Waiting for the dawn

The most notable economic development in the first quarter of this year was the US Federal Reserve's tilt towards a more relaxed monetary policy stance. Together with the cease-fire in the trade war between the US and China this has, at least temporarily, lent significant support to emerging market economies and asset prices.

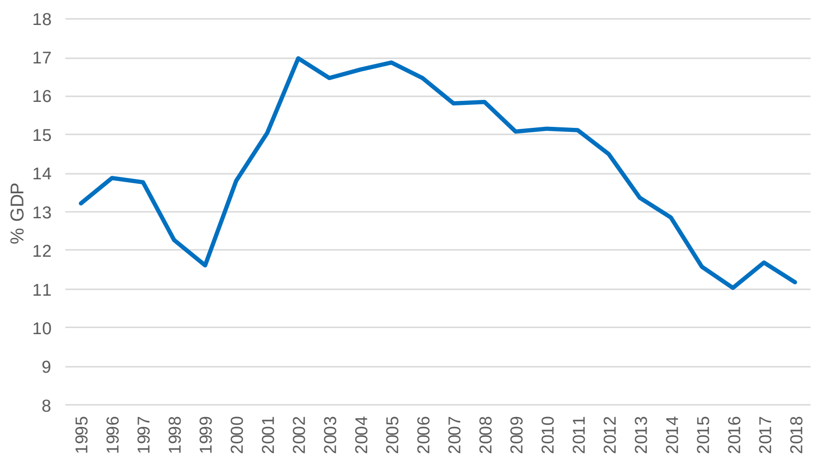
However, at the same time, the persistent decline in domestic company profits, measured as net operating surplus relative to GDP, from the mid-2000s to date begs the question: where is the economy heading?

One problem for businesses is the high level of local real interest rates against the backdrop of a deteriorated fiscal position. Government's 2019 Budget was disappointing – again. The National Treasury would have shown a measure of fiscal consolidation in the years ahead. But, contingent liabilities – notably government guarantees on state owned debt – that have been realised threaten to scupper South Africa's fiscal consolidation effort. Specifically, the government's Budget for 2019 indicates the National Treasury is planning to inject R23 billion per year into Eskom over the medium term expenditure framework period, which ends in March 2022 (possibly followed by R23 billion per year for the seven years thereafter).

In South Africa's developmental state economic model, the government plays a leading role in economic activity through direct spending and regulation of economic activity. Since 2002, the share of total public sector spending, including state owned companies (SOCs), increased from 22% to more than 26% of all expenditure on GDP.

Unfortunately, public sector spending has not been efficient. National Treasury data shows that after adjusting for capital expenditure and principal and interest payments on debt, the large SOCs, collectively, recorded a cash deficit of R136 billion in the 2017/18 financial year. Meanwhile, the return on equity for these SOCs was negative in the same year. To the extent SOCs spend on capital goods it is to be welcomed. But, their capital expenditure has declined markedly relative to GDP in recent years, while current expenditure has ballooned. Infrastructure bottlenecks are now the norm in, for example, water and electricity provision. And, transport infrastructure needs attention too.

A sustained downturn in non-financial companies' net operating surplus



Source: SA Reserve Bank, Sanlam

Two implications of these developments, which have a direct bearing on the growth trajectory of the economy, are state absorption of a large share of domestic savings and persistently high real interest rates costs. Together these developments have “crowded out” private sector investment activity.

Against this background, real GDP growth remains constrained. And, in the absence of a windfall in the form of, say, a commodity export price boom, it is difficult to see how the economy will deliver a strong, sustained economic upswing over the medium term. Indeed, real GDP growth of just 1.3% is now expected in 2019. The outlook for 2020 is, on current information, not much better.

None of the above is encouraging. At least, however, there is good reason to believe South Africa’s extended economic downturn is bottoming (although electricity outages may have resulted in a negative quarter of growth in 1Q19). Admittedly, news flow as regards some companies has been discouraging. But, company failures often occur towards the end of a downturn. Typically, stronger, more efficient companies remain standing and the overall level of productivity improves. I trust this will be the case again this time around.

Meanwhile, the increased willingness of the government to encourage engagement with the private sector in investment spending is welcome.

Further, President Ramaphosa’s State of the Nation Address, read in February 2019, contains the blueprint for better outcomes, including a plan to increase the efficiency of electricity provision and an aim to improve the ease of doing business (South Africa fell 50 places on the World Bank’s Ease of Doing Business Index in the last decade).

If these initiatives are implemented they would surely lift confidence and economic growth, in time, towards its current long-term potential of around 2% (although the benefits from skills development are a much longer term goal).

In the interim, optimism could be bolstered further if the Reserve Bank sees its way clear to cut its repo rate. US (and by implication global) financial conditions have eased materially in the opening three months of the year, which, along with well anchored domestic inflation expectations, may lend some stability to the Rand. If so, this could create an opportunity to nudge the Reserve Bank’s policy interest rate down later in 2019 – barring unexpected external shocks and provided the National Treasury sticks to its Budget.

A long-term potential real GDP growth of around 2% would not yield sufficient domestic demand environment so that small and medium enterprises (SMEs) – the lifeblood of employment creation – can thrive.

How do we, therefore, achieve the real GDP growth rate of 5% to 6% that we need? I would venture that in addition to the interventions noted above, South Africa needs to promote competition in the economy, remove barriers to entry (regulatory red tape) for small and medium enterprises, promote free trade (especially within Africa) and prepare its labour force for the “new economy”.

But, all of this will take a long time to implement. In the interim, the focus, in addition to stabilising energy supply, should be on delivering sovereign debt rating upgrades – as opposed to simply preventing downgrades. A return to a sustainable fiscal position should, in tandem with well anchored inflation expectations, lower the structure of interest rates, which would go some way towards supporting investments.

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