THE REAL ECONOMY BULLETIN

TRENDS, DEVELOPMENTS AND DATA THIRD QUARTER 2015

Introducing The Real Economy Bulletin

The Real Economy Bulletin is a TIPS review of quarterly trends, developments and data in the real economy, together with a comprehensive analysis of the latest news from the main manufacturing industries and key data in Excel format (available to *download online).*

This bulletin provides information about quarterly trends in the real economy – that is, agriculture, mining, manufacturing, construction and productive services – with an initial focus on manufacturing.

We will fill the gaps left by most quarterly bulletins on the economy by analysing growth, investment and employment at the industry level.

Every quarter, the bulletin will highlight major new projects, developments in leading manufacturing companies and policy changes in the past quarter. It will consolidate the available data on manufacturing subsectors into an easy overview of key trends. Periodically, we will present deep dives into key issues facing the real economy.

Growth in the GDP and employment

In the past quarter, manufacturing showed a significant recovery, although both mining and agriculture contracted.

As the following table shows, GDP growth in the past quarter, diverged sharply by sector. Manufacturing grew 1.5%, following two quarters of declining production. In contrast, agriculture saw its third quarter in a row of contraction, while mining output declined for the second month in a row. In year-on-year terms, however, mining grew 2.6% and manufacturing by just 0.3%, while agriculture shrank by 2.6%. In contrast, the rest of the economy – which includes retail and financial services as well as value-adding services and logistics – grew at 0.3% in the past quarter, and 1.6% over the previous year.

CONTENTS

Growth in the GDP and employment

Trends in trade

Productivity and investment

What's behind the trends?

Electricity and the carbon tax

Manufacturing Competitiveness Enhancement Programme in context

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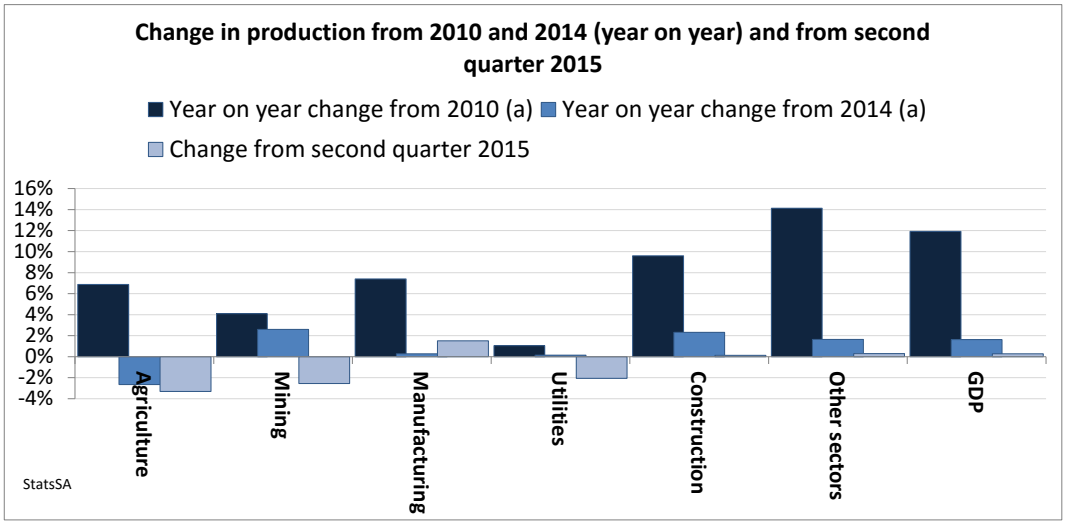
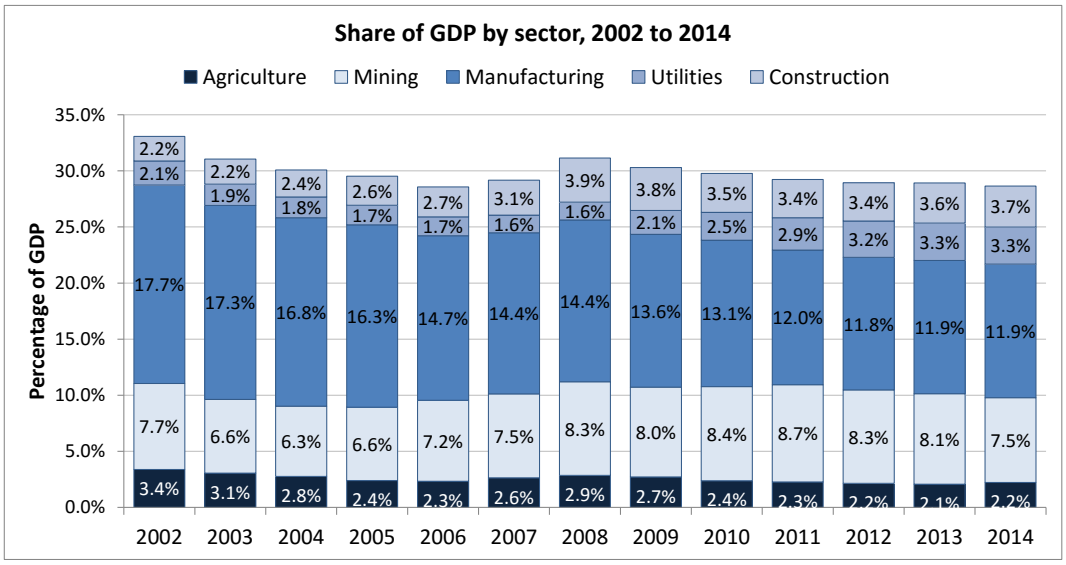
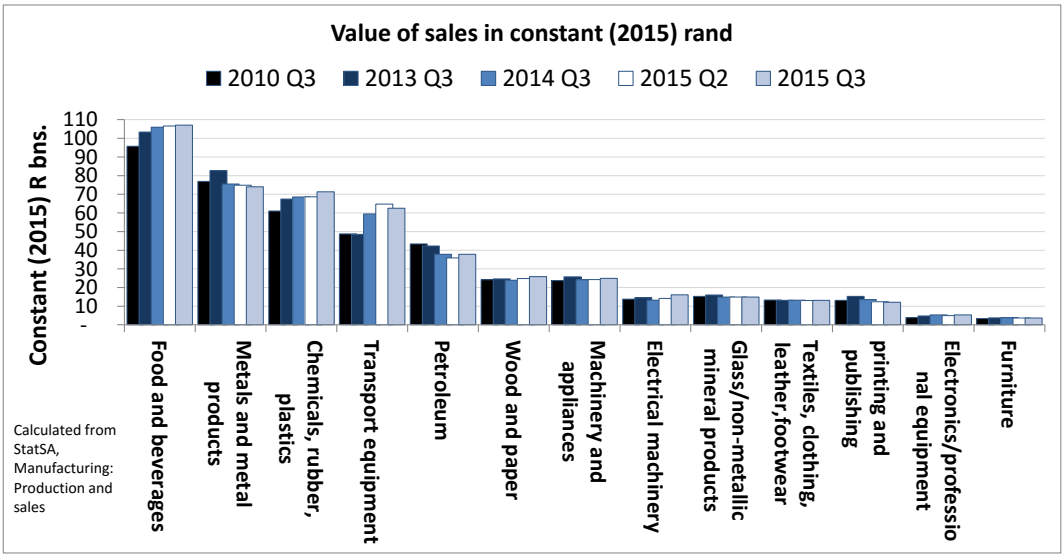


(a) That is, production in the four quarters to the third quarter of the specified year compared to production in the four quarters to the third quarter 2015.

Since 2011, the share of manufacturing in the GDP has essentially stabilised at around 12%, reversing a steady decline from 18% in 2002. In contrast, mining's contribution to the GDP rose from 6% in 2004 to 9% in 2011, but has since fallen back to 7.5%. Growth in the share of construction and the utilities has levelled out, while the share of agriculture has continued to decline.



The GDP data do not include the subsectors within manufacturing, but the following charts show sales in constant 2015 rand by manufacturing industry from the third quarter of 2010 to the third quarter of 2015.

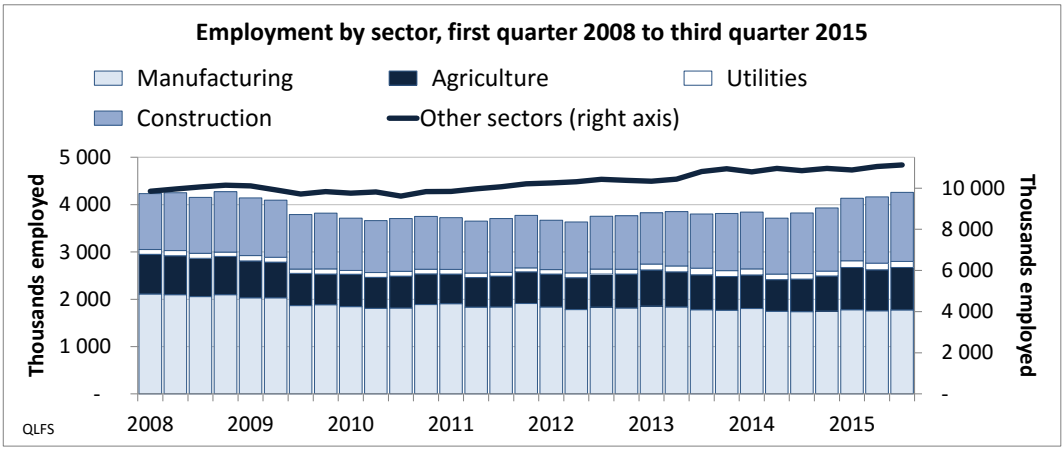


The main ***losers*** were the metals refineries, with Evraz Highveld in business rescue and Arcelor Mittal South Africa threatening substantial downsizing unless it receives tariff protection from Chinese products.

The ***winners*** were producers of inputs for the build programme and of consumer goods. Faster growth emerged for electrical machinery and transport equipment outside of cars; furniture; paper and paper products; plastics; and appliances.

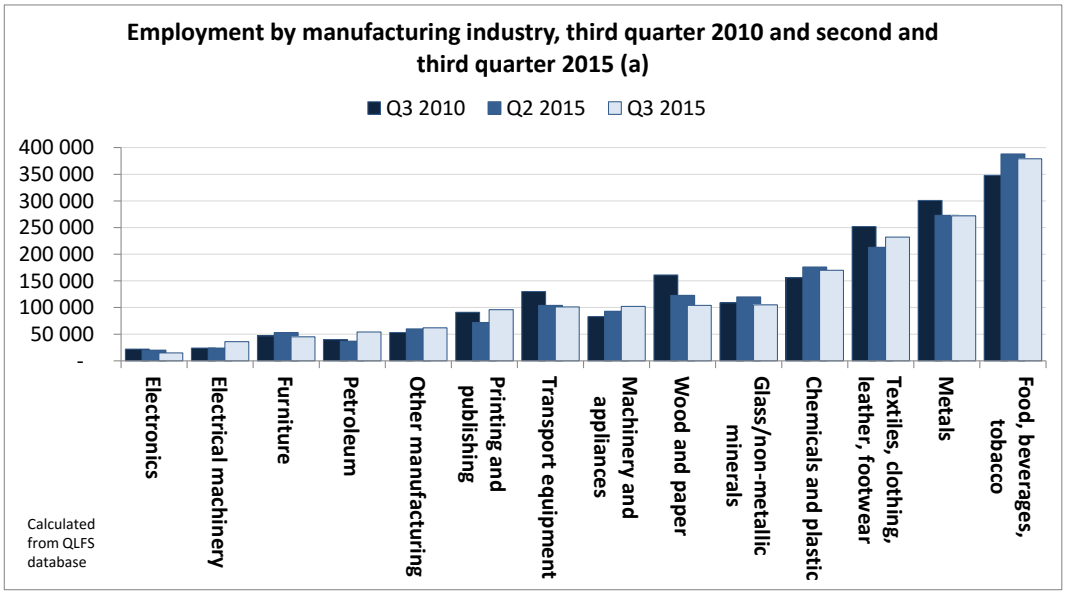
In the past quarter, however, food and beverages production – now the largest industry within manufacturing – saw slower growth, especially for milling and meat processing. That reversed five years of stronger growth than the rest of industry.

Taken together, agriculture, mining, manufacturing, construction and the utilities account for 30% of total employment. Over the past year, agricultural and construction showed substantial job creation. Moreover, employment in manufacturing appears to have stabilised over the past year, after a fairly steady decline from 2008.



Data on mining employment are only available through the second quarter.[1] They showed no growth after a fall of around 35 000 from 2012, but large-scale retrenchments are likely as metals prices continue to fall.

As the following chart shows, the stabilisation of manufacturing employment overall is associated with considerable churn at subsectoral level. Since 2010, growth has been primarily in food, beverages and tobacco, the chemicals value chain, and some smaller industries. Losses emerged in wood and paper, metals and metal products, and transport equipment.



Note: (a) The quarter on quarter figures are likely not statistically significant due to the small size of the samples, especially in smaller industries.

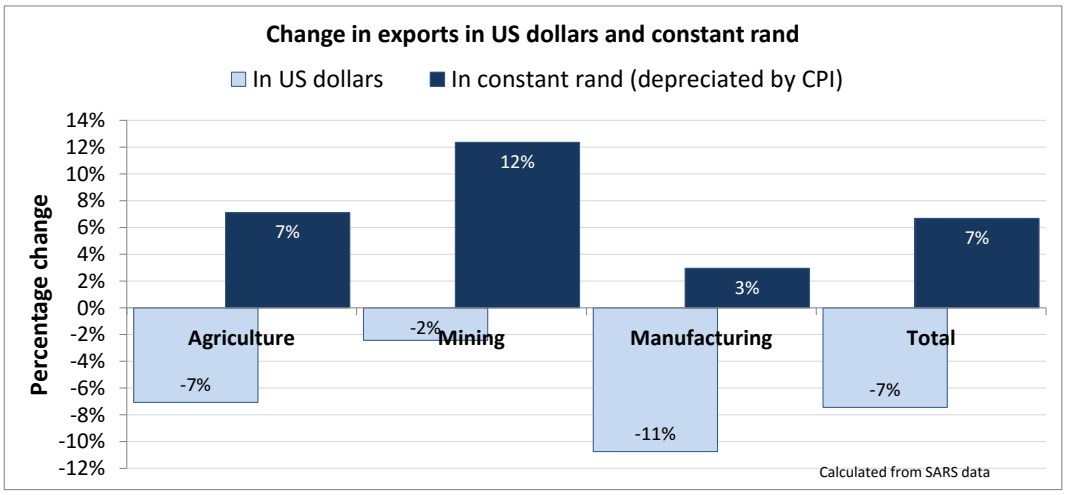
The document titled *Manufacturing industries to third quarter 2015* provides a more detailed review of key trends in each subsector of manufacturing through the third quarter of 2015.

Trends in trade

In US dollar terms, exports declined in the past year, but rapid depreciation means they have generally increased in rand terms. Within manufacturing, the past quarter saw higher exports from wood and paper and to a lesser extent from auto, but chemicals exports dropped sharply. Imports declined in both dollar and rand terms over the year to the third quarter of 2015.

In US dollar terms, exports of agricultural, mining and manufactured products all dropped in the year to the third quarter of 2014. But the sharp depreciation in the rand meant that for all three sectors export revenues increased in rand terms, as the following graph shows. In dollar terms, merchandise exports as a whole fell 7,4%, while in rand terms they increased 6,7%.

[1] For mining, Statistics South Africa recommends the use of data provided by employers through the Quarterly Employment Survey rather than the Quarterly Labour Force Survey data, due to the difficulty of weighting mining centres appropriately in the household survey data.



Persistent dependence on commodity exports emerged from the fact that both agriculture and mining showed a strong trade surplus, with exports exceeding imports. In contrast, manufacturing trade continued to show a deficit, with foreign purchases higher than exports. Manufacturing data include basic steel and ferroalloy products, which are generally traded as commodities and largely exported. Metals refineries accounted for 22% of total manufacturing exports, and were the only manufacturing sector with a strong balance of trade surplus. Metals and ores together contributed over half of South African exports.

Within manufacturing, exports declined in dollar terms for every sector except wood and paper in the year to the third quarter 2015, but most grew in constant rand terms. Export performance improved significantly from the second to the third quarter of 2015, which is not the usual seasonal trend and therefore likely indicates underlying gains. Wood and paper and the auto industry saw the fastest growth in exports in rand terms. In contrast, chemical exports contracted in both rand and dollar terms in the past year, and the fall accelerated in the past quarter.

In constant rand, imports fell by around 2% in the year to the third quarter of 2015. They increased by 13% in the third quarter compared to the second quarter of 2015, which was in line with normal seasonal fluctuations. As a rule, the third quarter accounts for virtually all import growth, mostly due to increased purchases of consumer goods for the festive season. In contrast, the rate of growth of imports of capital and intermediate goods does not vary much by quarter.

Value of and change in trade by manufacturing industry to third quarter 2015 (a)

Indica-tor	Manufacturing industry	value in Q3 2015		% change in constant rand to Q3 2015		% change in US$ to Q3 2015	
		ZAR bns	USD bns	From Q3 2014	From Q2 2015	From Q3 2014	From Q2 2015
Exports	Food and beverages	11.7	0.9	-4.4%	9.9%	-17%	3%
	Textiles, clothing, leather, footwear	5.4	0.4	0.3%	-2.6%	-13%	-9%
	Wood and paper	6.8	0.5	15.1%	11.6%	0%	5%
	Chemicals, plastics, rubber	21.9	1.7	-5.5%	-6.7%	-18%	-12%
	Glass and non-metallic minerals	1.5	0.1	4.3%	-1.8%	-10%	-8%
	Metals and articles of metal	32.2	2.5	1.3%	1.7%	-12%	-4%
	Machinery, appliances, AV equipment	26.9	2.1	2.3%	9.7%	-11%	3%
	Precision equipment	2.0	0.2	2.0%	4.5%	-12%	-2%
	Transport equipment	35.1	2.7	12.2%	6.5%	-3%	0%
	Other manufacturing	2.4	0.2	2.0%	7.2%	-12%	1%
Imports	Food and beverages	8.1	0.6	-1%	16%	-14%	9%
	Textiles, clothing, leather, footwear	16.4	1.3	12%	35%	-3%	27%
	Wood and paper	5.7	0.4	2%	15%	-12%	8%
	Chemicals, plastics, rubber	43.4	3.3	11%	19%	-4%	12%
	Glass and non-metallic minerals	3.4	0.3	4%	16%	-10%	9%
	Metals and articles of metal	14.8	1.1	13%	1%	-2%	-5%
	Machinery, appliances, AV equipment	70.0	5.4	4%	5%	-10%	-1%
	Precision equipment	7.6	0.6	9%	9%	-6%	2%
	Transport equipment	51.8	4.0	7%	14%	-7%	7%
	Other manufacturing	6.0	0.5	10%	40%	-5%	31%
Balane	Food and beverages	3.6	0.3	-11%	-2%	-23%	-8%
	Textiles, clothing, leather, footwear	-11.0	-0.8	19%	67%	3%	57%
	Wood and paper	1.1	0.1	241%	-4%	202%	-9%
	Chemicals, plastics, rubber	-21.6	-1.7	34%	65%	16%	56%
	Glass and non-metallic minerals	-1.9	-0.1	3%	35%	-11%	27%
	Metals and articles of metal	17.4	1.3	-7%	3%	-19%	-3%
	Machinery, appliances, AV equipment	-43.1	-3.3	5%	2%	-10%	-4%
	Precision equipment	-5.6	-0.4	11%	11%	-4%	4%
	Transport equipment	-16.7	-1.3	-2%	33%	-15%	26%
	Other manufacturing	-3.6	-0.3	17%	76%	1%	65%

Notes: (a) Figures for change from second quarter 2015 are not seasonally adjusted. Constant change in rand calculated using CPI to deflate current figures. *Source:* SARS data on trade.

Profitability and investment

In the second quarter of 2015 – the latest available - mining as a whole made a loss, but construction saw a higher return on capital. Investment trended down in mining compared to 2014, but increased in manufacturing.

Quarterly data on profits and investment can be calculated using Statistics South Africa's Quarterly Financial Statistics for the productive sectors outside of manufacturing. Data are however only available through the second quarter of 2015.

According to these data:

- Mining as a whole made losses through the first half of 2015, mostly because of the sharp drop in commodity prices. In 2015 rand, mining investment dropped fairly steadily from R69 billion in the year to the second quarter of 2012 to R56 billion in the year to the second quarter of 2015. That trend reflects falling profits as export prices dropped.
- In contrast, manufacturing profits increased for most of the year to mid-2015, recovering from a sharp fall in the third quarter of 2013. Moreover, investment in manufacturing reportedly climbed rapidly from early 2014, rising from R11,5 billion in the first quarter of 2014 to R23 billion in the fourth quarter of the year, then stabilised around that level in the first half of 2015. The increase reversed a tendency toward falling investment in manufacturing from 2012.

Profitability and capital expenditure by sector

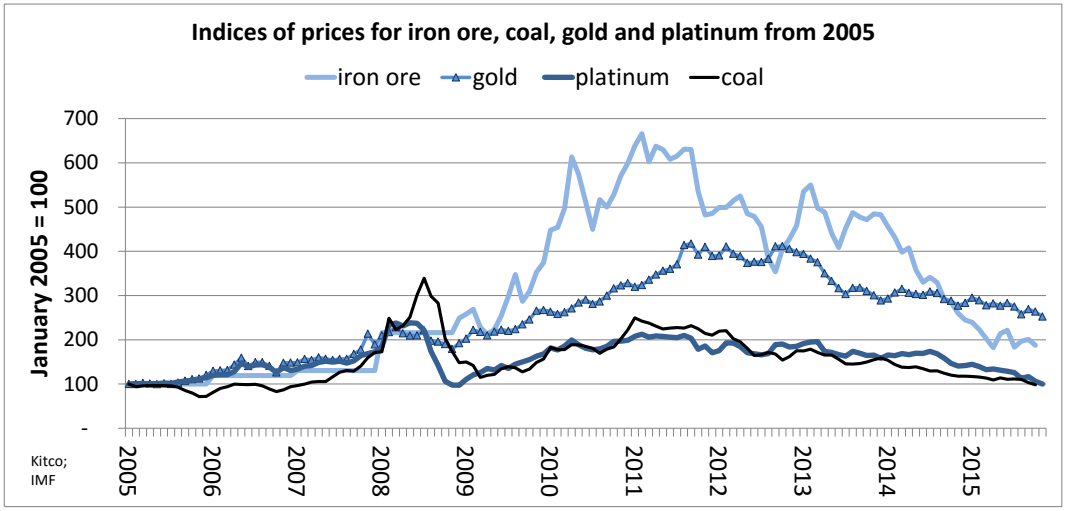
	Mining	Manufac-turing	Utilities	Construc-tion	Other	Total
Profitability **(a)**						
Profits in R bns, Q3 2015	-8,5	36,4	4,1	-0,1	77,7	108,9
Return on capital, Q2 2015	-1.6%	8.4%	8.7%	-0.2%	8.0%	4.4%
Return on capital, Q1 2015	-0.6%	5.1%	9.5%	-0.4%	8.8%	4.2%
Return on capital, Q2 2014	1.1%	5.3%	4.7%	0.6%	7.8%	4.5%
Capital expenditure						
Capital expenditure in Rbns, Q2 2015	12.0	23.6	3.1	17.6	31.8	88.1
Capital expenditure as % of assets, Q2 2015	2.3%	5.4%	6.6%	3.5%	3.3%	3.5%
Capital expenditure as % of assets, Q2 2014	2.9%	4.4%	5.4%	2.9%	4.7%	9.2%

Notes: Return as capital calculated as profits less tax divided by the carrying value of assets. *Source:* Calculated from Statistics South Africa, Quarterly Financial Statistics, relevant quarters.

What's behind the trends?

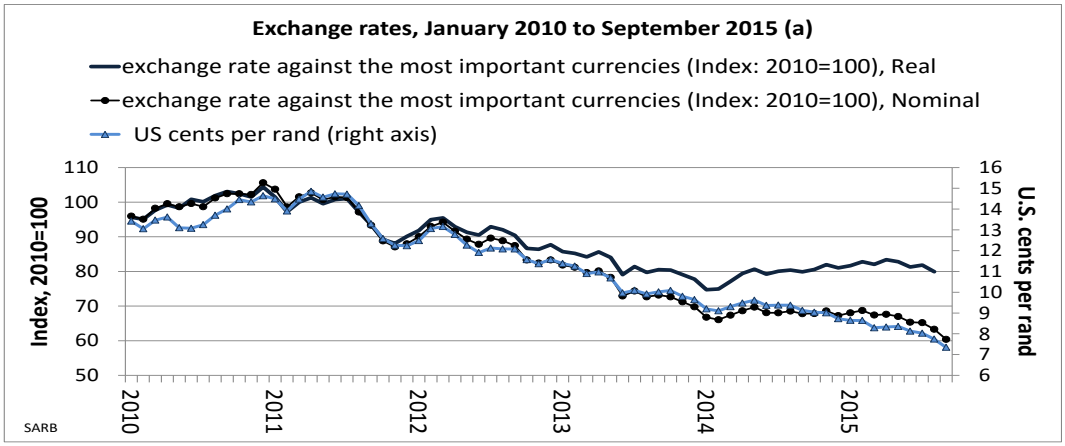
Slower growth in the real economy mostly resulted from the end of the commodity boom, with a particularly sharp downturn in mining and metals refineries. Still, within manufacturing, electrical equipment and most consumer goods industries have done well in the past six months, essentially due to the national build programme, the more competitive exchange rate, and the end of loadshedding. Agriculture and agro processing have however been slowed by the drought.

The past quarter saw continued slow growth overall, due mostly to the economy-wide repercussions of the end of the commodity boom. Since 2011, the prices of South Africa's main export commodities – iron ore, platinum, coal and gold – have fallen by a weighted average of around 50%. The main reason for the drop in commodity prices was slow growth in China. In the case of platinum, the development of methods to reduce the amount used in catalytic converters contributed to weak demand, and was only partially offset by higher purchases for jewellery production in India.



Mining has seen a fall to near zero profits for most commodities, with the exception of iron ore, with a substantial decline in investment and employment – and likely more retrenchments looming. In the third quarter of 2015, Lonmin tottered on the verge of bankruptcy. Anglo Platinum sold its holdings to Sibanye, reflecting the divestment of major foreign miners as profitability drops, a process that occurred over the past decade across gold mining.

The end of the commodity boom has however brought a far more competitive exchange rate (as shown in the following chart) and an end to loadshedding as the refineries downsized production. The result was an uptick in total manufacturing, but with very mixed results by subsector, as discussed in the section on GDP and employment outcomes.



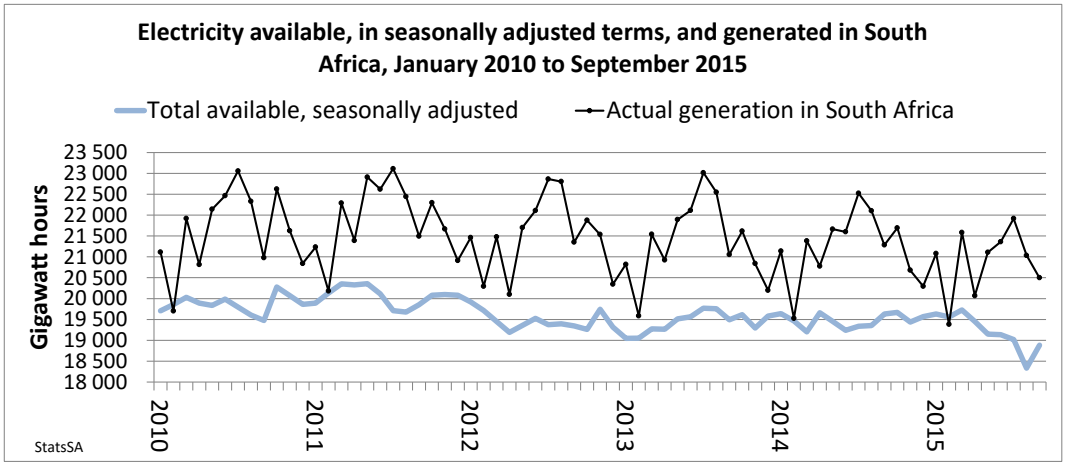
It seems likely that the slowdown in agro-processing reflected the initial effects of the drought. Broader consequences will arise if the drought leads to substantial imports of maize. South Africa is generally self-sufficient in food. When it has to import, however, the cost of transport (equal to around a third of the cost of production of maize) leads to sharp price hikes, which would be aggravated by the depreciation of the rand. As of October, the price of maize was up by 80% compared to the previous year.

Higher food prices would affect the real economy directly, by boosting wage demands across the economy. If it also fosters higher overall inflation, it could also lead the Reserve Bank to increase interest rates.

Electricity and the carbon tax

Lower production by the main metals refineries means loadshedding has ended, although breakdowns at municipal level still cause unpredictable blackouts. The National Treasury's proposed carbon tax aims ultimately to make coal and oil more expensive fuels. Although it is being initially introduced at a low rate, to achieve the desired outcome would require a fundamental shift in the structure of manufacturing.

Load shedding from late November through the second quarter of 2015 cost many manufacturing sectors dearly. Reduced metals refineries production from early 2015 has, however, provided significant relief. Electricity use dropped by almost 5% from March to September 2015, as the accompanying chart shows. Largely as a result, there has been virtually no loadshedding since the middle of the year.



In most municipalities, however, the failure to maintain substations and distribution systems means that unexpected blackouts still occur periodically as a result of equipment failures. In November, Johannesburg announced it would invest R500 million to upgrade substations, but the backlogs remain substantial across the country.

The National Treasury has published draft legislation to introduce a carbon tax, which would effectively increase the cost of non-renewable energy, both electricity and petroleum. In light of substantial resistance both inside and outside of government, its current proposals seek to minimise the initial impact through:

- An array of discounts and exemptions that would mean the effective increase in cost would be around 3% for electricity and 1% for liquid fuels for most companies, and
- Measures to ensure that the new tax would not lead to an increase in total tax income. For instance, Treasury might end the current electricity levy, which would largely offset the increase in the electricity price although it would not affect liquid fuels. In effect, the aim of this strategy is to change the relative cost of carbon fuels, not to increase total taxes on business.

Within the real economy, the carbon tax would mostly affect energy-intensive producers, notably the refineries (which already face serious difficulties), and transport costs. That said, if the Treasury does in fact eliminate the electricity levy, the cost of electricity will not be affected in the short run.

The longer-term challenge for manufacturing arises from the stated intention of reducing dependence on coal-based electricity, the main source of emissions worldwide. The refineries, which use around 20% of Eskom's (mostly coal-fired) electricity, constitute South Africa's second-largest manufacturing sector, after food and beverages. Chemicals, which Sasol dominates, are in third place. Measures to reduce dependence on coal by raising the cost of carbon will fundamentally affect growth prospects in these industries.

The carbon tax comes on top of increases in the electricity tariff from 2008 averaging 110% for the refineries, 150% for the mines, and 135% for municipalities, which in turn supply most of the rest of manufacturing. The higher price has both accommodated growth in renewable electricity and supported Eskom's construction of two new coal-based power plants.

In essence, policy debates around the carbon tax reflect different approaches to regulation. The tax relies essentially on a market mechanism to incentivise reduced dependence on carbon-based fuels. As with all market-based strategies, it is not expected to work efficiently in the presence of major market imperfections and factor immobilities. In the event, a combination of regulatory, technical and financial factors makes it difficult for companies to switch from Eskom to cleaner electricity sources or to move from road to rail. As a result, they cannot adapt efficiently or rapidly to the higher cost of carbon-based energy, which means the tax as a whole could have a more negative impact than anticipated on the real economy.

The Departments of Environmental Affairs and Energy have relied on industrial-policy approaches. That is, they are seeking to promote new sector-specific technologies through a combination of incentives and regulations.

The Davis Tax Commission has recommended that the carbon tax be introduced in 2017 with a zero rating to enable both the Treasury and companies to improve their information on emissions, adapt more efficiently, and improve implementation in ways that achieve the desired outcomes. A detailed *briefing on the carbon tax* includes the Davis Tax Commission recommendations.

Manufacturing Competitiveness Enhancement Programme in context

The recent freeze on applications to the dti's Manufacturing Competitiveness Enhancement Programme (MCEP) stirred controversy. The short-term decision to end applications essentially reflects increasing efficiency in the dti approval processes. In the medium term, however, Treasury's current efforts to reduce state spending seem likely to bring to a halt the past decade's rapid growth in the resources available for the incentive.

In October, the dti announced that it could not approve further applications under the MCEP because it had exhausted the available funds. Under this programme, the dti commits to reimburse successful applicants, most of which are small or medium enterprises, for projects to enhance efficiency and green technology. Approved applications average around R15 million per applicant.

The applications are approved essentially on a first come, first served basis. Approvals have typically taken over a year, with payments starting a year after that. To date, the dti has approved R5 billion for 335 mostly small and medium enterprises, and has paid R1,5 billion. At least in part, exhaustion of the MCEP's funds halfway through the financial year reflects increased efficiency in spending by the dti. Two years ago, only 82% of the incentive funds were spent during the budget year; by 2014/5, this had risen to 97%.

The widespread criticism of the freeze apparently arose because most applicants pay consultants to prepare the application. A survey of 40 applicants undertaken under the auspices of the Manufacturing Circle found that while most employed consultants on a contingency basis, more than third had to pay them at least something, whatever the dti's decision. In the sample, the dti had approved around half the applications. Over half felt that the dti's communication and service were below average or poor; only one said it was excellent and most of the rest found it average.

Treasury has committed to austerity budgets over the next few years. In this context, incentive schemes are vulnerable because the funds are generally not contractually tied up in advance and because it is often difficult to quantify their effectiveness.

The impact of the austerity strategy appeared in the latest dti budget. Transfers to business now account for around 40% of the dti's total expenditure, up from 20% a decade ago. From 2005/6 to 2014/5, the dti's transfers to private business quadrupled in constant 2015 rand, rising from R1,1 billion to R4,1 billion. In the coming two fiscal years, in contrast, these transfers as a whole are expected to fall 1% in real terms.

That said, incentives to manufacturing are still expected to climb by 10%, rising from R3,3 billion in 2014/5 to R3,6 billion in 2015/6 in 2015 terms. Moreover, the department's support for critical economic infrastructure – both through the Special Economic Zones and through targeted investment in other areas – is planned to double in the coming two years, with R1,3 billion budgeted for 2015.