Industrial Development Corporation

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Economic Overview

Recent developments in the global and South African economies

November 2013

Department of Research and Information

HIGHLIGHTS

The global economic recovery remains weak and the growth dynamics have changed. Advanced economies have switched to a relatively higher gear, while the performance of emerging and developing economies has lost some momentum.

With the tapering of US quantitative easing on the cards, proper management of the process is critical, so as to mitigate the fallout, particularly for emerging economies. The prolonged use of quantitative easing in the US, Europe and the UK has also been concealing the adverse impact of serious structural problems that will have to be addressed sooner rather than later.

The continued political brinkmanship of US lawmakers is affecting not only the performance of the US economy but also the global investment climate. Funding of US government activities is only secure through to mid-January 2014, while the debt ceiling predicament will resurface as the February 7th deadline approaches. For the time being, the US recovery is gaining strength, as indicated by the 2.8% growth in GDP in the 3rd quarter of 2013.

Economic activity in the Eurozone is starting to report an expansionary momentum. Germany and some of the bloc's peripheral countries are posting increases in manufacturing production. However, the economic recovery in this part of the world remains very fragile, prompting the European Central Bank to reduce its refinancing rate on November 7th.

China's growth is expected to decelerate, after having achieved remarkable rates of expansion for many years. Nevertheless, at around 7% annually, the average growth rate projected for the medium term remains enviable, considering the enormous expansion of its economic base in recent decades.

The pace of expansion in the African continent has remained relatively strong in 2013. Solid growth in domestic demand, supported by rising income levels, migrant remittances, as well as investments in productive capacity have been supporting robust performances in various individual African economies.

Key drivers of growth in the South African economy are faltering, specifically consumer spending and fixed investment activity. High debt levels, more moderate rates of increase in disposable incomes, high unemployment and low confidence levels are among the factors impacting on household spending. The deceleration in fixed investment growth, in turn, has been recently associated with capital expenditure by public corporations.

The economy is also struggling to reduce the large and widening deficit on the current account of its balance of payments. The export sector is still confronting weak trading conditions in key global markets and domestic factors are hampering output levels in various outward-oriented sectors. In contrast, demand for imported goods has remained fairly strong despite the currency's depreciation.

The budget deficit remains substantial at a projected 4.2% of GDP for 2013/14. Widening fiscal deficits in recent years have resulted in increased borrowing requirements and a higher interest burden. Nevertheless, government debt remains at manageable levels.

IMPLICATIONS FOR SOUTH AFRICAN BUSINESS

- The higher contribution to world growth expected from the advanced economies is largely concentrated on the USA, whilst the Eurozone, although having emerged from recession, may remain in a problematic state for a long while, due to cyclical as well as structural factors. Hence, South African manufacturers are expected to continue facing rather difficult conditions in key external markets despite the weaker rand, with the search for alternative markets intensifying around the globe.

- It is increasingly imperative for South African businesses to improve production efficiencies and enhance competitiveness in the global marketplace, focusing on the development of niche products and markets, including other BRICS countries and regional markets.

- South Africa's proximity to the rest of the African continent, among other comparative advantages, must be fully exploited, with increased regional cooperation and integration efforts being essential to realise the enormous intra-regional trade and investment potential.

- Although growth prospects for China and a number of other fast-growing economies have dimmed slightly, demand for commodities is still expected to remain fairly robust, especially over the medium term. However, China's commodity import requirements will change over time as it gradually shifts towards a more consumption-driven economy (i.e. more reliant on PGMs, oil, diamonds, copper, gold, etc.), instead of continuing to be heavily propelled by investment activity (i.e. iron ore for steel-intensive investments, construction materials etc.). Nevertheless, demand for investment-related commodities will continue expanding, albeit at a relatively slower pace.

- Considering relatively weak domestic demand, with a moderation in household expenditure and rather modest growth prospects for fixed investment (slowing where public sector investment is concerned and expanding only gradually within the private sector), companies that rely on local markets should find trading conditions quite challenging for some time.

- Efforts to ensure greater participation by domestic companies in the procurement requirements associated with the public sector's multi-billion rand infrastructure roll-out should be pursued with more vigour, as opportunities are present for localisation and/or import replacement. However, the capex momentum is decelerating, indicating that the "window of opportunity" is of a limited duration. The enhancement of domestic productive capacity derived in the process would also benefit from a gradual recovery in private sector investment demand in the years ahead, as well as from capex spending in other African economies.

- The volatile rand is likely to remain under serious pressure due to a series of external factors (weaker net capital inflows, with outflows possibly exacerbated as the tapering in US quantitative easing eventually begins; subdued demand in world markets; and, among others, changing global investor preferences vis-à-vis asset classes and markets) as well as domestic ones (higher risk perceptions, lower ROI expectations in foreign currency terms, rather modest economic growth and operational challenges locally – e.g. labour markets, energy supply, other infrastructure services constraints and respective costs etc.).

- South Africa's economy relies quite heavily on imported capital goods (machinery and equipment), raw materials, crude oil and refined petroleum products for its functioning, with a depreciating currency scenario applying upward pressure on imported inflation (with monetary policy implications) and thus on operating as well as well as fixed investment costs.

- Domestic business and consumer confidence are at low levels. Their revival is critical for an economy under severe strain, especially if it is to embark on a faster and more inclusive growth trajectory to address the enormous socio-economic challenges of unemployment, poverty and income inequality.

- Amongst the possible stimulants are clearly policy-related factors, including effective and coherent implementation, as well as visible energy, determination and persistence in the execution of policies and strategies.

- Efforts to improve working relations between social partners for the common benefit and in the national interest are also imperative, not only to restore confidence amongst domestic and foreign parties, but also to maximise the utilisation of productive capacity where demand conditions warrant it.

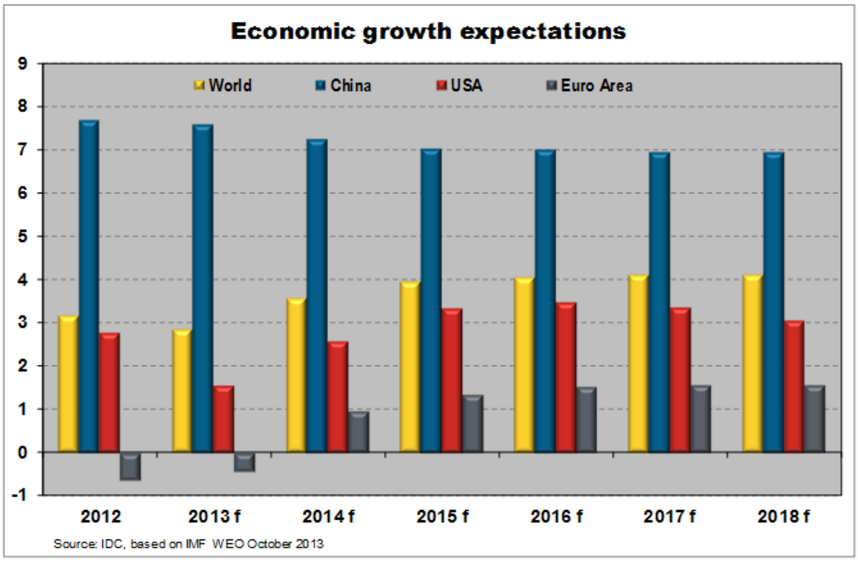
- The room for fiscal stimulus to provide counter-cyclical support has become more limited, as reflected by a continuously large budget deficit over the medium term. This may constrain government's direct and indirect contribution to economic growth, but could be partly offset through improved public sector effectiveness and delivery mechanisms, as well as cost-efficiencies. The tone has in a way been set in the MTBPS, but success beyond intent is of the essence.

- Although consumer inflation remains high at around the 6% mark, barring further excessive currency depreciation, expectations are that it will return to and remain within the target band, albeit towards the upper end. The MPC is expected to maintain the status quo on interest rates for some time, with the first rate hike anticipated by the final quarter of 2014.

- The JSE's performance, with numerous stocks deemed to be overpriced and yet still on the rise, has been raising fears of an imminent correction.

GLOBAL ECONOMIC CONDITIONS

The global economic recovery is gaining traction, with the more advanced economies reporting gradually stronger performances and thus expected to make relatively larger contributions to world growth. Quantitative easing (QE) has played a very important role in this regard, but it has also concealed major structural challenges, particularly in developed countries, that will have to be addressed sooner rather than later. Moreover, the excessive liquidity flowing through the global economy has brought about a new set of challenges. World markets have become unnervingly reliant on these routine injections of liquidity, with massive flows of short-term capital in search of high yields distorting asset prices and currency valuations.



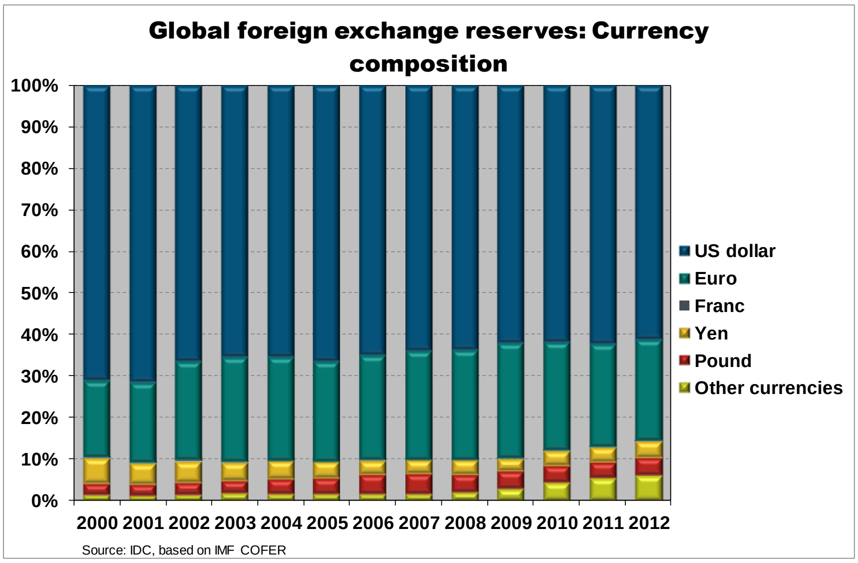
With the tapering of QE now on the cards, proper management of the process is proving critical, so as to mitigate the fallout, particularly for emerging economies. This was a clear message at the recent G20 meeting, where it was agreed that the tapering plans of the US Federal Reserve should take global consequences into account, with the policy communicated clearly. The continued failure to effectively coordinate the global financial system and address the underlying risk factors leaves it persistently vulnerable and crisis prone. Furthermore, inadequate coordination of economic policies at the global level is proving counter-productive, as well as constraining and possibly compromising the growth momentum.

The US economy posted strong growth in real GDP in the third quarter of 2013, at 2.8% on a quarter-on-quarter and annualised basis. Its performance in the fourth quarter, however, will have been adversely affected by the governmental shutdown for some 16 days in early October, with growth estimated to be between 0.25 and 0.6 percentage points lower as a result. Such developments contributed to the Federal Reserve postponing the start of its tapering of quantitative easing, possibly towards December 2013 or even into the first quarter of 2014.

Although the US government has re-opened and spending has normalised, the deal that was reached did not arrive at a permanent solution that inspires confidence. The funding of US government activities is only secure through to mid-January 2014, while the debt ceiling predicament will resurface as the February 7th deadline approaches.

The handling of the previous two debt ceiling deadlines points toward a further bout of political brinkmanship. During the previous debt ceiling crisis, in 2011, a super committee was created to find agreement in the changes in both government spending as well as tax adjustments, or the US would see significant reduction in spending programmes across the board. The committee did not reach an agreement and the sequester programme was implemented, which reduced the pace of recovery for the US economy significantly. Thus the ability of US lawmakers to deal effectively with the budget and debt ceiling issues in the early part of 2014 is in doubt. This inability to manage the government finances in a responsible and predictable manner have led rating agencies to indicate that the US credit rating may be downgraded further, while the status of global reserve currency enjoyed by the US dollar might come under the spotlight as well.

The gradual shift away from the US dollar has been observable in the changing composition of global foreign exchange reserves over time. As illustrated, the share of US dollar holdings declined from 71% in 2000 to 61% by 2012, with a significant rise in the share claimed by "other currencies". In future, the status of global reserve currency could eventually be shared between two or three currencies, with the euro and China's renminbi as contenders in conjunction with the dollar. The South African Reserve Bank recently announced a strategic decision to diversify its foreign exchange reserves towards currencies other than the dollar, including the Chinese renminbi, a move which is also reflective of the changing patterns of South Africa's trade and investment flows.



Notwithstanding the diversification trends in forex reserves, the US dollar plays a dominant role in the settlement of transactions, either for trade or investment purposes. It accounted for 87% of total foreign exchange transactions in April 2013, an increase of 2 percentage points compared to the previous survey undertaken in 2010, according to the Bank for International Settlements. When looking at specific transactions related to trade settlements, the US dollar accounts for almost 37% of all transactions using the SWIFT system, with the Euro comparable in share at 36%, while the use of the renminbi is increasing but still fairly insignificant at 0.9% of such transactions.

The world's second largest economy, China, is facing its own set of challenges. This is reflected in the revisions to economic projections recently announced by the International Monetary Fund (IMF), with Chinese growth estimates cut from 7.8% to 7.6% for 2013, while the forecast for next year has been reduced by 0.4 percentage points to 7.3%.

The sustainability of the stellar growth rates historically posted by the Chinese economy was always questionable. Nevertheless, a moderation of longer-term growth around the 7% mark is nothing short of remarkable. After all, China's economic base has expanded enormously. To illustrate, its annual import demand for iron ore rose from approximately 92 million tonnes in 2001 to 745 million tonnes by 2012. Similarly, its crude oil requirements increased from 60 million tonnes to 271 million tonnes yearly over the same period.

The Eurozone, in turn, is showing signs of economic recovery, although fixed investment activity remains a concern. The performance of the German economy is seemingly assisting some of the peripheral countries to lift their economic performance through exports. This is seen in the manufacturing production of countries such as Spain, Italy and Ireland. However, from a regional perspective these gains are being somewhat offset by the continued weak manufacturing performance in France, the bloc's second largest economy. Although the Eurozone has exited the longest recession since its formation, the recovery process remains fragile, and the region is likely to experience a relatively prolonged period of very weak growth. This fragility is reflected in the recent move of the European Central Bank, which lowered its refinancing rate by 25 basis points to 0.25% due to concerns over a potentially prolonged period of low inflation.

AFRICA'S GROWTH PROSPECTS

Notwithstanding the headwinds emanating from the global economy, the continent's growth remained relatively strong in 2013. Fast expanding domestic demand in many countries has contributed significantly to this economic performance, in the process helping to reduce their susceptibility to external shocks.

Rising consumer incomes and migrant remittances, as well as investments in productive capacity, including foreign direct investment, have supported this growth. However, weaker external demand from advanced economies, coupled with slower growth in some key emerging economies, particularly China, could constrain economic activity, especially in commodity-exporting African countries.

In its latest regional economic outlook report, the IMF expects real GDP growth in Sub-Saharan Africa to rise to 5% in 2013 and 6% in 2014. However, these projections are slightly lower than the previous set of forecasts.

Most mineral-exporting and low income countries such as Côte d'Ivoire, the Democratic Republic of the Congo, Mozambique, Rwanda, Sierra Leone, Burkina Faso and The Gambia are expected to record strong growth in 2013, while negative growth is likely in Central African Republic due to civil strife. Recent political developments in Mozambique, one of Africa's fastest growing economies for many years, are raising serious concerns in the investment community.

GDP growth forecasts for Sub-Saharan Africa

	2009	2010	2011	2012e	2013f	2014f
Sub-Saharan Africa	**2.6**	**5.6**	**5.5**	**4.9**	**5.0**	**6.0**
Oil-exporting countries	4.9	6.7	6.1	5.3	6.1	7.7
Middle-income countries	-0.8	4.0	4.8	3.4	3.0	3.6
Of which: South Africa	-1.5	3.1	3.5	2.5	2.0	2.9
Low-income countries	5.1	7.1	6.5	6.2	6.3	6.9
World	**-0.4**	**5.2**	**3.9**	**3.2**	**2.9**	**3.6**

Source: IMF, WEO - October 2013

The medium-term outlook for Sub-Saharan Africa remains relatively positive, with real GDP growth expected to average 5.7% annually over the five-year period to 2018. An anticipated strengthening in the global economy, improved export activity in countries with new mineral and oil discoveries and the related investments, as well as continuing economic and structural reforms in many countries, should provide impetus to the region's economic momentum.

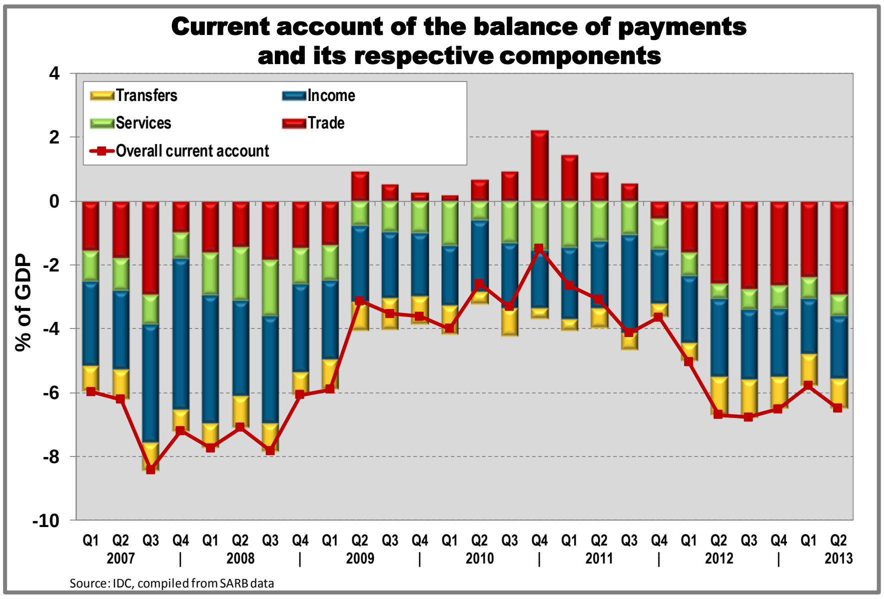
However, the downside risks are still significant, including a yet fragile global economic recovery, highly volatile commodity markets and developments in the principal sources of demand, particularly China.

ECONOMIC DEVELOPMENTS IN SOUTH AFRICA

The South African economy is struggling to sustain its expansion momentum. Key sources of growth are faltering under a very challenging environment, both domestically and abroad. It is also grappling with a large and widening deficit on the current account of its balance of payments and, despite efforts to curb public expenditure, weaker than anticipated tax collections are compromising the fiscal space for counter-cyclical interventions.

The first nine months of 2013 witnessed a significant deterioration in the balance of trade, with the cumulative deficit totalling just over R126 billion, compared to R84 billion over the same period a year earlier. South Africa's export performance has been hamstrung by weak global demand, particularly in key external markets for its manufactured products, as well as by home-grown factors that have limited output levels and goods transportation. Industrial action has been affecting production in several sub-sectors of mining and manufacturing, while bottlenecks in the electricity, transportation and logistics networks continue to hold back the supply-side of the economy.

At a ratio of 2.4% of GDP in 2012, the trade deficit was at its worst level since 1971, when the deficit measured 2.9%. Since the beginning of 2013, the trade deficit widened further to R96.6 billion at a seasonally adjusted and annualised basis, or equivalent to 2.9% of GDP by the second quarter of the year. The substantial shortfalls in net services, income and current transfer payments, are compounding the balance of payments predicament.. At 6.3% of GDP in 2012, South Africa had the largest current account deficit of all the Group of Twenty (G20) countries. South Africa's substantial foreign capital inflow requirements to finance its large current account deficit (which already stood at R109

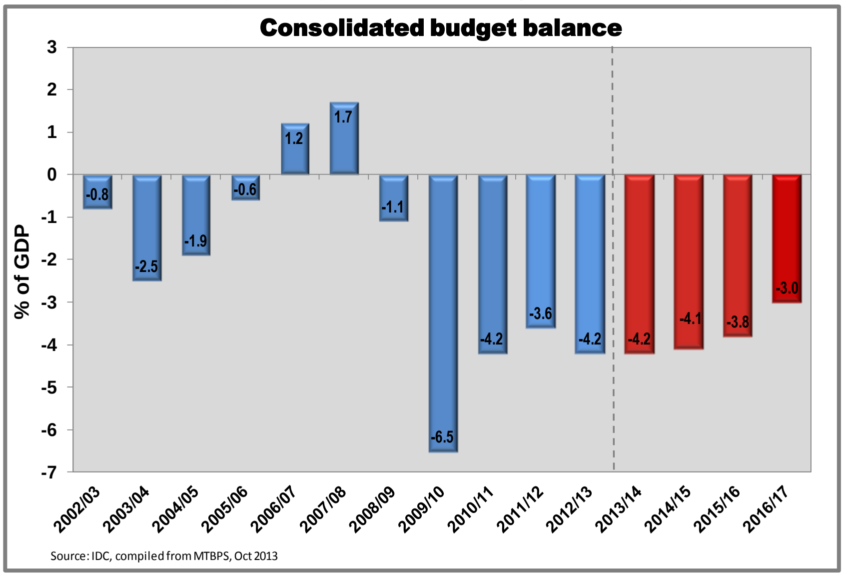


billion by the second quarter of 2013, compared to R197.6 billion for the whole of 2012), illustrates the extent of the challenge at hand in ensuring the sustained attractiveness of the country as an investment environment.

A substantial decline in foreign capital inflows has been observed relative to the quantum recorded during 2012. For the nine months to September 2013, net portfolio investments by non-residents in the South African bond and equity markets stood at a cumulative value of R44.4 billion, compared to R85.2 billion for 2012 as a whole. Net foreign purchases of shares amounted to R27 billion, whilst non-residents were net buyers of bonds to the value of R17.4 billion by September. However, overall capital inflows on the financial account (including unrecorded transactions) amounted to R95 billion by June 2013.

The country will continue to rely heavily on foreign capital inflows, whether these are of a direct investment (FDI) or portfolio nature, as the current account deficit is predicted to remain substantial over the next couple of years. FDI is obviously the preferred form, with this type of inflow totalling R30.3 billion in the first half of 2013, up from R16.8 billion during the equivalent period last year. A concerning factor is the impact of the eventual tapering in quantitative easing in the USA and the possibility of capital outflows associated with such action. Countries like South Africa are seen to be rather vulnerable to such capital flight possibilities in light of substantial macroeconomic imbalances.

On the fiscal front, South Africa is challenged by the need to raise expenditure to meet multiple socio-economic objectives, whilst simultaneously facing a revenue squeeze brought about by subdued rates of economic growth. Although the budget deficit is expected to improve to an estimated 4.2% of GDP in the 2013/14 fiscal year, compared to the 4.6% forecast in February, this is partly due to methodological changes in the October 2013 Medium Term Budget Policy Statement (MTBPS). Moreover, the deficit remains large, with only a very gradual reduction projected over the medium term, as illustrated in the adjacent graph.



A widening budget deficit in recent years has resulted in higher borrowing requirements by government to finance the shortfall, with subsequent implications on state debt costs. For the current financial year, interest payments are estimated at R106.6 billion, or 9.3% of overall expenditure, rising to 9.8% of expenditure by the end of the forecast period.

Continued budget shortfalls and higher borrowing requirements resulted in a steep rise in government debt over time, from R820.4 billion in 2010/11 to an estimated R1.37 trillion by 2013/14 and to R2.0 trillion by 2016/17. However, the MTBPS outlines a fiscal policy stance that will contain overall government debt within manageable levels, with the net loan debt-to-GDP ratio forecast to rise from 36.8% in 2012/13 to 43.9% by 2016/17.

Although the budget provides some comfort on how public finances will be managed in future, concerns remain over the actual outcomes in the light of global economic developments and the relatively muted growth prospects for the South African economy. The fiscal performance will be closely monitored by the international credit rating agencies, to ascertain whether the outcomes meet the predetermined objectives and/or their own expectations.

Fitch is particularly concerned with the high public sector spending not being backed by a high growth path. Moody's, in turn, appreciated the mini-Budget tabled in October, but stressed that growth must improve and that the barriers standing in the way of the National Development Plan's implementation must be attended to.

The Global Competitiveness Report recently released by the World Economic Forum indicates that South Africa's competitiveness landscape remained steady with a score of 4.4 over each of the past two years and ranked 53rd out of 148 countries (refer to the table below). This ranking was ahead of Brazil (56th), India (60th) and Russia (64th), but well behind China's 29th position.

South Africa's Global Competitiveness Rankings in 2013-14

Global Competitivess Index (GCI)	Rank (out of 148)	Score (1-7)
GCI 2013-14	**53**	**4.4**
GCI 2012-13 (out of 144)	52	4.4
GCI 2011-12 (out of 142)	50	4.3
Basic requirements (40%)	**95**	**4.2**
Institutions	41	4.5
Infrastructure	66	4.1
Macroeconomic environment	95	4.4
Health & primary education	135	3.9
Efficiency enhancers (50%)	**34**	**4.5**
Higher education & training	89	3.9
Goods market efficiency	28	4.8
Labour market efficiency	116	3.9
Financial market development	3	5.8
Technological readiness	62	3.9
Market size	25	4.9
Innovation and sophistication factors (10%)	**37**	**4.1**
Business sophistication	35	4.5
Innovation	39	3.6

Source: The Global Competitiveness Report 2013-2014

South Africa's ranking was largely supported by efficiency enhancers, whilst basic requirements remained a drag. For example, financial markets remain robust and the country boasts efficient markets for goods and services.

In contrast, health and primary education, labour market efficiencies and the macroeconomic environment continue faring poorly. Lack of higher education and training remain deterrents to efficiency enhancements. More needs to be done to improve the quality of the education system, which would enhance labour market efficiencies.

Labour market factors, including protracted industrial action in several sub-sectors of the economy, are not only affecting the operational performance of firms, particularly production and export levels, but also impact on business and investor confidence. The Governor of the South African Reserve Bank recently expressed concern over the adverse effects of the on-going industrial action on economic activity.

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