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Emerging Markets Spotlight

South Africa: Opportunities for growth in a difficult economic environment

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Economic situation Real growth Real private consumption expendi- Inflation rate	**The economy remains stuck in a phase of weakness** Mining, agriculture and manufacturing – the country's key economic sectors – started the year on a week footing. A major reason for the poor performance is the country's energy crisis. The global business cycle is not providing any positive impetus either. The weak economic trend of the last year is continuing. We therefore predict economic growth of around 1.0% for this year.
Growth financing Budget balance to GDP Current account balance in % of External debt to GDP	**The budget situation is tight** Under President Jacob Zuma (2009–2018) the country's debt nearly doubled from just under 30% to almost 60% of GDP. His tenure was characterised by a spending policy that sought to keep an economy bogged down by a backlog of reforms on a path of growth – without success. Moreover, state-owned enterprises' debt of some 10% of GDP is a strain on the national budget.
Growth resources Investment ratio Share of manufacturing Labour market participation	**High unemployment is the greatest problem** The economic growth of the past years was not enough to offset population growth. The structural transition to a service economy, which is associated with heightened demand for skilled workers, is exacerbating the situation. Poorly educated young South Africans are the main victims of this situation. The share of young people who are not working, undergoing training or pursuing a degree is nearly 40%.
Economic relations with Germany Germany's share of exports Germany's share of imports FDI inflows from Germany	**Trade and investment environment is weak** Foreign direct investment is lacking as a result of the weak commodity price environment of the past years and an erratic economic policy, as well as various corruption scandals. German enterprises are therefore reluctant to invest in the country, not least because the investment protection treaty has been terminated.

The current value is among the ...

Legend:	lowest	low	medium	high	highest

20% of the past 10 years.

Investment climate: Despite many problems, South Africa remains the no. 1 investment location in Africa

The election victory of the ANC provides an initial degree of stability and continuity but it does not yet form a basis for an urgently needed reform policy. The main goal of the government must be to win back investors' trust through prudent reforms. It has suffered massive setbacks in the past ten years from various corruption scandals and erratic economic policy. Despite these problems, South Africa remains a good investment location. Nowhere else in Africa are the infrastructure and the banking and finance system better and the rule of law more effectively applied. So it is not surprising that many international firms remain loyal to the location even in difficult times. Continued on p. 2

Focal theme: Industrial sector – opportunities for growth in a difficult economic environment

South Africa is widely regarded as the manufacturing hub of Africa. Since the 1990s, however, the share of manufacturing in economic output has dropped noticeably. Despite this negative development, some sectors are bucking the general trend. These include the food industry. The vastly expanded and more demanding middle class is supporting this trend. The continental domestic market that is emerging in the context of the pan-African free-trade deal can further promote this development.
Continued on p. 2

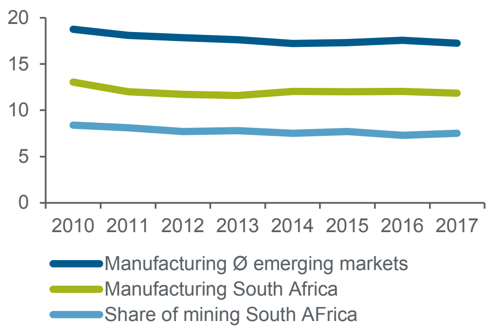
Our local expert's assessment: Despite many problems, South Africa remains no. 1 investment location in Africa

The ANC successfully defended its majority in the last parliamentary election. With around 57.5% of the votes cast, its result was below that of the election in 2014 but ultimately higher than expected. With a view to the future, an ANC government provides stability and continuity, although a majority for the ANC does not yet mean a majority for the necessary reforms. The ideological currents within the ANC are far apart. President Ramaphosa's challenge will be to find a majority for his policy within the party. **The new government must win back investors' trust.** This, incidentally, applies to foreign and local investors alike. The country and, above all, its state-owned enterprises were heavily plagued by various corruption scandals during the Zuma government and the most prominent case is surely that of the power utility company ESKOM. This seriously damaged the population's trust in the political system and economic structures and it is of enormous importance that it be dealt with transparently as a confidence-building measure and to stabilise the country. The final design of the much-debated land reform has not been finalised yet and is being monitored intensively. The issue has the potential to deter many investors for the long term. It is one of the reasons that German and European investors are keeping a close eye on whether and how the investment protection treaty terminated by the Zuma government will be renewed. Disputes currently need to be settled in national courts. These are very good and efficient but many investors feel uneasy about the prospect of having to bring their concerns before a domestic court. **A look at the economic environment provides little reason to rejoice.** A drought put the brakes on the agricultural sector and the downturn in global commodity prices affects the mining sector. Unemployment, particularly youth unemployment, remains alarmingly high. But this aggregate view conceals some interesting growth trends. The conditions for the food industry, communications technologies and the services sector are different. In the past, these sectors have grown more strongly than the average and have a certain potential to do so in the future. Mechanical engineering is another sector to be mentioned in this context. It benefits primarily from developments in the energy sector. Leaving the energy crisis and the problems of ESKOM aside, it must be emphasised that no other (African) country has implemented as many renewable energy projects since 2012. As a result, local companies possess a great deal of knowledge and experience which they are increasingly exporting to other places in Africa. The South African regions of Gauteng, which also includes Johannesburg and Pretoria (the capital), Cape Town and Western Cape also provide great dynamic and potential for new enterprises. **Despite a current phase of volatility, South Africa generally provides locational advantages over the rest of the region.** These advantages consist primarily of a well-developed infrastructure and stable conditions for the private sector. Many institutions, such as the justice system and the central bank, are independent and successfully warded off the attempts of political influence under President Zuma. The banking system and the consultancy sector possess a great amount of expertise, which is very important particularly for international companies tapping into markets and in their day-to-day dealings. The local currency – the rand – is freely convertible, unlike that of many other countries in Africa. This is a locational factor that should not be underestimated, particularly for international enterprises. All these factors have contributed to keeping German investment portfolios constant, even though the political and economic situation has become more difficult in the past years.

Based on an interview conducted with Anne Keppler (DEG Johannesburg Office Director) on 13 May 2019. ■

Figure 1: Shares of mining and manufacturing

In per cent of GDP



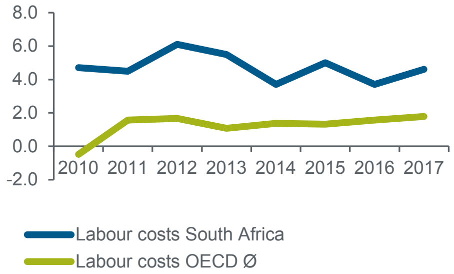
Sources: World Bank, Minerals Council South Africa, own calculations

Focal theme: Industrial sector – opportunities for growth in a difficult economic environment

Reasons for the country's deindustrialisation: South Africa suffers from premature deindustrialisation. In other words, the share of the manufacturing sector in economic output has been on the decline even before it has had a significant proportion of the country's value creation (Figure 1). The causes are various and complex. One of them is growing international competition. Before joining the WTO in 1995, the country was able to protect its industries with tariffs and it was internationally isolated because of the apartheid regime. Another important reason is the declining productivity of the mining sector, which is regarded as an important buyer of industrial products. Unlike other African countries such as Botswana, South Africa has failed to enact modern legislation as a way of injecting new momentum into its extractive industry. On the contrary: the debate on reforming the 'Mining Charter' went on for nearly a decade and upset many investors. It was not until the new President Cyril Ramaphosa succeeded Jacob Zuma in 2018 that a new law was finally passed. Lately commodity prices have also risen again. Investment

Figure 2: Development of unit labour costs in the producing sector

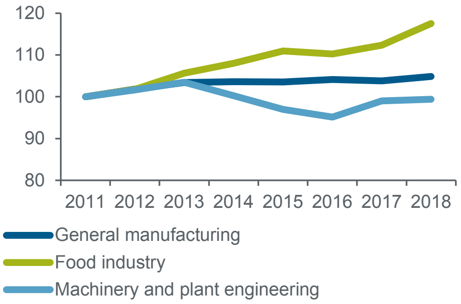
In per cent



Source: Datastream, OECD, own calculations

Figure 3: Growth sector food industry

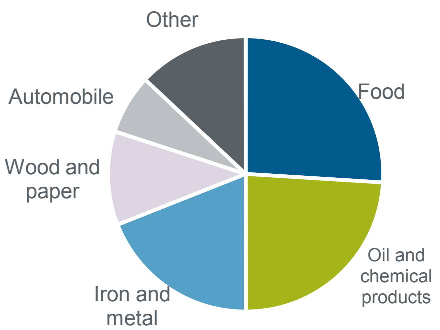
Index value 2011=100



Source: Datastream, own calculations

Figure 4: Industry sizes of the manufacturing sector

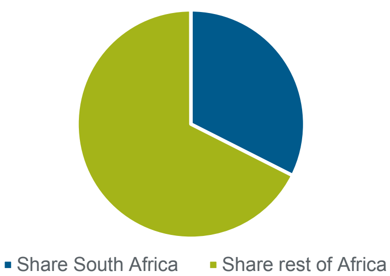
Share of value creation in per cent



Source: Statistics South Africa, own calculations

Figure 5: South Africa dominates intra-African industrial goods trade

In per cent



Source: UNCTAD, own calculations

in the mining sector can therefore be expected to rebound.

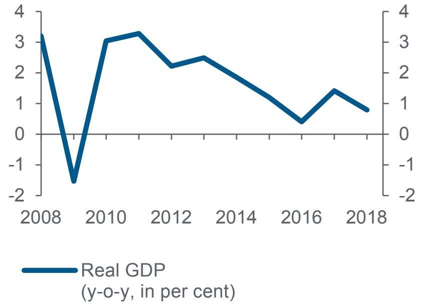
Wage and regulatory costs remain an issue. One disadvantage which the country has compared with international competitors, for example from OECD countries, which include emerging economies, results from its unit labour costs. These have increased by around 5% per annum on average in the past years (Figure 2). The other factor which impacts on the country's competitiveness is the implementation of the 'Broad Based Black Economic Empowerment' policy (BBBEE). This framework encourages businesses to increase and promote the economic participation of the black population, for example through on-the-job training, by hiring black managers, by purchasing from firms that implement the BBBEE and by donating to NGOs. Although these measures are not mandatory, failure to implement them can have adverse effects on business relationships. The BBBEE has very high symbolic value for South Africa and especially for the ANC. Reforms in this area are thus unlikely but efforts are nevertheless being undertaken to reduce the momentum of unit labour cost growth in other areas, for example by limiting wage increases in state-owned enterprises. The influence of the traditionally strong trade unions on wage negotiations is also decreasing. Fewer than 30% of jobs are now covered by collective bargaining arrangements.

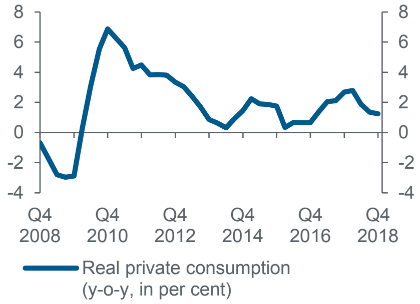
The food industry harbours potential despite weak growth. Although the proportion of manufacturing in economic output is falling and some 95,000 jobs have been lost in this sector since 2001, some sub-sectors are bucking the overall trend. The food industry is one notable example (Figure 3). The output of this industrial sub-sector contributes around one quarter of value creation of the manufacturing sector (Figure 4). The growth years definitely saw the emergence of a financially healthy middle class comprising some 16 million South Africans. That roughly equals the population of the Netherlands. As urbanisation continues and wages keep rising, South Africans have been demanding products of increasingly higher quality. This trend is clearly visible in the demand for high-quality foods. As a result of a value-added tax increase in 2018 and the country's economic problems, private consumption has developed only slowly in the past years and this has also impacted the food industry. Nevertheless, the food industry continues to be a sector with potential.

The African Continental Free Trade Agreement (AfCFTA) provides hope: The aim of this agreement is to eliminate around 90% of tariffs as well as many non-tariff barriers to intra-African trade. This is a particularly good opportunity for South Africa because many African countries do not yet have a manufacturing industry, or one that is competitive enough. The growing and more demanding middle class in the rest of Africa provides the basis for this. The country already dominates the African market with its industrial products. Around one third of industrial goods produced and traded in Africa come from South Africa (Figure 5). This is also due to the good transport infrastructure which extends from the country into the southern part of the continent. Goods destined for Kenya or Nigeria can be easily shipped through the large ports of Durban, Port Elizabeth and Cape Town. The agreement on creating this free trade area has already been ratified by 22 countries, which means it can already enter into effect within this group. All other countries except Nigeria plan to accede to the agreement in the near future. ■

Charts

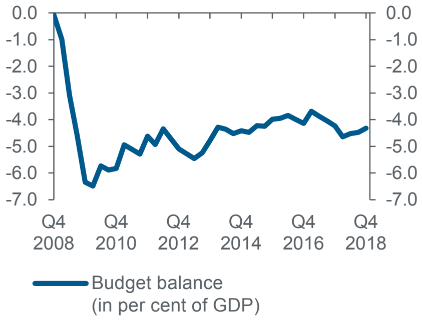
Economic situation

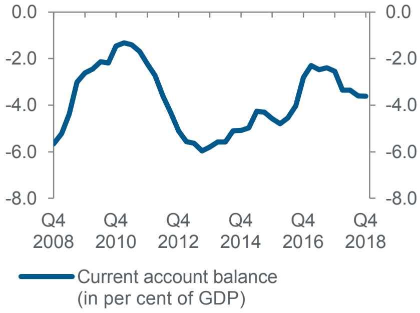


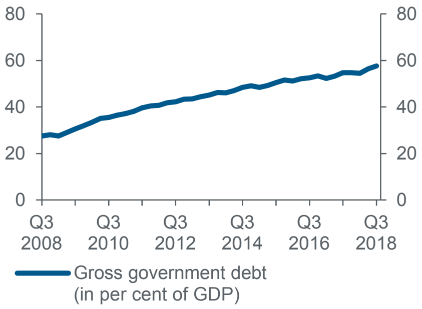


Source: Datastream; IMF, World Bank; own calculations

Growth financing

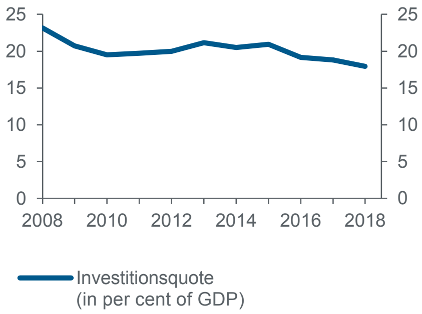


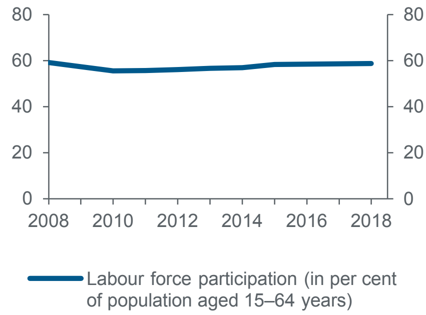


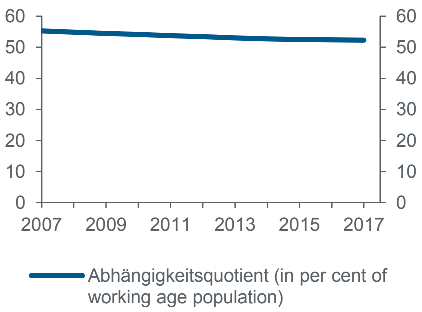


Source: Datastream; IMF, World Bank; South African Reserve Bank, own calculations

Growth resources

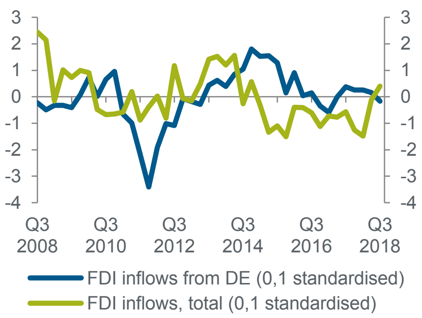






Source: Datastream; World Bank

Economic relations with Germany



Source: Deutsche Bundesbank; Datastream; IMF; UNCTAD; own calculations