

2

Economic outlook

In brief

- The global economic recovery has been weaker than anticipated. Growth in developing economies has moderated in response to lower commodity prices, subdued domestic demand and reduced capital inflows. Growth in some developed economies has offset this slowdown.
- The South African economy is expected to grow by 1.5 per cent in 2015, 1.7 per cent in 2016 and 2.6 per cent in 2017.
- Domestic inflation is lower, largely as a result of declining oil prices. The rand's depreciation, however, poses some risk to the inflation outlook.
- Public-sector infrastructure investment is projected to exceed R800 billion over the medium term. Private-sector investment remains muted, mainly funding capital replacement rather than new capacity.
- Efforts to reduce the electricity constraint and improve labour relations are priorities in the short term. Alongside the structural reforms set out in the National Development Plan, this will lay the foundation for faster growth as the business cycle improves.

Overview

The South African economy has grown more slowly than projected at the time of the February 2015 Budget. Electricity constraints continue to limit output and business investment has fallen. Weaker confidence at home and abroad has weighed on trade, consumption and investment. An improved performance by some developed economies has offset the slowdown in developing economies, but commodity prices continue to decline and financial markets remain volatile. Along with the prospect of slower growth in China, and higher interest rates in the United States, this creates a difficult environment for developing countries such as South Africa that have low domestic savings and rely on foreign capital to fund investment.

Global developments create a difficult environment for developing countries with low domestic savings

Rand depreciation, reduced labour-market tensions and improved demand from Europe have helped to shore up exports. The lower oil price has also provided a cushion for household spending by reducing transport costs. The inflation-targeting regime and prudent fiscal framework have

supported continued capital inflows, and the flexible exchange rate has buffered the economy from the full impact of global shocks. Yet increased competition for foreign capital is reducing the extent to which the macroeconomic framework can offset the effects of the global slowdown in developing economies.

Implementing NDP lays a foundation for more rapid future growth

Moving South Africa towards the growth rates envisaged in the National Development Plan (NDP) requires diligent implementation, as outlined in the medium-term strategic framework. Progress in these areas will enable the country to take advantage of the next upturn in the business cycle in a sustainable manner.

■ Global developments

World economic growth has slowed. During 2015 the International Monetary Fund (IMF) revised its in-year growth forecasts downwards three times, most recently to 3.1 per cent. The forecast for 2016 is 3.6 per cent.

Table 2.1 Annual change in GDP and consumer price index, selected regions/countries, 2014 – 2016

Region / country Percentage	Average 2010-2014	2014	2015	2016	Average 2010-2014	2014	2015	2016
		GDP growth ¹				Average CPI ¹		
World	4.0	3.4	3.1	3.6	4.1	3.5	3.3	3.4
Advanced economies	1.8	1.8	2.0	2.2	1.8	1.4	0.3	1.2
US	2.1	2.4	2.6	2.8	2.0	1.6	0.1	1.1
Euro area	0.7	0.9	1.5	1.6	1.7	0.4	0.2	1.0
UK	1.8	3.0	2.5	2.2	2.9	1.5	0.1	1.5
Japan	1.5	-0.1	0.6	1.0	0.4	2.7	0.7	0.4
Emerging markets and developing countries	5.7	4.6	4.0	4.5	6.0	5.1	5.6	5.1
Brazil	3.2	0.1	-3.0	-1.0	5.9	6.3	8.9	6.3
Russia	2.8	0.6	-3.8	-0.6	7.0	7.8	15.8	8.6
India	7.2	7.3	7.3	7.5	9.0	5.9	5.4	5.5
China	8.6	7.3	6.8	6.3	3.2	2.0	1.5	1.8
Sub-Saharan Africa	5.2	5.0	3.8	4.3	8.0	6.4	6.9	7.3
South Africa ²	2.4	1.5	1.5	1.7	5.3	6.1	4.8	6.2

1. IMF World Economic Outlook October 2015

2. National Treasury forecast

Economic growth in developed economies is expected to rise gradually. Lower energy prices, favourable interest rates, and improving confidence and labour-market conditions are expected to boost European and Japanese performance, and to support continued growth in the United States.

Growth in sub-Saharan Africa expected to decline to 3.8 per cent in 2015 from 5 per cent in 2014

By contrast, lower commodity prices, weaker domestic demand, tighter financial conditions and slower capital inflows have moderated growth in developing economies. If forecasts are realised, developing countries will experience the slowest three-year growth outcomes since the Asian financial crisis of the late 1990s. Growth in sub-Saharan Africa is expected to decline to 3.8 per cent in 2015 from 5 per cent in 2014, largely as a result of weaker commodity prices and lower demand from China.

Developing economies now produce about 58 per cent of global output, compared to just 42 per cent in the late 1990s, and there has been a corresponding shift in their influence on world financial markets. Recent exchange-rate policy changes in China, for example, prompted major market movements. The extent to which potential growth in developing countries has been lowered since the financial crisis remains unclear, with the resulting uncertainty contributing to market volatility.

Extent to which potential growth in developing countries has been lowered is unclear

For many developing economies, large debts accumulated over the past five years will constrain fiscal and monetary policy options. This is particularly true in countries reliant on foreign financing of debt, and which have elevated inflation or political risks, and large external balances. The weaknesses associated with these imbalances are expected to come into sharper focus when US monetary authorities act on their stated intention to raise interest rates. As a consequence, the speed of the global recovery is likely to depend on countries' ability to find domestic engines of economic growth.

Large debts accumulated over past five years will constrain developing countries' policy options

■ Domestic developments

South Africa's GDP grew by only 1.8 per cent in the first half of 2015 compared to the same period in 2014. Limited electricity supply weighed heavily on both mining and manufacturing production, and drought reduced agricultural output. Growth in the services sector (excluding government), which has supported growth by an average of 1.2 percentage points over the last five years, also slowed in the first half of the year.

Limited electricity supply continues to weigh heavily on industrial output

Domestic demand

Household consumption grew by 1.6 per cent in the first half of 2015, supported by lower petrol and food prices. However, the overall outlook is subdued, with consumer confidence below its long-term average. Employment growth remains weak. Credit conditions appear to have tightened, with both supply and demand for household credit shrinking.

Lower inflation has provided consumers with some respite. Consumer price index (CPI) inflation eased to 4.5 per cent over the first eight months of 2015, from 6.1 per cent in 2014, largely as a result of lower petrol prices. Core inflation, which represents the long-run trend of the price level and excludes temporary shocks, was unchanged at 5.7 per cent over the same period. Most upward pressure in core inflation has been generated by utilities, medical aid and education.

Inflation has remained within 3-6 per cent target band

Currency weakness and inflation risks

The effect of the exchange rate on domestic inflation has been muted over the past four years of rand depreciation. The Reserve Bank estimates that the current pass-through effect from a weak currency to goods inflation may be close to half its average longer-term level of about 20 per cent. Weak domestic demand seems to be limiting the ability of firms to pass on higher costs to consumers.

The ability of businesses to continue absorbing higher input costs may narrow if rand depreciation and shrinking profit share continue. In addition, inflation in services, which constitute 67 per cent of the core inflation basket, may be more affected by currency weakness. Given the weakness of the rand, higher global oil prices may pose a further upside risk to the outlook.

The Reserve Bank has pointed out that there are upside risks to the inflation outlook, including further currency depreciation. Given current

economic conditions, however, the pace and extent of rate increases is likely to be gradual. Policy rates remain below a 15-year average of 8.3 per cent.

Private-sector investment remains muted, and contracted by 0.1 per cent in first half of 2015

Private-sector investment remains muted. After contracting by 3.4 per cent in 2014, the decline in private-sector investment moderated to 0.1 per cent in the first half of 2015. The share of private investment funding capital replacement rather than new capacity rose from 58 per cent in 2006 to 79 per cent in 2014. There is, however, notable investment in new capacity in telecoms and renewable energy.

Since 2014, general government has made the largest contribution to investment growth. This trend partially offset the slowdown in annual investment growth by public corporations to 0.6 per cent in the first half of the year owing to construction delays at Eskom.

Private investment boosts electricity-generating capacity

As of October 2015, 92 projects had been selected as part of the Renewable Energy Independent Power Producer Programme. In aggregate, these projects represent R193 billion in private-sector investment and will add 6 327 MW of capacity to the national electricity grid. To date, 37 of these facilities have been connected to the grid, supplying as much as 1 800 MW of electricity.

The Minister of Energy recently issued a determination to procure another 6 300 MW through the renewables programme. The programme is expected to boost electricity capacity by 17 000 MW by 2022.

Government is expanding the independent power producer programme to include other generation technologies. The electricity regulator has approved 1 350 MW of short-term power-purchase contracts in 2015/16. An additional 2 500 MW of coal, 3 126 MW of gas, 1 800 MW of cogeneration and 2 609 MW of imported hydro power generating capacity is expected to be connected to the grid between 2020 and 2025.

Public-sector infrastructure spending to exceed R800 billion

Public-sector infrastructure spending is projected to be over R800 billion over the medium-term expenditure framework (MTEF) period. This expenditure is expected to crowd in private investment as infrastructure constraints ease. Government continues to encourage private-sector participation in infrastructure projects such as renewable energy and transport. These investments will contribute to a more efficient enabling environment that can support higher long-term growth when the economic cycle turns.

Labour markets

Formal-sector employment down but labour relations improving

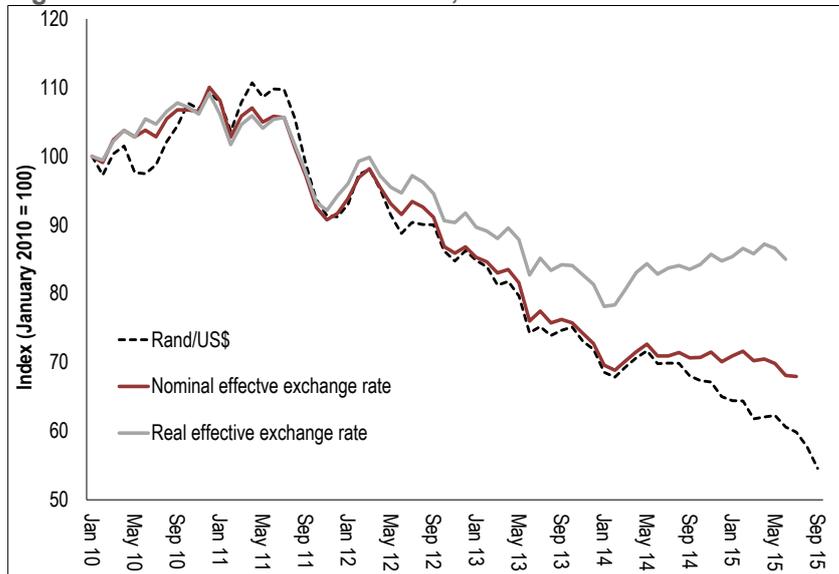
Persistently high unemployment remains one of South Africa's most pressing challenges. Labour relations have improved during 2015, with 176 000 workdays lost to industrial action in the first half of the year, down from 7.5 million in the first half of 2014. Strikes have been relatively short-lived, primarily affecting individual firms rather than entire subsectors.

Difficult trading conditions and low business confidence levels have limited hiring during 2015. According to Statistics South Africa, most of the 338 000 jobs created in the first half of the year were in the informal sector. The formal sector lost 76 000 jobs, with sharp declines in manufacturing and construction, as well as community, social and personal services. Employment is not expanding rapidly enough to absorb the estimated 659 000 new entrants into the job market in the first half of 2015. As at June 2015, there were an estimated 2.43 million discouraged work seekers.

Exchange rates, competitiveness and the current account

The prospect of weaker economic growth and higher US interest rates has weighed on global risk appetite, and in turn the performance of the rand.

Figure 2.1 Performance of the rand, 2010 – 2015



Source: Reserve Bank

All developing-country currencies have depreciated against the US dollar during 2015. By mid-October, the Brazilian real was down 28 per cent, the Turkish lira 19 per cent and the Mexican peso 16 per cent. The rand exchange rate had weakened by 13 per cent compared to the same period in 2014, reaching R13.35 to the US dollar. By contrast, the real exchange rate of the rand – which takes into account the relative inflation and exchange rates of South Africa’s main trading partners – appreciated by 5.4 per cent annually over the seven months to July. If South Africa’s inflation remains persistently higher than that of its trading partners, it will erode the export benefits of currency depreciation.

Exports grew by 9.7 per cent during the first half of 2015, up from 2.6 per cent in 2014, supported by improved European demand, capacity expansion at a major auto exporter and the cumulative effects of exchange-rate depreciation. Volume gains offset lower commodity prices. The trade deficit narrowed during the first six months of 2015, as did the deficit on the net service, income and current transfer balance. As a result, the current account deficit narrowed to 3.9 per cent of GDP in the first half of 2015 from 5.4 per cent in 2014.

South Africa’s capital markets have remained resilient despite heightened global volatility. Robust net portfolio inflows of R78.7 billion in the first six months of 2015 exceeded the 2014 figure of R50 billion. Direct investment flows both into and out of South Africa have been markedly lower in 2015. The balance on the financial account fell to R36.7 billion in the first half of 2015, from R81.6 billion in the second half of 2014.

To register lasting improvements in the current account balance, South Africa needs to lower the cost of doing business and build on the comparative advantages of local exports. The competitiveness gains of the

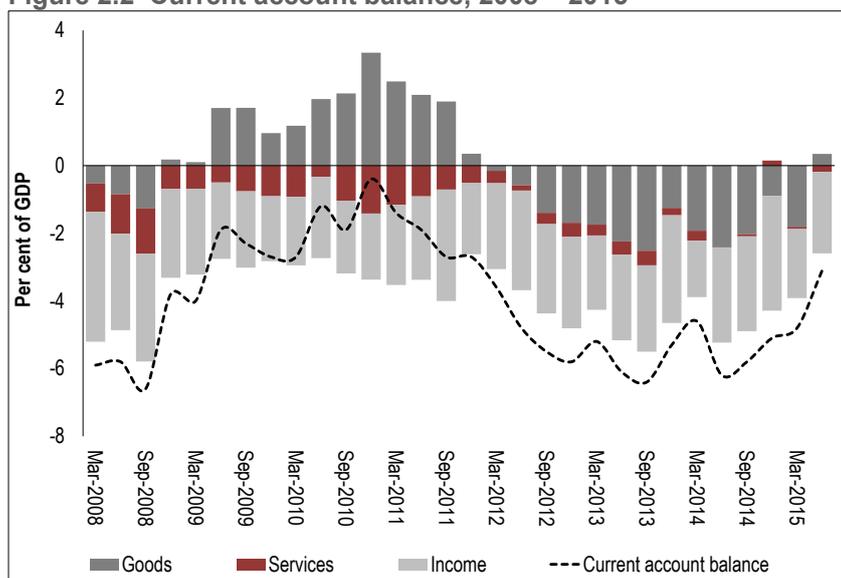
All developing-country currencies have been depreciating against the US dollar

Current account deficit has narrowed in response to export gains

Capital markets remain resilient despite heightened global volatility

last four years from a weaker currency cannot be taken for granted given similar trends in other developing economies.

Figure 2.2 Current account balance, 2008 – 2015



Source: Reserve Bank

Sharp decline in tourism, which contributes strongly to GDP, is of concern

Efforts to boost services exports to the rest of Africa and increase tourism will be important over the medium term. The World Travel and Tourism Council estimates that the direct and indirect contribution of travel and tourism to both GDP and employment was over 9 per cent in 2014. The sharp decline in tourism, which became pronounced in the second quarter of 2015, is of great concern.

■ Outlook

GDP growth to improve in 2018 as electricity constraint eases and demand increases

South Africa's real GDP growth, which was 1.5 per cent in 2014, is expected to reach only 1.5 and 1.7 per cent in 2015 and 2016 respectively. Electricity supply will remain a binding constraint through 2016, limiting output and dampening business and consumer confidence. Easing electricity, transport and telecommunications infrastructure constraints, alongside improved confidence and higher demand from major trading partners, are expected to boost GDP growth to 2.8 per cent in 2018.

Estimated investment growth of 1.2 per cent in 2015 is supported by general government. Private-sector investment is expected to improve in the outer year, bringing total investment growth to 3.8 per cent by 2018. With limited investment growth over the next two years, however, there will be little support for significant employment gains. As a result, household consumption growth is expected to rise above 2 per cent only in 2017.

Demand for capital and consumer goods will see import growth outpace export growth

Exports are forecast to grow by 8.3 per cent in 2015, bolstered by relatively strong performance in the first half of the year. Growth is not expected to be as strong during 2016 due to the high base of 2015. However, easing infrastructure constraints and improved global growth will support growth of 5.5 per cent by 2018. Import growth is expected to outpace export growth over the forecast period, as domestic demand recovers, boosting imports of both capital and consumption goods.

Table 2.2 Macroeconomic performance and projections, 2012 – 2018

Calendar year	2012	2013	2014	2015	2016	2017	2018
	Actual			Estimate	Forecast		
<i>Percentage change unless otherwise indicated</i>							
Final household consumption	3.4	2.9	1.4	1.5	1.7	2.5	2.8
Final government consumption	3.4	3.3	1.9	0.7	1.6	1.2	1.1
Gross fixed capital formation	3.6	7.6	-0.4	1.2	1.5	3.2	3.8
Gross domestic expenditure	3.9	1.4	0.6	0.6	2.0	2.7	2.8
Exports	0.1	4.6	2.6	8.3	3.2	5.0	5.5
Imports	6.0	1.8	-0.5	5.3	4.3	5.4	5.5
Real GDP growth	2.2	2.2	1.5	1.5	1.7	2.6	2.8
GDP inflation	5.5	6.0	5.8	4.6	6.0	5.9	5.8
GDP at current prices (R billion)	3 263	3 534	3 796	4 031	4 349	4 726	5 143
CPI inflation (Dec 2012 = 100)	5.7	5.8	6.1	4.8	6.2	5.9	5.8
Current account balance (% of GDP)	-5.0	-5.8	-5.4	-4.1	-4.4	-4.6	-4.8
Fiscal year	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
GDP inflation	5.8	6.1	4.8	5.4	6.0	5.9	5.8
GDP at current prices (R billion)	3 328	3 610	3 844	4 103	4 437	4 827	5 252
CPI inflation (Dec 2012 = 100)	5.6	5.8	5.6	5.5	6.0	5.8	5.8
Real GDP growth	2.1	2.2	1.6	1.2	2.1	2.7	2.8

Source: Reserve Bank and National Treasury

The current account deficit is expected to narrow to 4.1 per cent of GDP in 2015, owing to healthy export performance and terms of trade gains in the first half of the year. Import growth, however, is expected to widen the current account deficit to 4.8 per cent of GDP by 2018.

Inflation has been in line with 2015 Budget forecasts. Upward pressure on food prices and higher petrol inflation are expected to push CPI inflation above the 6 per cent target ceiling in the first half of 2016. The forecast takes into account a 12.7 per cent per year increase in electricity prices. Upside risks to the inflation forecast revolve around additional exchange rate depreciation, the extent to which businesses can continue to absorb higher input costs from the weaker rand and electricity price increases.

CPI expected to breach 6 per cent in 2016

External risks to the economic forecast include a further slowdown in the global economy (especially among South Africa's main trading partners), higher oil prices, lower export commodity prices and increased financial market volatility resulting in capital outflows. Electricity supply shortages pose the largest domestic risk to growth.

Further slowdown in global economy, higher oil prices and electricity supply are risks to economic forecast

Key assumptions underpinning the economic forecast are provided in the technical annex.

■ Charting a path to higher growth

Persistent weakness in the global economy underlines the importance of structural reforms in South Africa. Economic performance will depend on how well interventions to boost growth are coordinated and implemented within government and with private-sector partners. Government is guided in this regard by the medium-term strategic framework – which serves as the five-year implementation framework of the NDP. A synopsis of short and long-term actions to boost growth is provided below.

Persistent weakness in global economy underlines need for structural reforms set out in NDP

Action on binding constraints

Electricity supply

Progress in stabilising electricity grid and promoting measures to manage demand

Constrained electricity supply remains the single largest drag on economic activity, estimated to cost close to one percentage point of annual GDP growth. Over the past nine months, progress has been made in stabilising electricity supply, promoting measures to manage demand and contracting additional supply from the private sector.

The first unit of the Medupi power station was fully commissioned in August 2015, adding 794 MW to the national grid. Once the Koeberg power station returns from planned maintenance in December, there will be an additional 900 MW available to the grid. The Sere wind farm added 100 MW of capacity in February. The Majuba plant has been returned to service and work to repair the damaged boiler at the Duvha plant is in progress. Eskom has been taking steps to improve the efficiency of its maintenance programme.

Labour relations

Government, business, labour and community representatives working to address disruption caused by large, protracted strikes

In 2014, labour-related work stoppages reduced growth by at least 0.6 percentage points. Government has prioritised stability in labour relations. The Commission for Conciliation, Mediation and Arbitration is taking an active role in settling disputes, and has cut the duration of arbitration proceedings by more than 75 per cent since 2003. A National Economic Development and Labour Council task team is working to address the disruption of the economy caused by large, protracted strikes, and discussing a minimum wage. In September 2015, parties to the mining framework agreement declared their intention to limit job losses.

Policy coordination, certainty and implementation

Future legislation and regulations subject to socioeconomic impact assessment

Building a capable state requires government to improve the effectiveness of the public sector, expand partnerships with the private sector and strengthen the governance of state-owned entities.

Government has decided that from 1 September 2015 all future legislation and regulations will be subject to a socioeconomic impact assessment before being passed. This process will promote greater policy coordination, highlight potential implementation risks or unintended consequences, and allow for the development of mitigation strategies or alternative solutions before the legislative process begins. The Department of Planning Monitoring and Evaluation is also taking steps to strengthen monitoring and evaluation across government.

Operation Phakisa has been extended to improve coordinated planning by government, industry and other interested parties.

Operation Phakisa

Government launched the Phakisa programme, modelled on Malaysia's system for delivering results in key sectors of the economy, in mid-2014.

The **oceans economy** Phakisa focused on expanding trade in oil and gas, servicing maritime equipment, and oil and gas exploration off the South African coast. Projects include the following:

- Construction began on Saldanha Bay's liquefied petroleum gas terminal in February 2014, and civil works to support the 13.2 million barrel commercial crude oil blending and storage terminal began in 2015. In Cape Town, construction of the R660 million Burgan fuel storage facility should get under way soon.
- Port infrastructure upgrades of R9.7 billion have been announced to support trade and large-rig repair. Public-private partnerships were invited and projects should be commissioned by December 2017.
- A R30 million programme to rehabilitate ship-repair facilities in the Port of Durban is under way.

The **health** Phakisa identified interventions to raise standards of primary health care clinics. Progress to date includes the use of cellphone technology in 1 200 clinics to improve supply of antiretroviral medication. The **education** Phakisa to enhance basic education with technology has begun. A **mining** Phakisa to take place in late October 2015 will examine next-generation mining techniques that build on South Africa's expertise and allow for upstream opportunities for domestic producers, as well as other topics.

Long-term reforms

Investment in infrastructure

Major state-owned companies continue to roll out infrastructure:

- Investments in water and telecommunications infrastructure are taking place. South Africa's ratings in the World Economic Forum's *Global Competitiveness Report* improved seven places to 49 out of 140 countries, thanks largely to increased bandwidth.
- Projected capital investment by Eskom to expand electricity generating capacity totals R157 billion over the medium term. This includes the Medupi and Kusile power stations to augment generation capacity, and strengthening of the transmission and distribution grids.
- Transnet's R336 billion investment programme continues to expand rail infrastructure and renew rolling stock. Transnet recently secured R2.8 billion from development bank KfW to finance construction of 240 electric locomotives, and R30 billion over 15 years from the China Development Bank to finance a joint locomotive build project.

Competitiveness improves as result of broadband investment

Large cities are building modern rapid transit systems and upgrading commuter rail services. The metropolitan municipalities are promoting integrated development projects, helping to reshape the urban landscape.

Accelerating urban investment

Government is working with cities to promote inclusive economic growth. Considerable transformative investment activity is already under way:

- The R20 billion Cornubia project in eThekweni will include 25 000 residential units and 1.4 million square metres of commercial space. A 12 ha commercial hub is under construction and has already been sold.
- The Ekurhuleni metro has secured private investment projects worth over R20 billion, including manufacturing and mixed-use facilities.
- In Nelson Mandela Bay, the recent opening of the Baywest centre is likely to encourage greater private investment in surrounding areas.
- Johannesburg is investing R3.5 billion in its Corridors of Freedom project between now and 2017/18.
- Buffalo City's partnership approach in the tourism sector has led to the signing of a 20-year lease for motor racing facilities.

Reforms reduce port costs and turnaround times

The Ports Regulator of South Africa has begun a 10-year programme to ensure tariffs better reflect the cost of using port assets such as berths and quay walls. Cargo dues on export containers are 38 per cent lower than three years ago. The port of Durban has implemented an integrated ports management system, dramatically reducing turnaround times by replacing manual processes and improving train loading and cargo shipment.

Regional infrastructure and cooperation to promote growth

Regional infrastructure projects to improve two-way trade in SADC

Regional infrastructure projects seek to upgrade infrastructure and remove impediments to two-way trade flows. The vast majority of Southern African Development Community (SADC) trade takes place outside the region. In May, the SADC approved a US\$3.5 million feasibility study for a regional project to expand and transmit Mozambique's hydro power and diversify South Africa's electricity supply. The free-trade area agreed by the SADC, East African Community and Common Market for Eastern and Southern Africa aims to bring together a market of 600 million consumers. Participants have agreed on tariff liberalisation and related rules, and the next phase will focus on trade in services.

Support for business

Government to review all incentives to business over the medium term

Government provides a range of business support incentives, including direct transfers and tax incentives. Over the medium term, government will review all incentives to assess their effects on economic growth, productivity, competitiveness, the balance of trade and employment.

To promote transformation, government has reformed the broad-based black economic empowerment legislation, as well as state procurement legislation. The Industrial Policy Action Plan remains a central component of government's strategy to diversify the economy.

The 200 businesses with high-growth potential to be selected under the Department of Small Business Development's Gazelles programme will receive financial support, as well as coaching from the private sector.

Doing Business in South African cities

The *Doing Business 2015* report for South Africa was produced by the World Bank on behalf of the National Treasury, Department of Trade and Industry, South African Cities Network and nine urban centres.

Local firms evaluated performance across six indicators. The survey found that South African entrepreneurs face different regulatory hurdles depending on where they establish their businesses.

Across the nine participating cities, it is easiest to start a business in Ekurhuleni, Johannesburg and Tshwane; deal with construction permits in Cape Town; get a commercial electricity connection and enforce a contract in Mangaung; and register property in Johannesburg. There is no relationship between the size of the city and the rankings, and no single city performs equally well on all indicators.

The results suggest that well-targeted administrative improvements that do not require legislative changes can make a difference for small or medium-sized firms. If each metro were to adopt the good practices found across the nine cities for construction permits, getting electricity and enforcing contracts, they would surpass the average performance of high-income members of the Organisation for Economic Cooperation and Development.

Conclusion

A weak growth outlook is not unique to South Africa. Diligent attention to address binding growth constraints and strengthened partnerships with the private sector will create a platform for investment, employment and development.