

Economic Research:

Q&A: South Africa's Economy Still Suffers From Skill And Infrastructure Bottlenecks

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Q&A: South Africa's Economy Still Suffers From Skill And Infrastructure Bottlenecks

Like many emerging economies, South Africa faces the challenge of balancing the need to spend on infrastructure and increase workforce skills against cutting its current account deficit. In an uncertain global environment, Jean-Michel Six, Standard & Poor's Chief Economist for Europe, the Middle East, and Africa, answers questions from Konrad Reuss, Managing Director for South Africa and southern Africa, about the economic outlook for the Republic of South Africa (foreign currency BBB+/Negative/A-2, local currency A/Negative/A-1, South Africa national scale zaAAA/--/zaA-1).

Questions And Answers

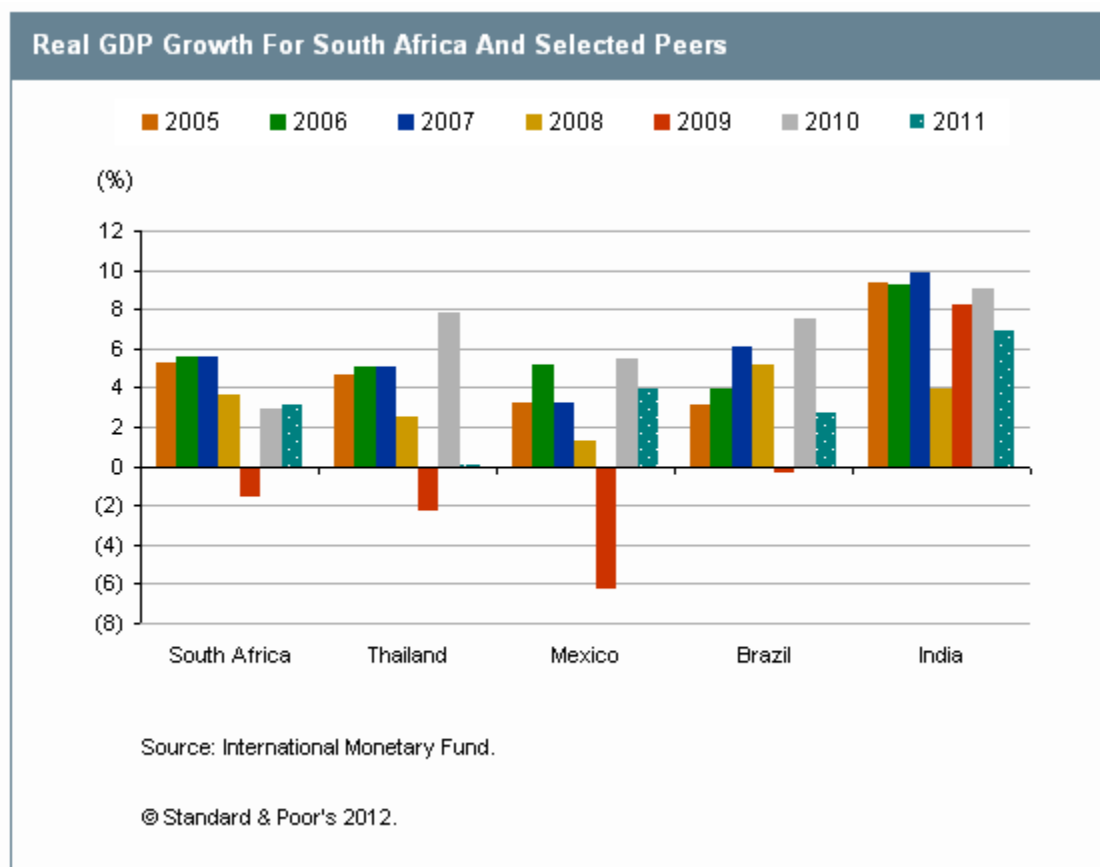
What's your growth forecast for South Africa and what do you see as the major challenges ahead?

We expect GDP growth to slow to 2.7% this year from 3.1% in 2011, before accelerating again thanks to stronger exports toward 3.6% in 2013. Looking beyond those numbers, the key issues facing South Africa are, first, endemic unemployment that calls for vigorous labor market reforms and a push for skills development; and second, a widening current account deficit. In 2011, the current account deficit stood at 3.3% of GDP, helped by strong export growth and favorable terms of trade. For 2012, we anticipate that the deficit will increase to 4.2% of GDP. Like other emerging economies that face similar trends, South Africa depends on foreign direct investment and portfolio flows to finance this deficit. This dependence could become a liability if sudden shifts in global risk appetite dry up portfolio flows.

How does South Africa's economic performance compare with that of other middle-income countries?

I would say that South Africa's growth performance puts it in the middle of its peer group. Its real GDP growth since 2005 has outperformed Thailand and Mexico, but fell behind Brazil and India (see chart 1). This is because the South African economy continued to suffer from supply shortages, including those resulting from infrastructure bottlenecks and the skill shortages that we've mentioned. At an estimated \$7,800 in 2012, South Africa's GDP per capita remains below that of Brazil or Mexico, but it is far higher than India's.

Chart 1



However, the need to improve infrastructure remains a key priority for the government and we believe spending in this area will continue to be a major growth engine for the economy. On the back of the government's infrastructure drive, the South Africa's ratio of investment to GDP recovered to 19.3% in 2010 from 17.0% in 2005, but was still down from 23% in 2008. Last year, this ratio sank back slightly to 18.9% after projects related to South Africa's hosting of the 2010 World Cup came to an end. The government's infrastructure projects for the years ahead include power plant construction, expansion and upgrade of transport networks, and the provision of new sanitation and water infrastructure.

How do you characterize South Africa's performance of 3.1% real GDP growth last year?

Growth was solid and fairly balanced in 2011, with private and government consumption on the one hand, and investment spending on the other contributing equally--while real exports rose by nearly 6%. After rising in the first half of the year, unemployment fell in the third and fourth quarter, pulling the jobless rate down to 24% by year-end. Most of the job gains were in finance and other business services and the trade sector. Employment in the manufacturing sector was roughly flat on average for the year.

Still, this improvement in the labor market is somewhat misleading. Although a total of 372,000 jobs were created last year, data from the South African statistical office reveal that the number of discouraged workers rose by 108,000, which reduced the size of the workforce. Truly reducing unemployment therefore remains a major challenge. We note that the South African central bank (SARB) estimates that GDP growth would need to exceed

7% to meaningfully and sustainably reduce unemployment. South Africa hasn't seen such growth in the past decade.

Why do you believe growth will slow in 2012?

South Africa is a relatively open economy where exports of goods represent about 25% of GDP. The flipside to this is that it makes the country vulnerable to weaker economic conditions in the rest of the world and especially in developed markets.

That said, if we look at South Africa's exports by regional destination, Asia comes first with 37.6% of the total in March of this year. True, exports to China and other Asian markets have slowed since the middle of last year. But we anticipate that these markets will regain momentum on the back of accommodative monetary policies in the final quarter of this year. Europe is the second-largest export destination, with 23% of the total, and the region is experiencing recessionary conditions. However, South African exports aren't feeling the full brunt of this because more than 85% of its exports to the region go to Germany, the U.K., Switzerland, the Netherlands, and Belgium. These markets should fare relatively better than those in the southern part of Europe such as Spain and Italy.

We expect South Africa's real export growth to slow to about 2.5% this year from 6% last year. Yet, we also anticipate that the trade balance will deteriorate proportionally more than export trends would suggest. We believe the trade balance will swing from a surplus of 0.6% of GDP in 2011 to a deficit equivalent to 1.5% of GDP, widening the current account deficit as well. This deterioration is due to South Africa's high import propensity, especially for manufactured goods, which will be boosted by a surge in demand in coming years from the government's infrastructure drive.

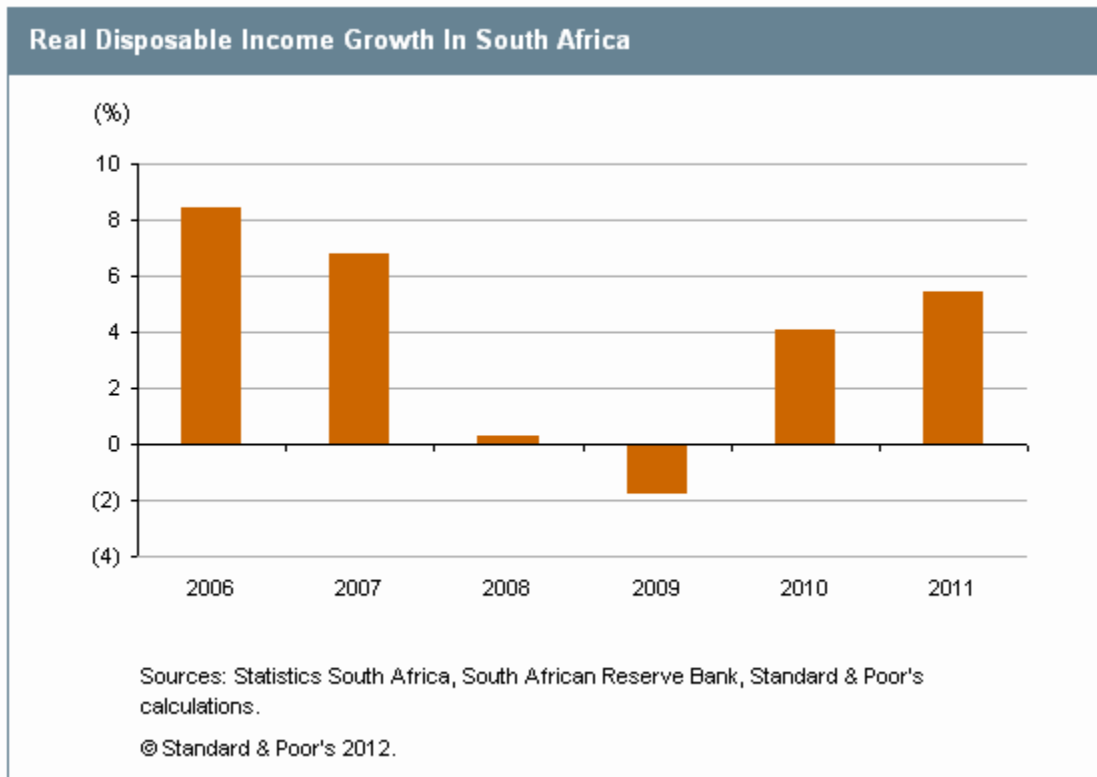
Do you believe that growth in domestic demand can offset weaker foreign trade?

We think that the recovery in fixed investment, which started in 2010, is likely to continue. First, as noted above, government infrastructure spending will remain a major support for growth. Private-sector capital spending should also remain a contributor, in our view, mainly because of low interest rates and improved corporate profitability. Nevertheless, the outlook for consumer demand, which represents more than 60% of GDP, appears more uncertain.

But retail sales picked up in March according to the latest figures released by Statistics South Africa. Isn't this a positive signal?

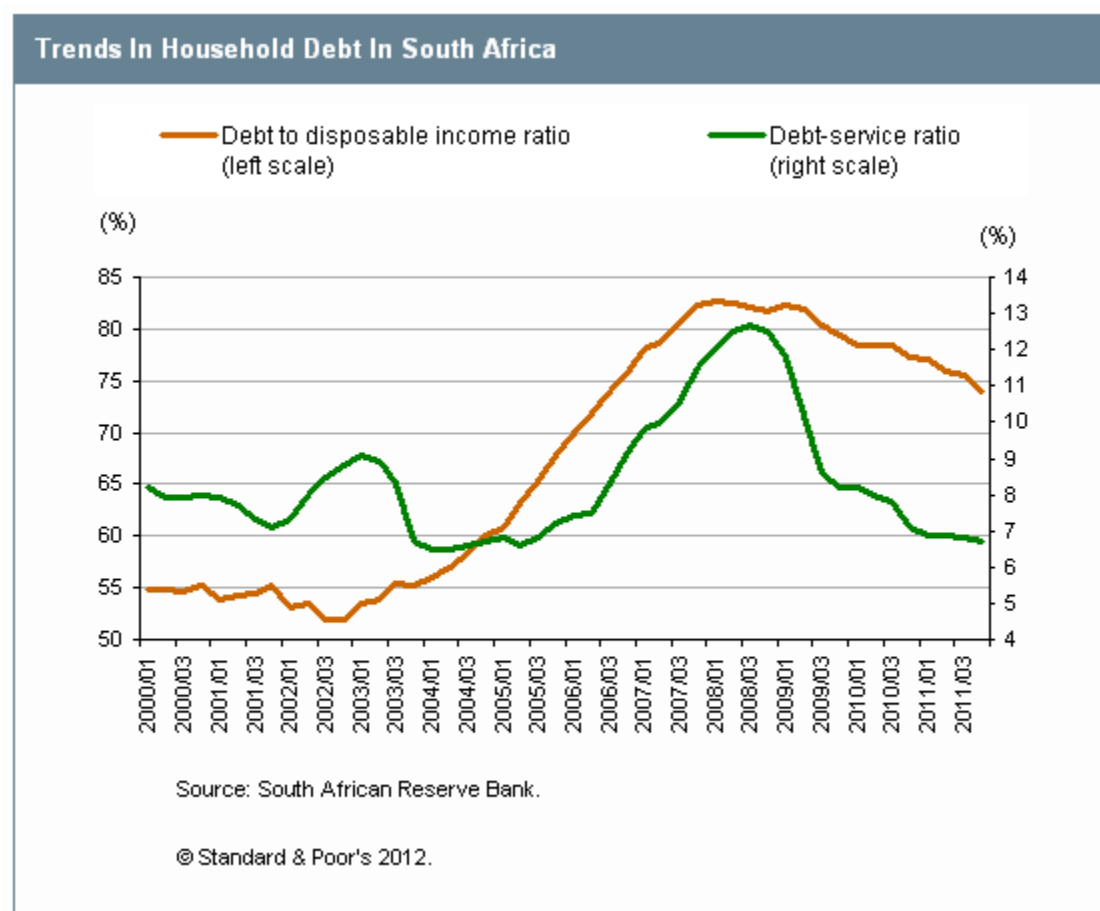
Retail sales indeed rose 5.3% in the 12 months to March from 3.1% a month earlier. But on an annualized basis, the rate dropped 4.5% in the first quarter of 2012, compared with 9% growth in the last quarter of 2011. What's more, we believe that the fundamentals point to weaker overall consumption growth this year. Real disposable incomes rose by 5.4% in 2011, according to our calculations. But that rate should come down to about 3.5% this year on the back of lower wage increases and rising discretionary costs, such as for utilities and fuel.

Chart 2



Furthermore, the household sector is still deleveraging. It's focused on reducing debt rather than taking on more. Household debt has fallen from its 2008 peak of 82.7%, but remains high, at 74% in the final quarter of last year. On the other hand, the drop in the debt-service ratio from low interest rates should come as a welcome relief to households. Overall, we expect household consumption to grow a slower 3.5% this year and in 2013, compared with 5% last year.

Chart 3

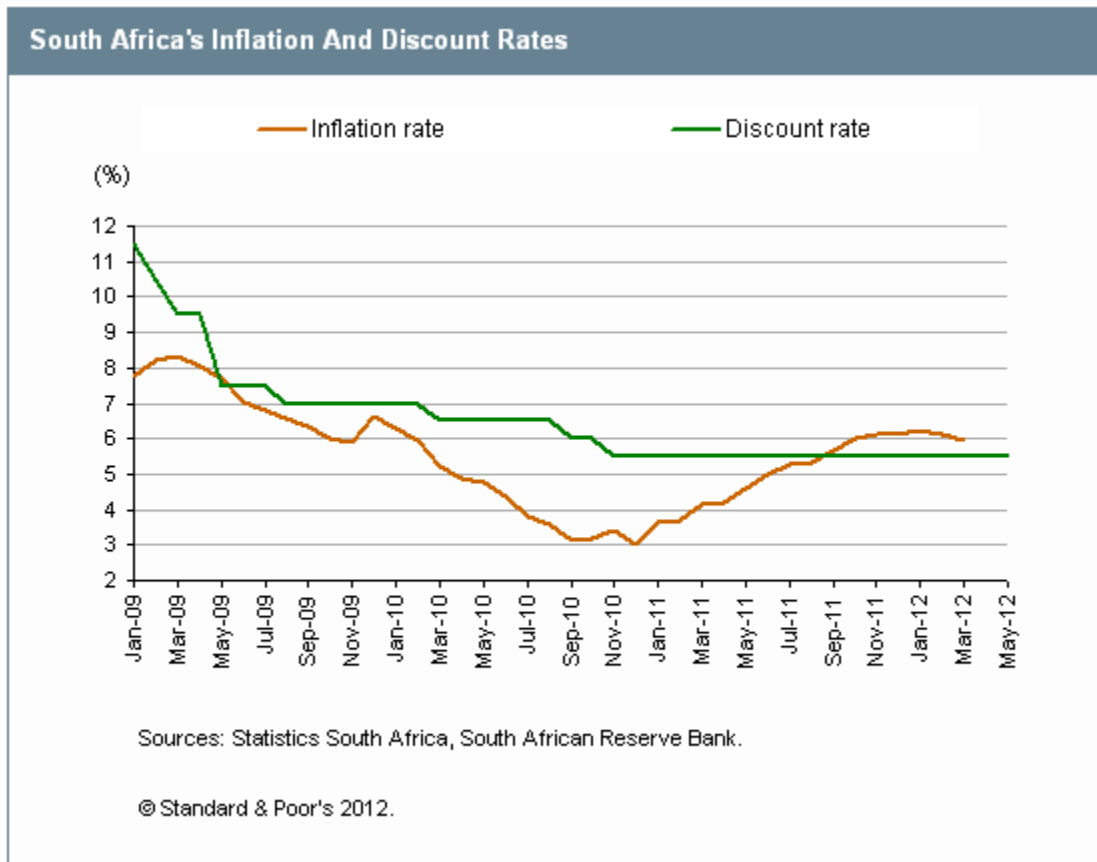


What about monetary policy? Hasn't credit growth underpinned consumer demand?

Bank loans to the private sector expanded 9.1% in the 12 months to March, up from 7.9% in February. Although below the 20%-25% between 2005 and 2008, the recent acceleration in loan growth is still a risk, in our view, as the share of uncollateralized loans keeps going up.

The SARB has kept its policy rate flat since November 2010 despite a steady increase in the inflation rate. We think that inflation will remain at the top end of the bank's 3%-6% target range. Still, we wouldn't expect that the SARB will start tightening before the very end of this year because it will remain concerned about slower growth in the economy.

Chart 4



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