advantage of the better environment. The South African Reserve Bank (SARB) forecasts growth to increase to 1.7% YoY in 2019 and 2.0% YoY in 2020, from 1.2% YoY in 2018. Risks to growth could come from the run-up to national elections due in August 2019, particularly if it leads to weaker consumption and investment.

(2) High unemployment

Unemployment has remained high, increasing from 23.2% in 1Q 2008 to 27.2% in 2Q 2018 (Chart 5) and feeding into social pressures within the country. Over the same period, labour costs have been increasing, making it more costly for employers to hire (Chart 6). Rising labour costs are due to weak productivity, rigid labour and product market laws, and a shortage of employable skills.

Chart 5: Unemployment



Source: Stat SA, MUFG Bank Economic Research Office

Chart 6: Labour Costs

Source: SARB, MUFG Bank Economic Research Office

As a result of high unemployment, pressures on the government to improve living standards are high. But with growth averaging 1.6% (2009-2017) and population growth averaging 1.5%, these pressures are difficult to resolve. One of the challenges from social pressures is how this could affect South Africa's economic model. If, for example, these pressures resulted in changes to economic policy, that damages the business environment. There are concerns over possible changes to South African land reform initiated in 1994. These reforms are aimed at addressing skewed ownership through land redistribution, restitution and tenure. If changes to the existing policy increases long-term risks to property rights, this would affect the business environment and be negative for long-term growth prospects.

(3) Rising government debt

Rising government debt reduces room for manoeuvre. Government debt has doubled since 2008, increasing by 26 percentage points of GDP to 52.6% of GDP in 2017, and is on an increasing trajectory, shown by latest budget 2018 forecasts in Chart 7. This has also led to an increasing interest payments burden on fiscal finances (Chart 8), which diverts spending away from more growth enhancing expenditures like capital spending that would help to boost longer-term growth. Interest expenditures as a percent of revenues are forecast at 13.0% in FY2018/19 (ending 31st March) and expected to rise to over 13.5% of revenues by FY2019/20 (around 4% of GDP), according to the latest IMF WEO forecasts.

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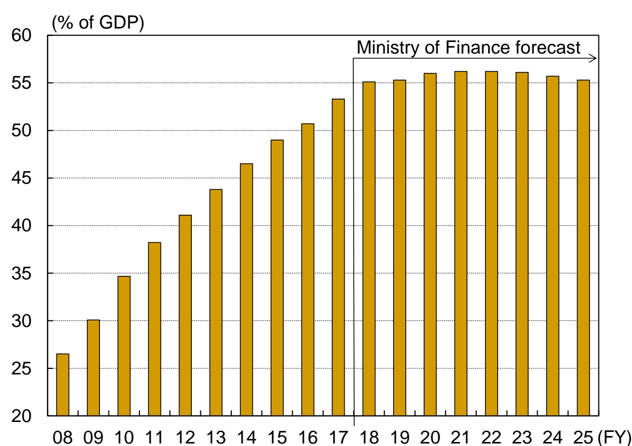
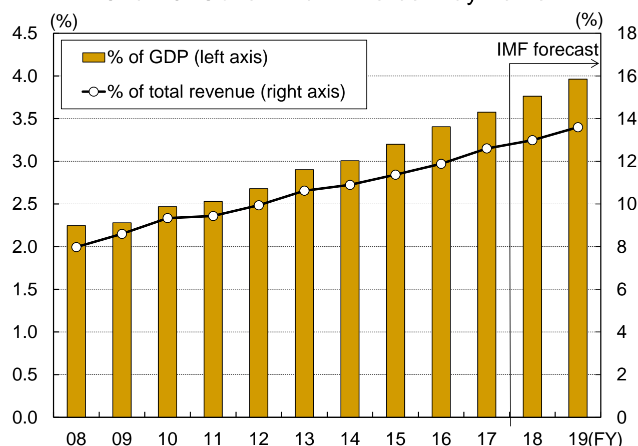


Source: Ministry of Finance, MUFG Bank Economic Research Office



Source: IMF, MUFG Bank Economic Research Office

Added to the rising level of government debt, there is also the possibility that State Owed Entities (SOEs) and their government guarantees will rise, further increasing the overall level of public indebtedness. Public debt includes both gross general government debt as well as that of the wider public sector such as SOEs. The IMF currently estimates contingent liabilities at 16% of GDP in FY2017/18 from 8% of GDP in FY2007/08, and further government support for SOEs is expected.

However, the structure of government debt reduces risks. Foreign currency and roll-over risks are low with government bonds around 90% denominated in local currency and having a long maturity of 15 years. Sovereign bonds are also supported by developed local capital markets (broad money averaging 70.0% of GDP, and private credit averaging 144.6% of GDP over 2012-2017) that benefit from good supervision.

(4) Current account deficit

The latest monthly figures for the current account deficit (CAD) show deterioration in 1Q 2018, shown in Chart 9, due to the increasing deficit in the income account, as well as a slight deficit in the goods account. The income account deficit has been widening since 4Q 2016. However the latest figure in 1Q 2018 is due to a large surge in income payments versus receipts, as a result of increasing interest payments on non-FDI. The CAD is largely funded by volatile portfolio inflows that are exposed to global financing conditions, as shown in Chart 10. Highlighting increasing pressures, latest IIF data show portfolio outflows of 6.4 billion USD in the second quarter of 2018.

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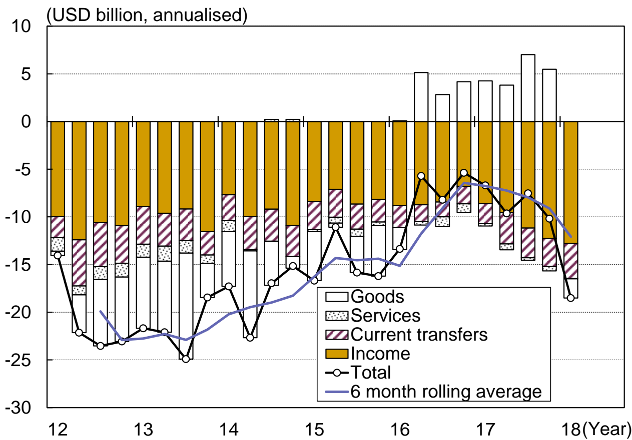
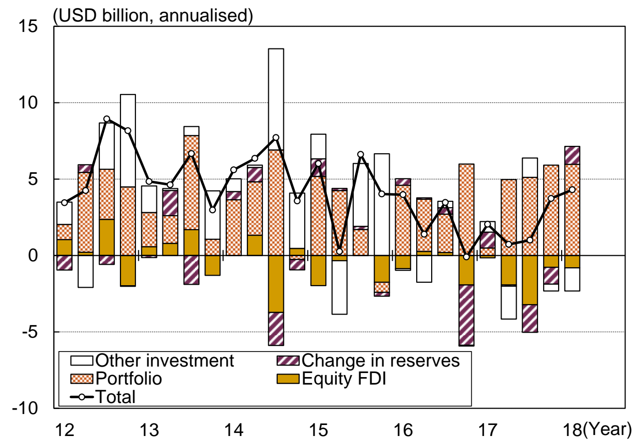
Chart 9: Current Account Balance



Source: SARB, MUFG Bank Economic Research Office

Chart 10: Financial Account Balance



Source: SARB, MUFG Bank Economic Research Office

Latest consensus forecasts the CAD to increase to 12.6 billion USD (3.4% of GDP) in 2018 and 13.7 billion USD (3.5% of GDP) in 2019, from 8.6 billion USD (2.5% of GDP) in 2017. The CAD will be driven by a deteriorating income account and stronger domestic demand which is expected to lead to higher imports.

South Africa is expected to remain vulnerable to global financing conditions and rising US Fed rates, with the ZAR down by around 14% since the start of the year versus the USD. The current baseline scenario of the SARB is that US Fed tightening is expected to follow a 'measured path in the absence of significant inflation or growth surprises' but that 'higher-than-expected US fiscal deficits could result in a stronger monetary policy response'. This could feed into further ZAR currency depreciation and capital outflows.

3. Reforms

Estimates of the increase to potential growth from such measures are hard to come by, but the IMF has estimated a full comprehensive reform package comprising governance, product and labour market reforms and improved fiscal policy resulting in greater fiscal buffers as increasing potential growth up to 4%. This would require deep reforms, correct sequencing and strong public and political support, a tall order.

(1) Improving governance

The government aims to improve overall levels of governance to increase growth potential and reduce social pressures. The boards of several major Sate Owned Entities (SOEs) have been changed with governance of the South African Revenue Service (SARS) also to be strengthened. Authorities are also looking into procurement as well as wasteful public expenditures as areas to reform.

With regards to corruption, charges covering fraud, racketeering and money laundering have also been pressed against politicians by the national prosecuting authority. Major SOEs that experienced a change of board include Eskom, the state electricity company; Transnet, the railway operator; South African Airways (SAA), the national airline; as well as Denel, the national defence company. While these reforms are positive, there is still further to go and it will take some time before feeding into higher growth potential.

(2) Product and labour market reforms

Product market reforms will look into reducing several regulations which result in more inefficient and costly services than other countries, for instance in telecommunications and energy sectors. Authorities are looking into reducing the cost of broadband which would lower prices, boosting technology adoption and innovation. Added to this, the government is also hoping to increase investment into its extractive industries by revising its new mining charter. Negotiations for the mining charter are in final stage.

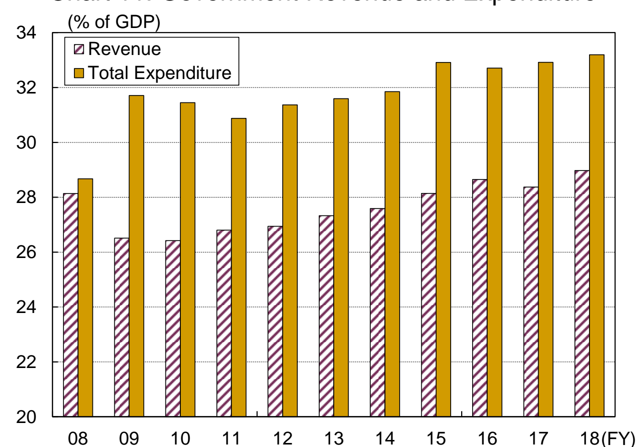
Labour market changes include optimising social benefits paid to the poorest, reducing the inefficiencies of the existing system and introduction of the new national minimum wage (NMW) and collective bargaining code of good practice. The new code is hoped to lead to better employer-employee relationships helping to reduce the incidence of strikes and disputes. Deeper reforms would involve changing the collective bargaining system by allowing companies to negotiate their own wage increases on a more local scale, unbinding them from wider wage agreements.

(3) Tighter fiscal deficit

Government expenditures have remained elevated since the financial crisis, while revenues have only gradually increased as shown in Chart 11, making it difficult for authorities to drastically reduce the fiscal deficit. Latest quarterly fiscal figures (Chart 12), up to March 2018, show a slight loosening of the fiscal deficit, highlighted by the 12-month rolling average. However tax measures, which came into effect on April 1st, are expected to lead to an improvement in the fiscal deficit figures over the rest of 2018.

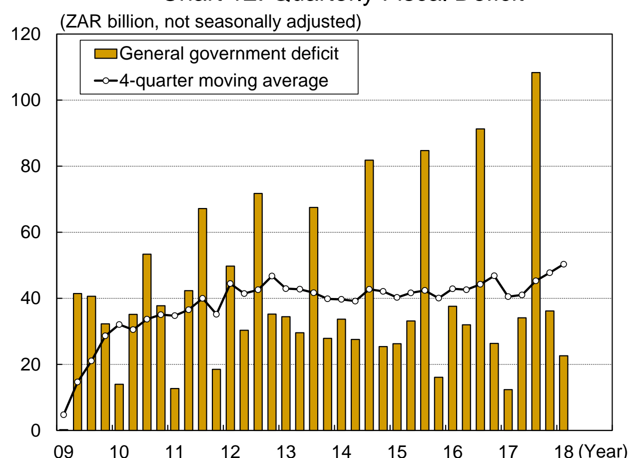
Tax measures include an increase in the VAT rate by 1 percentage point to 15%, partial relief of bracket creep (raising 6.8 billion ZAR), as well as higher rates of excises on cigarettes and alcohol (raising 2.6 billion ZAR) and general fuel levy. Partial relief of bracket creep occurs as inflation pushes income into higher tax brackets leading to greater income taxes paid.

Chart 11: Government Revenue and Expenditure



Source: IMF, MUFG Bank Economic Research Office

Chart 12: Quarterly Fiscal Deficit



Source: Ministry of Finance, MUFG Bank Economic Research Office

The 2018 budget projects the fiscal deficit to decline to 3.6% of GDP in fiscal year (FY) 2018/19 and FY2019/20 from a deficit of 4.3% of GDP in FY2017/18. Total expenditure is forecast to remain fairly constant at around 33.3% of GDP with revenues forecast to increase

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up to around 29.7% of GDP in FY2018/19 from 28.8% of GDP in FY2017/18 due to introduction of tax measures.

The 2018 budget forecasts growth of 1.5% YoY in 2018 increasing to 1.8% YoY in 2019 and 2.1% YoY in 2020. The 2018 forecast is slightly more bearish than the consensus forecast, but more bullish versus SARB forecasts. We expect the fiscal deficit to gradually decline, though risks will remain, especially if growth disappoints.

4. Conclusion

Significant challenges remain. South Africa suffers from some of the highest rates of inequality in the world which remain deeply entrenched. This is a key time for South Africa which is experiencing rising external vulnerabilities and less favourable global financing conditions. The stable outlook South Africa currently has from ratings agencies indicates a level of stability over the medium term.

On the policy front, there is less room for manoeuvre and South Africa is now at a weaker equilibrium than before. Government debt has increased to 52.6% of GDP in 2017, and the central bank must run tight monetary policy at the same time as the country is affected by USD Fed rate hikes. The only route for South Africa is through deeper structural reforms.

Reforms would help to boost long-term growth but South Africa has been slow to get through reforms in the past. Strong political support would be needed to push through comprehensive reforms, with general elections set for 2019 potentially slowing roll-out. The country has a window of opportunity to implement deeper structural reforms over the medium term which it needs to take if it is to alleviate longer term pressures such as high and rising youth unemployment, poverty rates and inequality.

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