



REAL RECOVERY STILL OUT OF REACH DESPITE EASING MONETARY POLICIES

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KEY TAKEOUTS

- DESPITE WIDESPREAD RATE CUTS, A TRADE WAR RESOLUTION IS NEEDED FOR ECONOMIC RECOVERY.
- CURRENT FRUSTRATIONS CENTRE ON THE LACKING TURNAROUND PLAN FOR ESKOM.
- NDP AND BETTER POLICY IMPLEMENTATION CAN HELP SA'S GROWTH IN THE SECOND HALF OF 2019.



GLOBAL ECONOMY: CONTINUED TRADE TENSIONS RAISED RISKS OF GLOBAL RECESSION

While overall global growth was always expected to be slower in 2019 than last year, the ongoing and escalating trade war between the USA and China has lifted risks that the USA, and indeed the global economy, might enter a recession some time in 2020. The prolonged trade war has meant that growth forecasts have been downgraded even further in the past few months.

Throughout April and early May, optimism was still building that a trade deal between the USA and China could be signed by late May. However, negotiations broke down and the USA raised tariffs from 10% to 25% on US\$200bn worth of Chinese imports with threats of tariffs on the remaining US\$300bn of untaxed imports as well. Tensions eased somewhat after Presidents Trump and Xi met on the sidelines of the G20 summit but this did not last long; President Trump soon announced tariffs on the remaining US\$300bn of Chinese imports not yet taxed. China retaliated quickly and this re-escalation hit business confidence hard. We have since seen a significant impact on markets, with the manufacturing purchasing managers' index (PMI) and currencies of a number of countries being notably hit.

Apart from this extension to the trade war, the other surprise in Q2 was the easing policy stance virtually everywhere. While the policy stance of the Federal Reserve Board in the USA (the Fed) had already evolved from the tightening bias during 2018 to a more patient approach early this year, the resultant trade-related growth risks moved them to an easing policy stance at their June policy meeting. The Fed did go on to cut rates by 25 basis points at the July meeting, however it disappointed the market when it indicated that this shouldn't be interpreted as the start of a lengthy cutting cycle. Nonetheless, the recent risk escalation probably means a slightly more aggressive cutting cycle than what was assumed just after the Fed's July meeting.

Worldwide many other central banks have turned more dovish, and with quicker rate cuts than expected. Apart from the USA, Australia, New Zealand, India, Philippines, Thailand, Peru, Brazil, Russia, Malaysia and South Africa have cut rates recently. Many of these have cut multiple times and deeper than expected. The European Central Bank (ECB) has turned more dovish and a rate cut is now on the cards within the next few months. Furthermore, the ECB could even extend Quantitative Easing (QE). And China could potentially join the rate cutters in the next few months.

While easier policy will certainly help the global economy avert recession, it will not be enough on its own to engineer a stronger economic recovery. Confidence will only recover sufficiently once the trade war has been resolved. And though it is unlikely that a deal will be signed very soon, any news of progress on this front will help confidence.

Outlook for the global economy: I remain of the opinion that recession risk remains low and growth rotation from the USA to elsewhere could still be on the cards if the trade war is resolved. With USA rate cuts on the cards, I expect the dollar to weaken towards the end of this year and into 2020. This could still be a better environment for emerging markets in general and South Africa in particular.

SA ECONOMY: A turnaround in growth needs urgent policy change

First off, despite uncertainty, volatility and very weak economic growth, I believe the "Winds of Change" investment theme is still on track. While recent events have meant more depressed consumer, business and investor confidence, I believe that all the small, incremental improvements of the past 18 months mean that the potential for an upside surprise is somewhat bigger than the potential for a downside surprise. While slower than expected or needed, the broad underlying trend is still up. Thus, despite all the inherent Eskom and fiscal risks, my strong belief is still that the next five years will be better than the past five years.

The election outcome in May was in line with my expectations – a positive outcome for the political centre. The fringe parties have remained at the fringe while the ANC's share of the vote has improved from the 2016 local government elections. This better election outcome allowed President Ramaphosa to improve his Cabinet – cutting the size and removing some non-performing ministers. Perhaps the Cabinet is not perfect yet, but it certainly is a vast improvement. Again, it would be unrealistic to expect overnight change. We are moving in the right direction: the headwinds holding us back are dying down and even turning into tailwinds pushing us forward.

The second quarter did have its share of bad news. The economy turned out to be even weaker than previously expected. While negative growth was expected for the first quarter – due to loadshedding – growth was recorded at -3.2% at an annualised pace. The slump was fairly widespread – going beyond the impact of electricity shortages – and obviously confidence among consumers and business was very weak amidst the pre-election uncertainty. A strong turnaround in some of the key sectors like electricity and mining production as well as some uplift in manufacturing production and retail sales means Q2 GDP growth could be in the region of +2.5% to +3.0% annualised growth. Nevertheless, 2019 GDP growth is now likely to stay close to the 0.8% reached last year.

The more recent sense of depression and frustration centres around the lack of more decisive policy change and action regarding Eskom's turnaround plan. While a Chief Restructuring Officer for Eskom was appointed, the lack of progress and significantly higher budget deficit on the back of extra spending to support Eskom have raised concerns about potential negative ratings action from Moody's.

Clearly a confidence turnaround is needed to help lift economic growth. And this is still possible through policy change. One of the highlights of President Ramaphosa's State of the Nation Address was the return of the National Development Plan (NDP) as the guiding light to get economic growth onto a higher trajectory. The NDP is a great plan but has not been implemented to the extent needed. Recent news suggest that a slight rewrite is under way by the National Planning Commission (NPC) to improve the focus of the NDP. Better policy and stronger confidence could lead to increased economic activity and then I believe 3% growth is possible by 2022/2023.

Investors are now awaiting the promised Eskom policy document in mid-September, which should provide more clarity around Eskom's debt and corporate restructuring, and the Medium Term Budget Policy Statement toward late October. While it has become clear that the budget deficit will be significantly higher this year (around -6% of GDP vs

the February budget estimate of -4.5%) and the next few years (due to extra spending and much lower growth), some positive news came from planned expenditure cutbacks over the next few years. National Treasury has instructed government departments to plan for expenditure cuts of 5% in the 2020/21 fiscal year, 6% in 2021/22 and 7% in 2022/23. This will alleviate some of the pressure on extra taxes. Nevertheless, the Budget deficit will be higher over the medium term versus previous plans.

Inflation remains muted, with almost no evidence of second round price pressures despite significant cost increases in areas such as electricity and petrol. Food inflation has been well contained but is expected to rise towards December. I expect inflation to average 4.3% this year and 4.7% in 2020.

A much more dovish global monetary policy stance, combined with local growth downside surprises (both in terms of actual and forecast growth) and muted inflation has led to an easier policy stance by the South African Reserve Bank. I now expect another rate cut to follow the cut at the July Monetary Policy Committee (MPC) meeting. Unfortunately, there is not room for a significant down cycle – we can have one or two more rate cuts at most. While rate cuts will certainly help lift sentiment, I do not expect them to have a big impact on the growth outlook. For that we need confidence boosting policies.

Outlook for the SA economy: Easing global policy and a weaker USA dollar should help to improve the environment for emerging economies. However we also need an end to the trade war. This, in turn, should help SA this year. The comeback of the NDP and better policy implementation should also help growth to slowly gather pace in the second half of the year. Inflation will likely remain subdued. While another rate cut is on the cards, better policy implementation and stronger confidence are needed. I expect the rand to benefit later this year from the weaker dollar and improved confidence and growth.

