2

Economic outlook

In brief

- The coronavirus pandemic has led to a global recession, and the recovery is expected to be long and uneven.
- As the domestic economy recovers, real GDP growth is expected to average 2.1 per cent over the medium term. Although growth rates are likely to improve quickly, off a low base, output is only expected to return to pre-pandemic levels in 2024. There is significant uncertainty associated with the forecast, particularly if a second wave of the pandemic forces a return to a stricter lockdown.
- The fiscal position is a risk to the outlook: higher long-term borrowing costs and risk premiums have started to affect the broader economy. Steps to narrow the budget deficit and stabilise debt will support long-term growth.
- The economic recovery plan agreed in partnership between government, business, labour and civil society targets short-term measures to boost energy production, infrastructure investment and public employment, alongside crucial structural reforms that will raise long-term growth. Operation Vulindlela, a joint initiative of the Presidency and the National Treasury, is tasked with speeding up implementation of priority reforms.

Introduction

South Africa's economy is expected to contract by 7.8 per cent this year in real terms. COVID-19 and measures taken to protect public health resulted in steep declines in consumption, investment and exports. GDP growth is expected to rebound to 3.3 per cent in 2021, and to average 2.1 per cent over the medium term. Based on this projection, the economy will only recover to 2019 levels in 2024.

The sharp downturn in the domestic economy follows a decade of economic stagnation, complicating South Africa's recovery. Over the past 10 years, real GDP growth averaged 1.4 per cent, while the population grew by 1.6 per cent per year.

In this context, there is a need to forge a national consensus through a social compact that addresses both short- and long-term structural growth challenges. In recent months, government, business, labour and civil society have developed an economic recovery plan. Recognising that many plans fail to translate into action, the Presidency and the National Treasury have established Operation Vulindlela, an initiative to accelerate

effective implementation of structural reforms to boost the rate of sustainable economic growth.

A social partnership to boost confidence, restart the economy and conduct urgent reforms

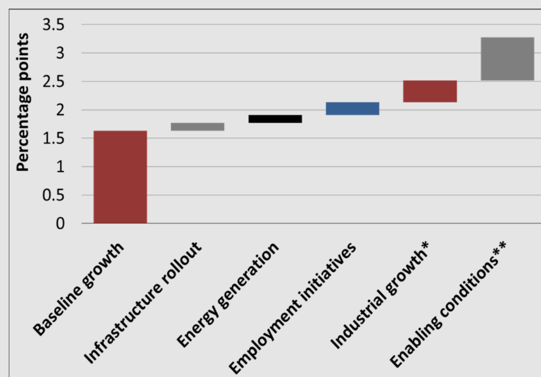
The economic recovery plan was developed through extensive consultations between government, business, labour and civil society. It has two broad components.

A range of immediate and short-term measures will be taken to rebuild confidence, kick-start the economy and continue to mitigate the effects of the pandemic. And structural reforms will promote faster, more inclusive growth and employment over the medium to long term. Many of these reforms are drawn from government's long-term structural reform agenda as outlined in the discussion paper that the National Treasury released in 2019 – *Economic Transformation, Inclusive Growth, and Competitiveness: Towards an Economic Strategy for South Africa*. Parliament approved the plan on 15 October 2020.

In the short term, the plan will focus on rolling out infrastructure, expanding energy generation capacity, creating mass public employment and supporting rapid industrialisation. At the same time, government will implement structural reforms such as modernising network industries, reducing barriers to entry, and increasing regional integration and trade. The National Treasury estimates that reforms in these areas can raise growth to over 3 per cent over the next 10 years and create more than 1 million jobs.

The plan is accompanied by a detailed implementation schedule that will be overseen by a council chaired by the President. It will be supported by a leadership team that coordinates reporting and identifies areas where more effective partnerships are required.

Figure 2.1 Economic recovery plan effects on growth by 2030



**Agriculture and industrial initiatives*
***Reducing barriers to entry, easing the skills constraint and implementing tourism initiatives*
Source: National Treasury projections.

Operation Vulindlela: implementing structural reforms

Many of the proposed reforms in the economic recovery plan and their potential benefits have been detailed in recent editions of the *Budget Review* and *Medium Term Budget Policy Statement.* Yet implementation has been delayed by a lack of agreement over proposed reforms, a failure to prioritise and sequence reforms that have been agreed on, and lack of capacity in government.

Operation Vulindlela will support the implementation of the economic recovery plan by accelerating priority structural reforms. It is based on similar "delivery unit" initiatives in countries such as the United Kingdom and Malaysia, as well as lessons learnt in South Africa. The initiative will be staffed by a full-time technical team that draws on additional expertise and capacity in the public and private sectors. The team will assist the economic cluster, Cabinet and the President to coordinate and accelerate the implementation of a limited number of priority reforms.

Global outlook

The International Monetary Fund (IMF) expects global output to contract by 4.4 per cent in 2020, rebounding from a low base to 5.2 per cent growth in 2021. While GDP growth in many countries recovered more quickly than expected in the third quarter of 2020, resurgent coronavirus infections and additional lockdowns are serious risks to the outlook. Large economies such as the United States, Brazil and India continue to battle high infection rates, and subsequent waves of infection have required the return to partial lockdowns in continental Europe and the United Kingdom.

Table 2.1 Economic growth in selected countries

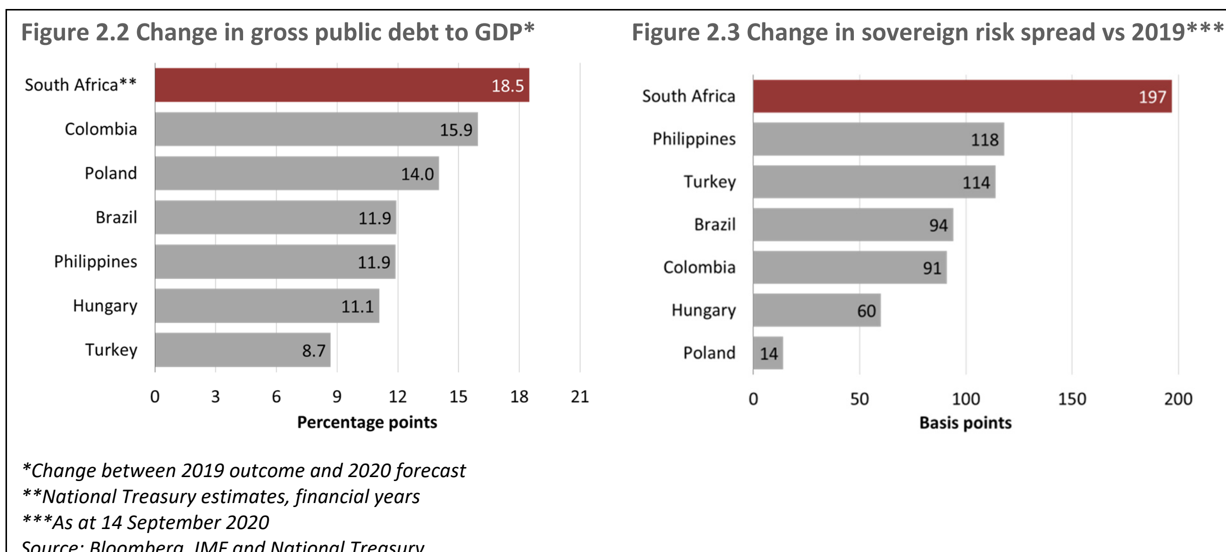
Region/country Percentage	2018	2019	2020	2021	2020	2021
	Actual		Projections		Difference from June 2020 projections	
World	**3.5**	**2.8**	**-4.4**	**5.2**	**0.8**	**-0.2**
Advanced economies	**2.2**	**1.7**	**-5.8**	**3.9**	**2.3**	**-0.9**
United States	3.0	2.2	-4.3	3.1	3.7	-1.4
Euro area	1.8	1.3	-8.3	5.2	1.9	-0.8
United Kingdom	1.3	1.5	-9.8	5.9	0.4	-0.4
Japan	0.3	0.7	-5.3	2.3	0.5	-0.1
Emerging and developing countries	**4.5**	**3.7**	**-3.3**	**6.0**	**-0.2**	**0.2**
China	6.7	6.1	1.9	8.2	0.9	–
India	6.1	4.2	-10.3	8.8	-5.8	2.8
Brazil	1.3	1.1	-5.8	2.8	3.3	-0.8
Russia	2.5	1.3	-4.1	2.8	2.5	-1.3
Sub-Saharan Africa	**3.3**	**3.2**	**-3.0**	**3.1**	**0.2**	**-0.3**
Nigeria	1.9	2.2	-4.3	1.7	1.1	-0.9
South Africa[1]	0.8	0.2	-7.8	3.3	-0.6	0.4
World trade volumes	**3.9**	**1.0**	**-10.4**	**8.3**	**1.5**	**0.3**

1. National Treasury forecasts
Source: IMF World Economic Outlook, October 2020

Containment of COVID-19 is expected to support an improving growth outlook in advanced economies in 2021. Developing countries are set to grow faster than their developed counterparts next year, but their economic prospects remain precarious given the weight of highly exposed sectors such as tourism, and a disproportionate reliance on external finance and remittances.

After posting record declines in March in response to the pandemic, global equity markets have since broadly regained (and in some cases exceeded) their levels from the start of the year. Markets have been buoyed by a massive injection of liquidity from central banks. This liquidity and high investor demand for lower-risk assets fuelled a large increase in purchases of developed economies' government bonds, leading to notable declines in their bond yields.

The bond yields of many developing countries have declined more moderately, reflecting comparatively lower demand. Brazil, Turkey and South Africa, however, were exceptions: the increase in their government borrowing costs reflects higher risk perceptions due to deteriorating economic and fiscal metrics (Figures 2.2 and 2.3).



*Change between 2019 outcome and 2020 forecast
**National Treasury estimates, financial years
***As at 14 September 2020
Source: Bloomberg, IMF and National Treasury

Precious metal prices have risen amid demand for safe-haven investments, and following production interruptions associated with lockdowns. Global interest rate cuts and central bank liquidity injections helped push gold prices to record highs of over US$2 000 per ounce in August.

As oil demand collapsed, the Brent crude oil price fell to lows of about US$20 per barrel in April. It is now forecast to increase gradually in line with a measured recovery in demand.

After depreciating against the US dollar in the first four months of this year, as the extent of the COVID-19 pandemic became apparent, developing-country currencies have recovered some ground. A broad index of these currencies weakened by 1.9 per cent against the dollar in the first nine months of 2020, while the rand is down 16.4 per cent on concerns about fiscal sustainability and economic prospects.

Declining appetite for risk led to a significant fall in capital inflows to developing economies, many of which have large current account deficits and rely on foreign savings to finance these deficits. In the second quarter of 2020, South Africa's financial account of the balance of payments posted its largest outflows since the global financial crisis, as non-residents sold off investments. Continued monetary policy stimulus, particularly in major developed economies, may support a moderate rise in risk appetite.

Borrowing to support the coronavirus response has increased the global stock of sovereign debt. Multilateral financial institutions have emphasised the need for policy makers to do what is necessary to support near-term growth with a sustainable rate of debt accumulation, while avoiding a build-up of unsustainable risks over the medium term. Global growth prospects will ultimately depend on the efficacy of efforts to bolster economic resilience, supported by investment and structural reforms that enhance growth and equity.

The gains from reform: the case of Brazil

Credible fiscal and economic reforms, the full effects of which may only be realised over the medium term, can reduce government borrowing costs and boost investor confidence in the short term, as recently demonstrated in Brazil.

Brazil and South Africa are often compared as developing-country peers. In both nations, GDP growth rates have declined over the past decade, partly due to weaker commodity prices and reduced business confidence, and government debt has risen rapidly. These fiscal challenges are reflected in elevated risk premiums – the higher returns governments must pay to compensate investors for perceived riskiness – and elevated bond yields.

South Africa and Brazil have tended to move closely together in both categories. Since late 2018, however, Brazil's risk premium and the yield on its 10-year government bond have declined in comparison with South Africa. Although its debt has risen sharply, Brazil has made significant progress on a range of long-awaited and far-reaching reforms. This included simplifying its tax system (one of the world's most complex systems) and revisions to its pension framework. It is now estimated that Brazil's debt will no longer balloon to over 140 per cent of GDP over the next decade, but rise on a more moderate trajectory to about 100 per cent of GDP by 2030. As investor confidence subsequently improved, lower borrowing costs created additional fiscal space beyond the direct economic effect of the reforms.

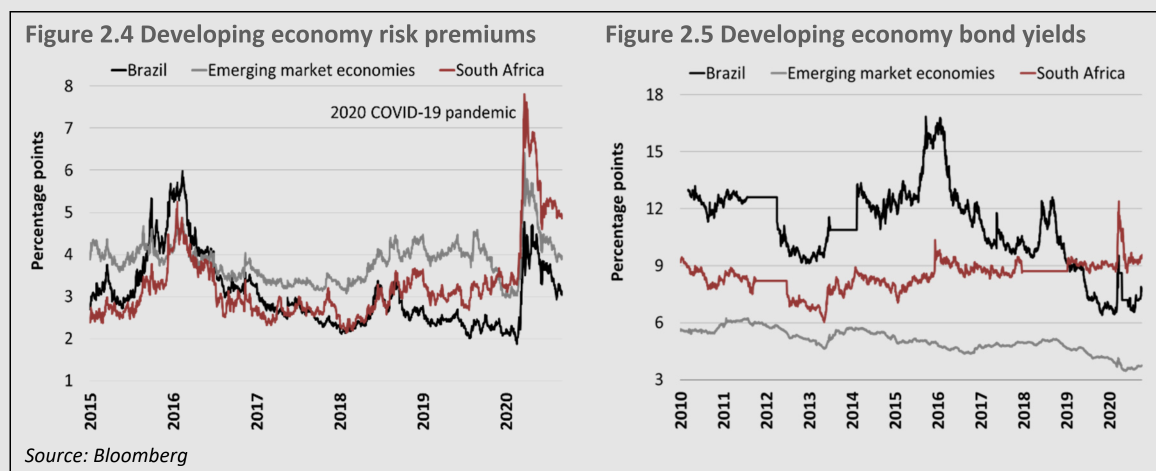


Figure 2.4 Developing economy risk premiums

Figure 2.5 Developing economy bond yields

Source: Bloomberg

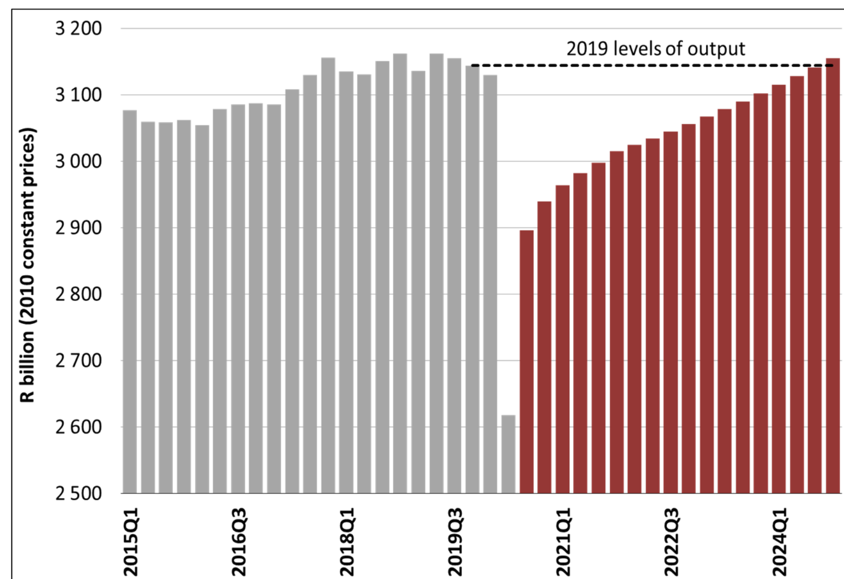
Domestic outlook

The National Treasury projects real economic growth of 3.3 per cent in 2021, following an expected contraction of 7.8 per cent in 2020. Real GDP growth is expected to moderate to 1.7 per cent in 2022 and 1.5 per cent in 2023, averaging 2.1 per cent over the medium term.

South Africa experienced its largest recorded decline in economic output in the second quarter of 2020 due to the strict COVID-19 lockdown. Real GDP fell by 17.1 per cent relative to the previous quarter (or 51 per cent on a seasonally adjusted and annualised basis), with all major sectors except agriculture declining. The second-quarter results were weaker than expected in the June special adjustments budget, which projected a contraction of 7.2 per cent in 2020.

High-frequency data for the third quarter – such as the volume of electricity distributed, mining and manufacturing output, business confidence and the Absa Purchasing Managers' Index (PMI) – shows evidence of a limited rebound. Although growth rates are likely to improve quickly as restrictions are removed, based on current projections output is only expected to return to pre-pandemic levels in 2024.

Figure 2.6 Anticipated recovery in economic activity



Source: National Treasury calculations and Statistics South Africa

Risks to the growth outlook

The main risks to the economic outlook are weaker-than-expected growth, continued deterioration in the public finances and a failure to implement structural reforms. A second wave of COVID-19 infections, accompanied by new restrictions on economic activity, would have significant implications for the outlook.

Government's fiscal position is a risk to growth: higher long-term borrowing costs and risk premiums have started to affect the broader economy, as discussed in Chapter 3. In addition, recovery efforts will fail unless structural constraints (including in energy, infrastructure and competitiveness) are urgently addressed. While the reforms required in these areas do not immediately affect growth, they are critical for confidence and investment.

Globally, there are persistent risks associated with COVID-19 and rapid debt accumulation. While global monetary policy is expected to continue supporting growth and liquidity, financial market sentiment is likely to remain volatile. This implies continued bouts of risk aversion and lower global capital flows to small, open developing countries like South Africa.

There is also the possibility of a faster-than-expected global recovery if reopening economies normalise quickly. The development of a safe and effective COVID-19 vaccine would likely improve sentiment, productivity and growth in the short to medium term.

Table 2.2 Macroeconomic performance and projections

Calendar year	2017	2018	2019	2020	2021	2022	2023
Percentage change		Actual		Estimate		Forecast	
Final household consumption	2.1	1.8	1.0	-7.9	4.7	2.2	1.9
Final government consumption	0.2	1.9	1.5	1.0	-2.5	-2.4	-3.6
Gross fixed-capital formation	1.0	-1.4	-0.9	-19.6	-1.4	3.9	3.9
Gross domestic expenditure	1.9	1.0	0.7	-8.5	2.9	1.6	1.3
Exports	-0.7	2.6	-2.5	-12.8	5.9	3.0	2.7
Imports	1.0	3.3	-0.5	-14.7	4.7	2.8	2.2
Real GDP growth	**1.4**	**0.8**	**0.2**	**-7.8**	**3.3**	**1.7**	**1.5**
GDP inflation	5.3	3.9	4.0	4.3	3.9	4.2	4.3
GDP at current prices (R billion)	**4 654**	**4 874**	**5 078**	**4 885**	**5 240**	**5 553**	**5 877**
CPI inflation	5.3	4.6	4.1	3.2	4.1	4.4	4.5
Current account balance (% of GDP)	-2.5	-3.5	-3.0	-0.8	-1.6	-2.0	-2.7

Source: National Treasury, Reserve Bank and Statistics South Africa

Macroeconomic assumptions

The forecast incorporates assumptions outlined in Table 2.3 below. The main changes since the June special adjustments budget include upward revisions to key export prices. A gradual recovery in nominal investment by government and public corporations, while public consumption declines in nominal terms, reflects fiscal consolidation that is weighted towards the public-service wage bill and seeks to protect capital spending from reductions.

Table 2.3 Assumptions informing the macroeconomic forecast

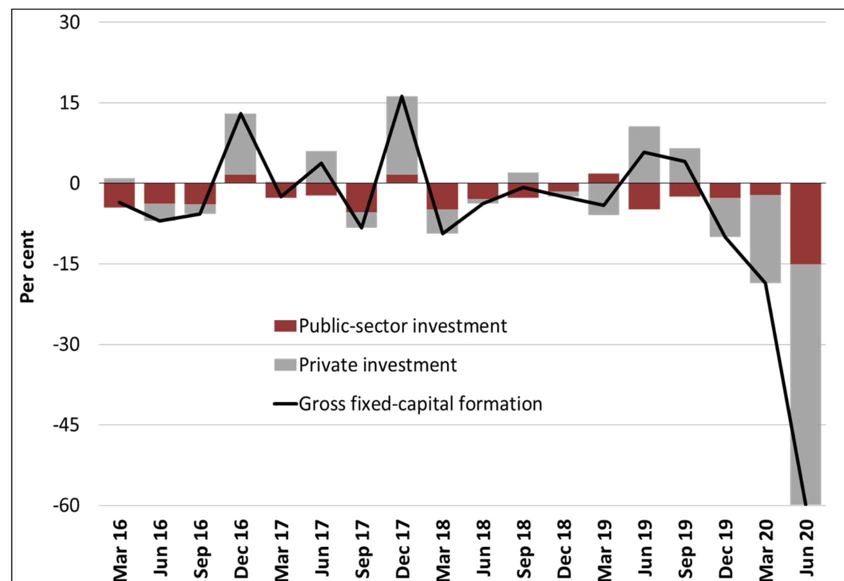
	2018	2019	2020	2021	2022	2023
Percentage change	Actual		Estimate		Forecast	
Global demand[1]	**4.4**	**3.3**	**-2.7**	**6.2**	**4.5**	**4.4**
International commodity prices[2]						
Brent crude oil (US$ per barrel)	71.0	64.3	40.8	43.0	45.2	46.7
Gold (US$ per ounce)	1 269.3	1 392.5	1 776.8	1 921.9	1 938.6	1 959.4
Platinum (US$ per ounce)	880.7	863.8	870.0	903.3	927.5	952.1
Coal (US$ per ton)	90.5	78.5	63.5	67.9	71.0	73.2
Iron ore (US$ per ton)	67.2	91.1	99.8	90.5	76.2	65.0
Food inflation	**3.6**	**3.4**	**4.2**	**4.3**	**4.5**	**4.6**
Sovereign risk premium (percentage point)	**3.1**	**3.2**	**5.2**	**4.8**	**4.0**	**3.7**
Public corporation investment	**-12.5**	**-1.6**	**-26.9**	**-4.1**	**3.9**	**2.3**

1. Combined growth index of South Africa's top 15 trading partners (IMF World Economic Outlook, October 2020)
2. Source: Bloomberg futures prices as at 14 October 2020
Source: National Treasury

Investment

The decline in gross fixed-capital formation across the public and private sectors deepened in the second quarter. South Africa is on course for its fourth consecutive year of contracting investment, and investment as a percentage of GDP has fallen from 23 per cent in 2008 to an average of 17 per cent in 2020 to date. A credible fiscal framework and the rapid and effective implementation of the economic recovery plan, including addressing electricity supply constraints, is crucial to boost investment.

Figure 2.7 Gross fixed-capital formation



Source: Statistics South Africa

Household consumption

Household expenditure has evolved in line with lockdown restrictions, with high-contact, consumer-facing sectors (retail, leisure, alcohol and tobacco) experiencing a sharp drop due to COVID-19 containment measures. Conversely, higher spending on communication, housing and utilities is consistent with increased home-based work and leisure.

Aggregate household consumption is expected to remain below pre-pandemic levels for some time. Consumption will be severely constrained by record job losses, steep declines in incomes and low confidence. Despite lower interest rates and inflation, demand for credit remains muted, implying that households expect prolonged economic weakness.

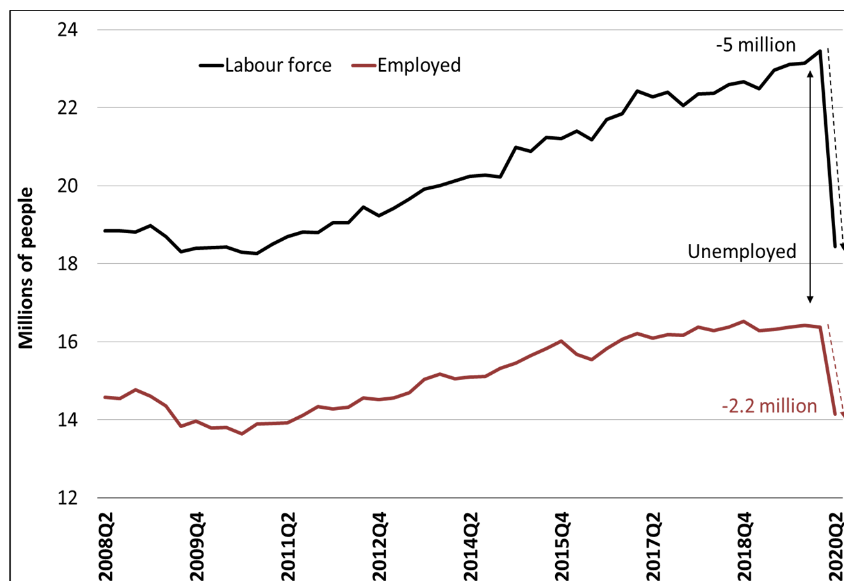
Inflation

Headline inflation is at the lower end of the 3 to 6 per cent target range. Goods and services inflation has broadly declined due to weak demand and falling oil prices. Inflation is forecast to fluctuate around the 4.5 per cent midpoint over the medium term in line with moderating inflation expectations. Below-potential economic output and weak imported inflation are also expected to keep inflation contained.

Employment

The coronavirus pandemic and the associated lockdown led to record unemployment, as businesses closed and millions were unable to seek work. In a population of 59.6 million, with a labour force of 18.4 million, only 14.1 million South Africans are currently employed (Figure 2.8).

Figure 2.8 The South African labour market



Source: Reserve Bank and Statistics South Africa

Restrictions on movement and activity resulted in a technical fall in the official unemployment rate in the second quarter of 2020 (to 23.3 per cent, from 30.1 per cent in the first quarter). Although 2.2 million fewer people were employed in the second quarter, millions more were defined as economically inactive – outside the labour market – because they were unable to look for work. The expanded unemployment rate, which includes those out of work who were not actively looking for work, increased by 2.3 percentage points to 42 per cent – its highest level since the Quarterly Labour Force Survey began in 2008.

Recent surveys, including the second round of the National Income Dynamics Study – Coronavirus Rapid Mobile Survey, show that many temporary job losses are at risk of becoming permanent as lockdown restrictions lift.

Worker mobility, skills and productivity

In the long run, economic growth is driven by productivity gains. Worker mobility across firms is one channel through which productivity can rise, if workers bring new technological knowledge that boosts the productivity and innovative ability of their new firms. This is likely where large knowledge gaps exist between firms, and where workers are moving from high- to low-productivity firms.

Recent research[1] indicates that, on average, South African workers are more likely to move from low-productivity to high-productivity firms, which lowers the average productivity of the receiving firms. This is likely due to significant skills shortages in the South African labour market, which constrain long-term growth.

[1]A. Hlatshwayo (National Treasury), F. Kreuser, C. Newman, and J. Rand. 2019. *Worker Mobility and Productivity Spillovers: An Emerging Market Perspective* (https://sa-tied.wider.unu.edu)

Job creation is a top priority of the economic recovery plan that will guide policy actions over the medium term, supported by new infrastructure investment and large-scale public employment programmes. In addition, targeted skills development will improve productivity and employment prospects.

Sector performance and outlook

Growth in real output contracted by 8.7 per cent in the first six months of 2020 compared with the same period in 2019. The steep annualised contraction in the second quarter marked the fourth consecutive quarter of contraction.

Agriculture

Agriculture was the only sector that increased output during the first half of 2020. Real gross value added in the agriculture, forestry and fishing industry grew by 11.7 per cent in the first half of 2020 compared with the same period in 2019. Favourable weather conditions are expected to support grain production, as shown in a substantially higher maize crop and optimistic forecasts for wheat production in 2020. This will also support the livestock industry, which has largely recovered from the outbreak of foot-and-mouth disease in 2019.

Agriculture recorded a trade surplus in the first half of 2020, bolstered by higher exports in citrus, maize, apples, macadamia nuts and sugar cane. Exports are expected to remain strong for the rest of the year, supported by high external demand.

Mining

Reflecting the global downturn, mining production contracted by 19.8 per cent in the first six months of 2020 compared with the same period in 2019. Mining remains susceptible to fluctuating global demand. In addition, domestic structural challenges such as regulatory uncertainty, lack of investment and electricity disruptions continue to affect sector performance. As a result, production is likely to remain weak for the next few years.

Manufacturing

Manufacturing output contracted by 18.3 per cent in the first six months of 2020 compared with the same period in 2019. This was the largest contribution to the overall decline in output. Over the same period, manufactured exports and imports fell by 26.7 per cent and 11.2 per cent respectively.

While production remains below pre-pandemic levels, improving business conditions boosted the Absa PMI to 58.3 index points in September 2020 – its fifth consecutive month above the neutral 50-point mark. Production is expected to recover gradually, and the outlook remains subdued due to unstable electricity supply, low demand, and weak domestic and global growth.

Electricity

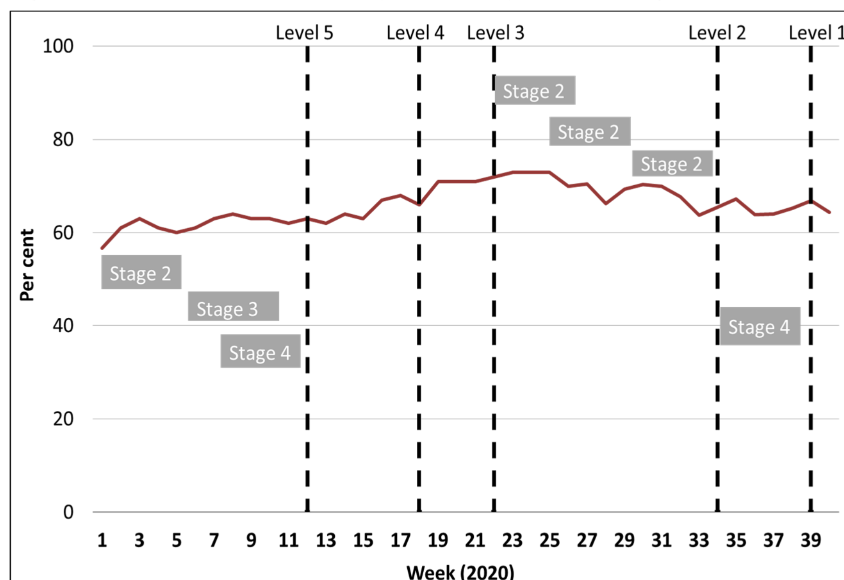
The electricity, gas and water sector contracted by 8.7 per cent in the first six months of 2020 relative to the first half of 2019. The decline was largely due to a broad industrial and mining shutdown for much of the second quarter, and the poor performance of Eskom plants.

The Level 5 lockdown offered an opportunity for Eskom, whose staff were defined as essential workers, to expedite maintenance. As the economy

reopened, however, capacity was still insufficient to meet demand. The electricity availability factor from coal-fired power stations improved to 73 in June, before deteriorating to 65 in September as lockdown levels eased.

Electricity remains a binding constraint on economic recovery, with power interruptions expected to continue into 2021. Private generation will only be able to plug the electricity gap to a limited extent over the next year.

Figure 2.9 South African electricity availability factor during 2020



Source: Eskom and National Treasury calculations

Construction

Real gross value added in the construction sector fell 19.2 per cent in the first half of 2020 relative to the corresponding period in 2019. Sector outcomes correspond with falling investment – particularly lower investment by public corporations. The sector has contracted for the past eight quarters.

The lockdown resulted in a near-complete shutdown of the construction sector, which employs over 1 million people. Employment fell by 10.8 per cent in the first half of 2020 compared with the same period in 2019. Uncertainty, low investment and electricity supply interruptions are expected to hamper recovery over the medium term.

Transport, storage and communication

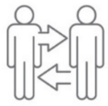
The transport, storage and communication sector contracted by 15.1 per cent in the first half of the year relative to the same period in 2019. Lockdown restrictions severely affected land and air transport, as well as support services, with the effects of travel restrictions outweighing the gains from increased demand for networking and data services to support remote work and business continuity.

Finance and business services

The finance and business services sector contracted by 1.8 per cent in the first half of 2020 compared with the same period in 2019, marking the first quarter-on-quarter decline since 2009. Lingering risks to the banking sector include a build-up of credit losses, deteriorating profitability and exposure to weakness in the broader economy. That said, domestic banks and insurers remain largely sound, highly liquid and well capitalised.

Banks have continued to provide credit to the rest of the economy. However, a deeper economic downturn amid increasing indebtedness and associated credit defaults could undermine financial resilience over time.

Conclusion



The economy has begun to recover from a historic contraction, but the economic growth outlook remains muted. The economic recovery plan agreed on by the social partners targets short- and longer-term reforms to boost growth and remove constraints to investment and employment. Rapid and effective implementation of this plan is a critical driver of higher and sustained growth over the medium term.