South Africa – Economic Challenges

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Key Points

- High unemployment, low levels of job creation and often poor standards of educational achievement will need to be addressed if the cycle of poverty is to be broken.
- The weakened rand is still trading at low levels and the fear of further political missteps will be a contributing factor in keeping the currency in the region of R14 per US dollar.
- At R470 billion ($41.8 billion), the wages bill for South Africa’s 1.3 million public servants is a severe drain on government finances.
- In pushing up interest rates, the South African Reserve Bank is undertaking a delicate balancing act of reining in inflation while trying not to reduce the prospects for economic growth and job creation.
- The poor performance of many State-Owned Enterprises is a structural drain on the economy.

Summary

The headwinds confronting the South African economy are such that they might better be characterised as an economic perfect storm. As an economy that is heavily dependent upon commodities exports, reduced demand from China for South African raw materials has hit hard.
Added to its political challenges and the problems caused by the drop in global commodities prices are the further negatives of low consumer, business and investor confidence, labour market pressures, high unemployment, a poorly skilled workforce, a weak currency that is prone to external shocks, the lingering possibility of credit rating downgrades, the effects of electricity shortages, high levels of public debt and the continuing spectre of political interference. In a reflection of those problems, Africa’s second-largest economy is forecast to grow by just 0.9% in 2016.

To make matters worse, the above problems are occurring at the same time as democratic South Africa is gripped by unprecedented social discontent and is experiencing increasing disillusionment with the ruling élite. Despite the emergence of a growing black middle class, South Africa in many ways remains two countries. One is a wealthy, developed country with first-world living standards and economic opportunities and the other is a developing country riven by glaring and persistent social inequalities with correspondingly low levels of incomes, educational standards and employment opportunities.

While a return to higher commodity prices will obviously be of benefit, it would also continue to mask deeper structural problems. Without the political will to implement necessary but difficult reforms, the situation is not likely to improve in the near future. In that case, the economy will continue to limp along, impeding the ability of the government to implement the policies needed to address inequality and poverty.

**Analysis**

Much has been written on the global resources slowdown, weakening demand from China and the fall from grace of emerging markets, including South Africa. This paper, therefore, will instead focus on the issues of unemployment, credit ratings, the weak rand, the size of the public sector and instances of political mismanagement, together with the economic challenges posed by energy requirements and the environment.

Suffice it to say, that even during the boom times, the South African resources sector was in difficulty. The mining industry, for instance, was confronted by high wage demands, lengthy strikes, low productivity and the need to drill deeper just to maintain output. With the so-called “strike season” again approaching in the gold and platinum sectors as wage negotiations get underway towards the middle of the year, the knock-on effect that saw GDP growth reduced by about 0.7% during the 2014 strikes could re-occur and hesitation is once again the order of the day.

**High Unemployment**

Unemployment remains persistently high at around 25 per cent, with youth unemployment at twice that rate. Stubbornly high unemployment combined with low levels of job creation and educational attainment has resulted in large numbers of semi- and unskilled workers at a time when the labour-intensive industries such as farming, agriculture, mining and manufacturing that might traditionally employ them, have downsized their workforces. Compounding that challenge is demography. More than half of the working-age population is under the age of 25. If the burgeoning youth cohort is to secure meaningful, well-paid
employment, the South African education sector will need to be improved so that, at a minimum, all students are able to complete their schooling with at least a sound basic education, including literacy and numeracy skills, and with access to relevant tertiary and vocational training.

The February 2013 “National Development Plan Vision for 2030” attempts to end poverty by taking a long-term approach to addressing social and economic inequalities, including unemployment and education, through the provision of improved services via both the public and the private sectors. Ambitious in its scope and desired outcomes, two years after its inception, there are few, if any, NDP runs on the board yet.

It is interesting to note that, according to the World Bank, of the jobs that have been created in South Africa since 2000, the majority have been in the services sector. Given the dual nature of the South African economy, that growth will be likely to continue, even if it occurs more rapidly at some times than others. In the absence of jobs growth in the primary industries and improved educational outcomes to create a better-skilled workforce, unemployment – and its many associated ills – will continue to be a long-term feature of South African society, despite the worthy intentions of the National Development Plan.

**Credit Ratings and a Weak Currency**

The value of the rand remains weak. The steady decline that the rand experienced in the early 2010s has accelerated and it is now trading at R14.6 to the US dollar. The currency hit a then-record low of R15.9 to the dollar in December 2015, following the unexpected replacement by President Jacob Zuma of former Minister of Finance, Nhlanhla Nene, with a little-known backbencher, David van Rooyen. The rand lost almost ten per cent of its value against the dollar but recovered ground four days later when van Rooyen was replaced by Nene’s predecessor, Pravin Gordhan. A new low was reached in January 2016, when it fell to R16.8 to the US dollar. Another spike occurred in late February, reflecting jitters around the time of the Budget.

Factors such as weak consumer and business confidence, labour market pressures, weakness in global gold and platinum prices, the continuing imbalance in South Africa’s terms of trade and fears of further political missteps are all likely to see the rand remain in the region of R14 per US dollar, albeit with spikes as the markets react to instances of the above factors.

While a weakening rand does aid the competitiveness of South African exports, it also reduces buying power and hurts consumers by making imported products such as oil and, therefore, petrol, more expensive.

On a more positive note, South Africa has seemingly avoided a downgrade of its sovereign credit rating by Moody’s Investors Service. Following a fact-finding mission to South Africa in March, the ratings agency has not yet indicated that it will lower South Africa’s rating from Baa2 to Baa1, its lowest investment-grade rating and just one notch above speculative, or “junk bond”, status. The other two ratings agencies, Fitch’s and Standard and Poor’s already rank South Africa at the lowest investment grade so, to a certain extent, it may be argued
that a future downgrade by Moody’s would be little more than a formality. Regardless, the Zuma Administration will want to avoid the bad publicity, higher borrowing costs and further weakening of confidence that would all flow from another downgrade.

**Inflation and Interest Rates**

The South African Reserve Bank (SARB) raised its benchmark interest rate (known as the “repo rate”) by 25 basis points to seven per cent. The 17 March rise is the sixth in a cycle that began in 2014 when the rate stood at five per cent. The SARB has a target of keeping inflation to a range within three per cent and six per cent, but it continues to creep upwards. As of February 2016 – the most recent figures available – consumer price inflation had reached 7.0%, up from 6.2% in January and heading towards its all-time peak of 8.0%, in May 2009.

The possibility of more rises as the SARB acts to curb inflation cannot be ruled out but, as is the case everywhere, it will be a delicate balancing act requiring the bank to be strong enough to rein in inflation without crimping economic growth and job creation.

**The Public Sector and Political Mismanagement**

The South African Government’s Budget deficit currently stands at 3.9% of GDP. The combination of judicious cuts to expenditure, adjustments to personal tax brackets and modest increases to certain taxes that were contained in the February 2016 Budget are intended to see the deficit reduce to 3.2% in the 2016-17 financial year and to 2.4% in 2018-19.

After government and public sector union negotiators reached agreement in June 2015 on a three-year seven per cent rise, the wages bill for South Africa’s 1.3 million public servants amounted to R470 billion ($41.8 billion). The public sector wages bill has blown out by more than 80 per cent over the decade to 2015, with annual increases averaging more than six per cent above inflation diverting funding from other spending priorities. The Zuma Government contains a particularly large Cabinet: 35 ministers and 37 deputy ministers.

Compounding the issues above are the prevalence of red tape, political interference in the form of ill-conceived policies and the drain on the economy from poorly-performing State-Owned Enterprises.

The tourism industry offers a compelling case study of the adverse effects of poor policy on a previously successful industry. Compounding the economic downturn has been the effect of new visa regulations on the South African tourist industry. Tourism is a valuable earner, bringing in R357 billion ($31.8 billion) and accounting for 9.4 per cent of GDP. Regulations introduced in 2014 (and amended in June 2015), however, have not aided the industry. Under the changes, all persons aged 18 or under entering or leaving South Africa must produce their full birth certificate (in addition to a passport and, if required, a visa). Nationals of non-visa waiver countries must report to a South African diplomatic post in person when applying for a visa. Arrivals from previously strong markets such as India (down by more than eight per cent) and Russia have fallen. Along with China, both were important source countries with large, dispersed populations but with limited South African diplomatic
representation. Slightly more positively, the number of arrivals from China still managed to record growth of 2.1%. The re-introduction of non-stop flights between Beijing and Johannesburg should help to boost that figure further in 2016.

Confirming industry fears, Statistics South Africa reported that overall tourist arrivals in 2015 were down by 6.8% on the year before. That such a drop occurred when South Africa’s affordability was boosted by the record weak rand will certainly be of concern. Arrivals from the other important long-haul markets – all of which enjoy visa-free status – were all down at a time when the weakness of the rand might have been expected to enhance the attractiveness of South Africa as a destination.

Of greater concern is the estimate by the Tourism Business Council of South Africa that some 5,800 jobs may have been lost due to the effect of the 2014 regulations. The loss of earnings and jobs in a valuable, high-profile industry from poorly thought-out policy does little to boost national confidence even if the government moves to ease the regulations. In the meantime, the tourism industry will be hoping that a number of new air routes linking the three main airports of Johannesburg, Cape Town and Durban with several African and East Asian hubs that were inaugurated in the second half of 2015 will aid a recovery in visitor numbers. South African tourism officials will need to redouble their efforts at promoting their country in the face of red tape if the industry is to achieve anything like its full potential.

The poor performance of many State-Owned Enterprises (SoEs) acts as another structural drain on the economy. Two of the highest-profile underperforming SoEs are electricity utility Eskom and national carrier, South African Airways (SAA). In the case of the latter, poor business performance combined with political interference is thought to have been a factor in the sacking by President Zuma of respected former Finance Minister Nhlanhla Nene. Following the June 2015 African Union Summit in Johannesburg, Zuma reportedly aided Sudanese President Omar al-Bashir to avoid being detained in South Africa after the Pretoria High Court issued an interim order that he remain in the country awaiting a decision on whether he would be sent to face the International Criminal Court on charges of war crimes, crimes against humanity and genocide.

Rather than complying with the court’s ruling, Zuma facilitated a hasty departure for al-Bashir from the nearby Waterkloof Air Base. Two days later, SAA Chairwoman Dudu Myeni called for SAA to open a route between Johannesburg and Khartoum as a show of support from Zuma for al-Bashir. The Khartoum route was first formulated some three months earlier, despite there being no market basis for a route that, it was estimated, would lose 30 million rand ($2.66 million) in the first two years of its operation. Nene refused to rubberstamp the money-losing presidential proposal.

SAA received a government guarantee of R6.488 billion ($578.5 million) in January 2015 and the national carrier may require more this year. Had Nene acceded to Zuma’s demand for a Khartoum route, the state Budget would be haemorrhaging even more money. Zuma dismissed Nene without warning on 9 December, after further acrimony between Nene and Myeni over the purchase of new Airbus aircraft for SAA. Unfortunately, future political interference in State-Owned Enterprises cannot be ruled out. If, and when, it does happen, it
will again be an impediment to the efficient operation of the SoE in question and, indeed, to the economy in general.

**Energy and Environmental Challenges**

The nationwide “load shedding” – scheduled rolling blackouts to prevent the total collapse of the electricity grid – that took place between late-2014 and mid-2015 had a severe effect on the economy. Load shedding affected everything from street lighting to mining operations to food production facilities and, according to *The Economist*, citing Eskom itself, was estimated to be costing the South African economy between R20 billion and R80 billion ($1.8 billion to $7.2 billion) per month in 2015.

Since early August last year, the first of six turbines at the much-delayed Medupi power plant has been online, easing pressure on the grid and ending the need for load shedding. Eskom’s network, while now improving, is still sub-par and continues to be an impediment to economic growth.

As if the issues above were not enough, the South African economy is also facing an environmental hurdle, in the form of the record drought now gripping much of southern Africa.

As Future Directions International has noted in a recent *Strategic Analysis Paper*, the previously buoyant agricultural sector has been hard hit by the drought. According to Statistics South Africa, the drought is responsible for 16 billion rand ($1.4 billion) in lost revenue in the agriculture sector.

The water shortage resulting from the drought has further economic implications because water is essential to the cooling process at the coal-fired power plants upon which South Africa depends for the majority of its electricity generation. The Medupi and Kusile plants, when completed, will be vital economic motors, but are both located in water-scarce regions.

The Koeberg Power Station, near Cape Town, is the only nuclear power station in Africa and uses seawater to cool the condensers in its two pressurised water reactors, but only generates around five per cent of South Africa’s total installed capacity. The use of seawater for cooling purposes is a good alternative to water sourced from drying river catchments, but government plans for another six nuclear plants to be operational by 2030 are now on hold due to the large sums involved and the deleterious effect that such expenditure would have on the already stressed Budget.

In the longer term, the South African economy may yet face further constraints because Eskom is unable to run some or all of its coal-fired plants at full capacity due to water shortages.

President Zuma and Finance Minister Gordhan have much to contend with. The scale of the economic challenges confronting South Africa is daunting by any standards. With reduced options for tackling them at a time of global economic uncertainty, it is by no means clear
whether those problems can be turned around as quickly as possible, thus enabling all of the country’s citizens to realise their full socio-economic potential.

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