BUREAU FOR ECONOMIC RESEARCH

Manufacturing

Quarterly analysis of manufacturing activity

Second quarter 2017

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ISSN 0258-9338

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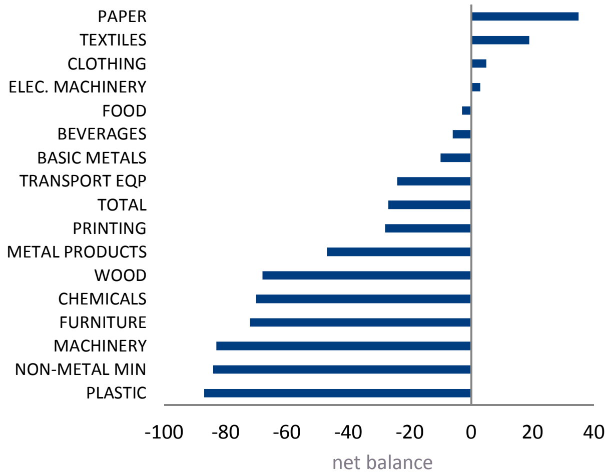
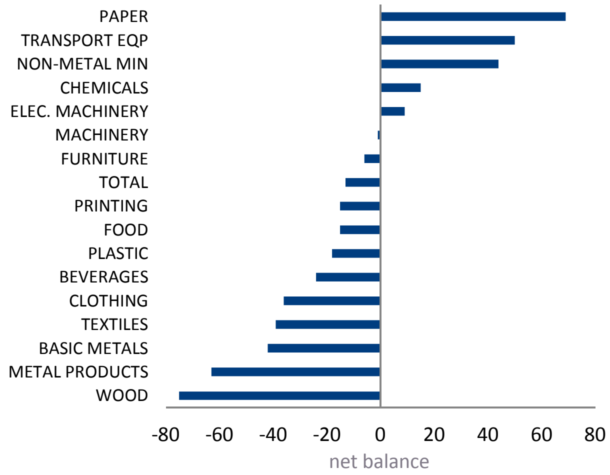
The manufacturing survey at a glance

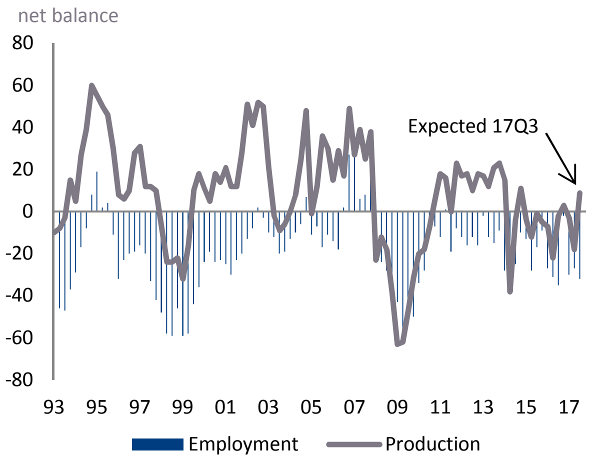
Domestic sales volumes
(BER survey: 16Q2 compared to 17Q2)



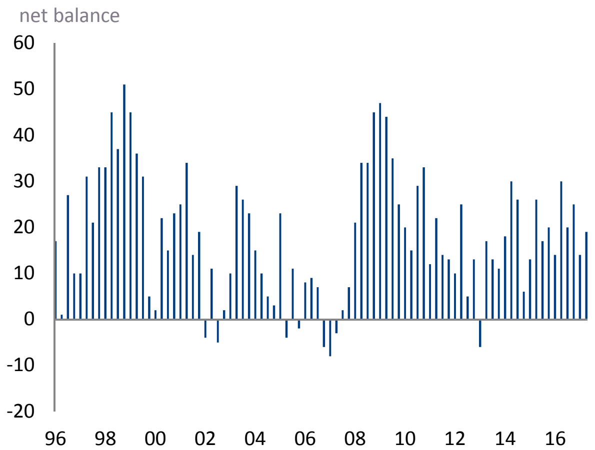
Real fixed investment: 2017Q2
(machinery & equipment: 12 month outlook)



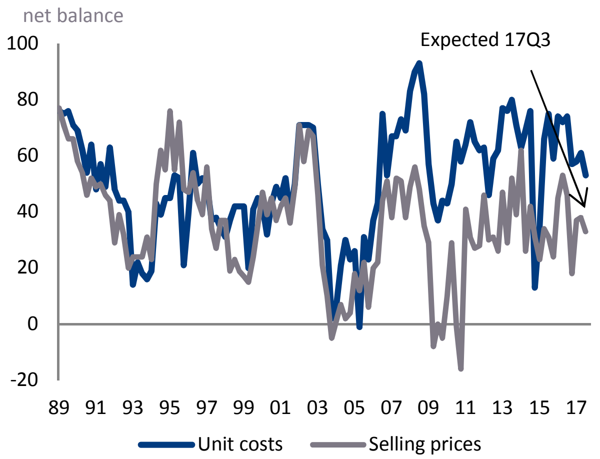
Factory employment vs production volumes



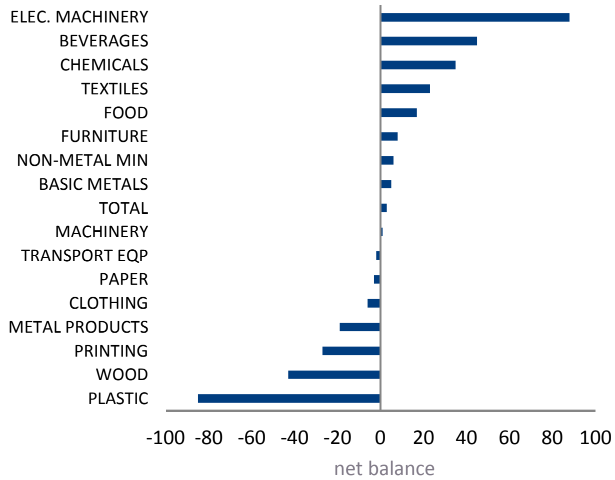
Finished goods stocks
in relation to expected sales



Rate of increase: total unit cost vs
domestic selling prices



12 month export expectations
(BER survey results: 2017Q2)



Executive summary

According to the Absa Manufacturing Survey, manufacturing business confidence deteriorated sharply in the second quarter of 2017[1], falling to 16 index points from 28 previously. This was the weakest level since 2009, when the South African economy was in a deep recession, and near all-time lows. The pessimism was widely shared among subsectors, with all but one subsector being on the unsatisfied side of the spectrum.

A key driver of the decline in business confidence was the sharp deterioration in domestic demand conditions. While the domestic demand indicators have been in negative territory for some time, the indicators now declined further. In addition, export orders also slumped to an almost five-year low and manufacturers turned notably less optimistic about longer-term export prospects.

As a result, manufacturers rated insufficient demand as a more serious constraint to overall business conditions. The only constraint to be deemed more serious was the general political climate. Both constraint indicators are at, or just below, record-high levels.

Amid weaker demand, manufacturers reported a decline in production volumes. This was in stark contrast to expectations formed in the first quarter, which were suggestive of an uptick in demand and production. With production declining, the employment indicators also remained subdued.

Due to significantly weaker volume growth (particularly on the domestic side), downward pressure on profitably (or at least turnover) likely remained. This was another key factor weighing on overall business confidence.

The manufacturing sector also continues to be plagued by slack capacity. On the back of other headwinds, this explains why plans for longer-term investment in machinery and equipment were scaled back significantly.

The most concerning result of the survey was that the biggest net majority ever recorded expects business conditions to deteriorate in 12 months' time. This is particularly worrying because manufacturers are already so downbeat about current conditions.

[1] The survey was conducted between 2 May and 5 June 2017.

This report was completed on 22 June 2017.
Please refer to the **glossary on the BER's website** for explanations of technical terms.

Contents

Introduction

The manufacturing sector continued to be a drag on economic growth in the first quarter of 2017. According to Statistics South Africa (Stats SA), the sector contracted for a third consecutive quarter (on a quarterly basis) and also declined compared to the first quarter of 2016. The Absa manufacturing survey results unpacked in this report suggest that the sector continued to face headwinds in Q2.

The manufacturing sector contracted by 3.7% quarter-on-quarter (q-o-q)[2] in the first quarter of 2017 after declining by 3.1% in the fourth quarter of 2016. Output in seven out of 10 manufacturing sectors (as classified by Stats SA) declined in Q1, with the biggest declines in the clothing and footwear, petroleum and chemicals as well as electrical machinery subsectors.

SA economy falls into recession in Q1

Due to most of the other sectors in the economy also declining in the first quarter, overall GDP growth was stuck in negative territory for a second consecutive quarter. The economy contracted by 0.7% q-o-q after a 0.3% drop in the fourth quarter of 2016, which means that the economy entered its first technical recession since 2009. On an annual basis, the economy grew by a meagre 0.6%, while the performance of the manufacturing sector was an even more bleak 0.7% contraction.

Agriculture and mining only sectors to record positive growth

The only positive surprise from the latest GDP data, which was very poor compared to consensus forecasts, was the better-than-expected growth in the agricultural sector. The agricultural sector grew by 22.2% q-o-q in the first quarter of 2017 and growth should remain well supported by the impact of the expected bumper maize crops during the remainder of the year. A strong recovery in agriculture could filter through to higher demand for inputs from the manufacturing sector. However, most of the agricultural sector's machinery, equipment and other required inputs (such as fertilizers and seeds) are imported, which limits the boost to local manufacturing. The only other sector to grow on a quarterly basis was the mining sector, expanding by 12.8% in the first quarter of 2017. A sustained improvement in mining could benefit the local manufacturing sector. However, business sentiment in this sector was knocked by the release of the updated Mining Charter mid-June, which is likely to offset the potential positive impact of the local procurement requirements.

[2] Unless specified otherwise, all the quarterly numbers quoted are at a seasonally adjusted annualised rate.

Consumer spending contracted in Q1

Measured from the demand side, the GDP data showed some concerning reversals from earlier growth trends. Most notable was the broad-based weakness in consumer spending, which contracted by 2.3% q-o-q in Q1. Given the likely confidence shock that spilled over into the second quarter in the wake of the cabinet reshuffle and credit rating downgrades, spending is likely to remain depressed. Sustained weak demand growth remains an important headwind for the manufacturing sector.

The outlook for GDP growth for the remainder of the year is subdued. Indeed, after the disappointing first-quarter figure, it is likely that GDP growth for 2017 as a whole will come in little changed from 2016's 0.3% expansion – despite initial expectations for growth to be stronger this year.

Mixed growth outlook for SA's export markets

On the bright side, the global economy is improving and growth prospects are particularly upbeat for the Eurozone (a key market for locally manufactured goods). However, growth is still expected to recover only slowly in sub-Saharan Africa, another important destination for factory good exports. Some economies within the region are still grappling with the lower commodity price environment and the impact this has had on the fiscal health of these economies. This means that manufacturers targeting the African export market may also still face weak demand conditions.

The remainder of the report provides an overview of the situation in the manufacturing sector as it developed during the second quarter of 2017 (2017Q2), expectations for the third quarter of 2017 (2017Q3) and also 12 months hence. The main section of the report discusses the trends in the overall manufacturing industry with the assistance of graphs, followed by a brief outlook for the sector. After this section, separate tables and graphical displays of the survey data are also provided for each individual sector and province[3].

[3] In this edition of the Manufacturing Survey, we cover 16 out of the 19 major subsectors and the four main provinces (Eastern Cape, Western Cape, Gauteng and KwaZulu-Natal).

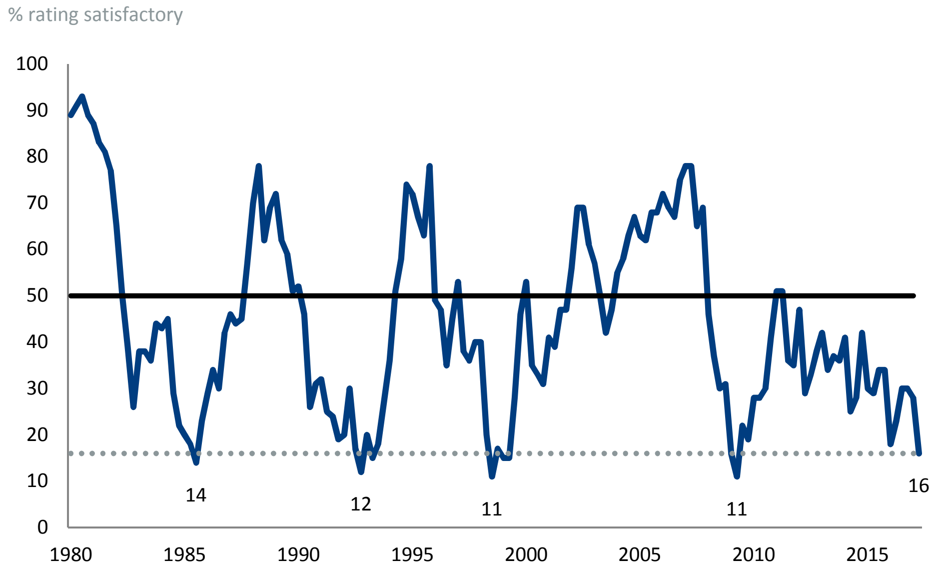
The 2017Q2 Absa Manufacturing Survey results

Manufacturing business confidence plummets

More than eight out of ten manufacturers unsatisfied with conditions

Manufacturing business confidence deteriorated sharply in 2017Q2, falling to 16 index points from 28 previously. This was the weakest level since 2009Q3, when the South African economy was in a deep recession. Indeed, as illustrated in Figure 1 below, the current level is near all-time lows and business confidence has rarely dropped below the current level. At 16 points, it means that more than eight out of ten respondents to the manufacturing survey were unsatisfied with prevailing business conditions. Indeed, a net majority of 62% – the biggest since 2009Q2 – reported that business conditions deteriorated compared to a year ago.

Figure 1: Manufacturing business slumps to near all-time lows[1]



[1] The dotted grey line equals the current level of 16 index points and solid black line represents neutral 50-points level.

Source: BER

Only one manufacturing subsector has a confidence reading above 50

The pessimism was widely shared among subsectors, with all but one subsector being on the unsatisfied side of the spectrum. Only in the paper subsector, where confidence came in at 77 index points, were the majority of respondents satisfied with prevailing business conditions. In fact, in the wood, printing and electrical machinery subsectors business confidence stood at zero, which means that not a single respondent in these subsectors was satisfied with business conditions. In the transport, basic metals, furniture, machinery, plastics, beverages and non-metal minerals subsectors business confidence was at 8 points or lower. These very depressed levels of confidence bode ill for future investment growth and job creation.

Barring new vehicle dealers, manufacturers were again the most unsatisfied compared to the other sectors (wholesalers, retail traders and building contractors) surveyed in the overall RMB/BER Business Confidence Index (BCI). The overall BCI also slumped to recession-low levels, falling to 29 points from 40 previously.

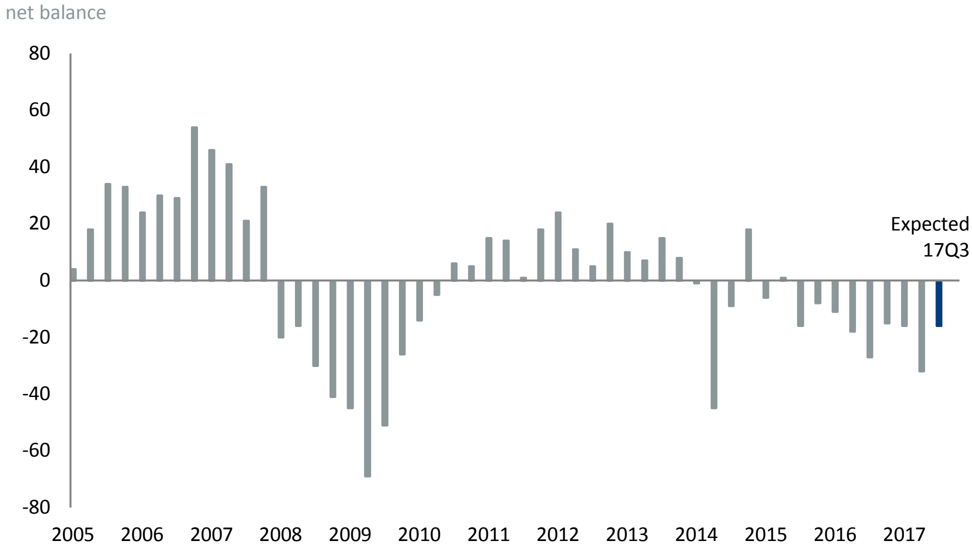
Domestic demand deteriorates sharply

A key driver of the decline in business confidence was the sharp deterioration in domestic demand conditions. While the domestic demand indicators have been in negative territory for some time, the indicators now slumped back to the lowest level since 2014Q2. Indeed, barring that single quarter in 2014 when demand was affected by the five-month platinum mining strike, the indicator is now at the lowest level since 2009 – see Figure 2.

Domestic orders significantly lower

A net majority of 32% reported a decline in domestic sales orders in 2017Q2, up from 16% in 2017Q1. The worsening domestic demand conditions were contrary to manufacturers' expectations as a net majority of 1% expected domestic orders to tick up in 2017Q2. While volumes declined, the indicator measuring the rate of increase in the average domestic selling price per unit remained virtually unchanged compared to 2017Q1 and is in line with the long-term average level. This suggests that there was no trade-off between lower (or higher) volumes and faster (or slower) price increases as we have seen in previous quarters.

Figure 2: Domestic sales orders slump further into negative terrain



Source: BER

As with the downbeat confidence reading, the experience of lower domestic demand was widely shared among manufacturers in the different subsectors. Only three subsectors (electrical machinery, clothing and textiles) reported an improvement in domestic order volumes received compared to the same period last year. In the wood, plastics, machinery, printing, non-metal minerals and furniture subsectors, net majorities exceeding 70% reported a decline in domestic orders.

Export indicators point to mixed performance in Q2, but deterioration going forward

Export sales still in positive terrain, but order volumes slump

The drop in the export order volumes indicator to an almost five-year low was disappointing. A net majority of 14% reported a decline in export orders compared to the same period last year, while in 2017Q1, a net 1% still reported an increase. On the other hand, the net majority reporting an increase in export *sales* volumes remained more or less unchanged at 7% in 2017Q2 from 9% in 2017Q1. This means that current sales orders were still in positive terrain, but that orders (for future sales) declined. To highlight the divergence from a subsector perspective, seven out of 16 subsectors reported an increase in *sales*, while only three subsectors reported an increase in *orders*. Particularly basic metal producers (a key export sector) were upbeat about sales, with a net majority of 29% reporting an increase, but a net 89% reported a decline in orders.

Overall, manufacturers were less optimistic about longer-term export growth as well. A net majority of just 3% (the lowest since 2012) expected an increase in volumes in 12 months' time, down from 37% in 2017Q1. Again, a big turnaround in sentiment in the basic metals subsectors (from a net majority of 84% expecting an increase in 2017Q1 to only 5% in 2017Q2) contributed to the drop in the overall figure.

According to the South African Reserve Bank's (SARB) June Quarterly Bulletin, the rand value of manufacturing exports declined for a third consecutive quarter in Q1. The survey suggests that this downward trend could continue going forward.

Export selling price inflation ticks up

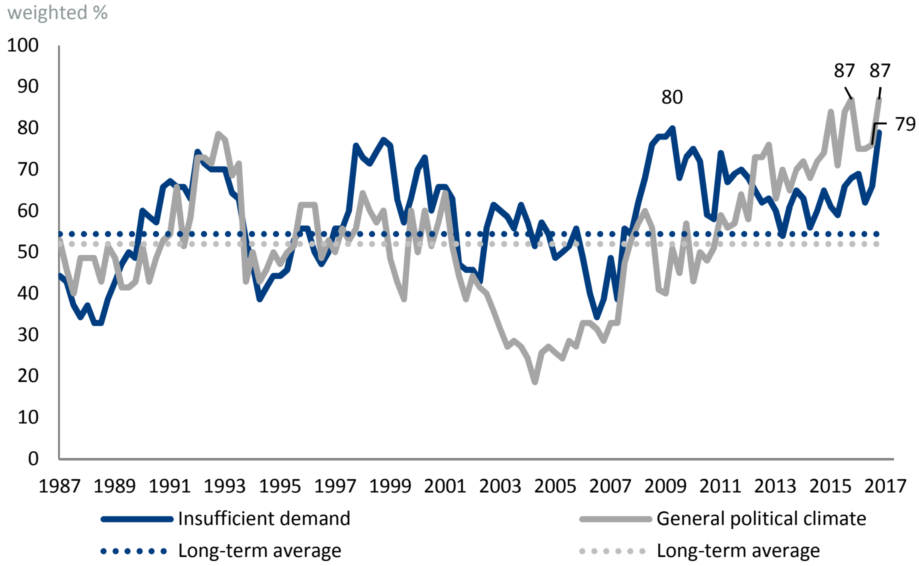
On a positive note, manufacturers reported an acceleration in the rate of increase in the average export selling price per unit of production compared to the same period last year. This was despite the rand exchange rate being significantly stronger in 2017Q2 compared to 2016Q2. Usually a stronger rand exchange rate means less rand income for the same foreign-currency denominated product.

Insufficient demand and general political climate rated as more serious constraints to business

Surge in general political climate and insufficient demand constraint indicators

As a result of the further deterioration in domestic demand indicators, coupled with a drop in export orders, manufacturers rated insufficient demand as a more serious constraint to business conditions compared to 2017Q1. At 79%, the constraint indicator is now at the highest level since 2009 and well above the long-term average reading of 54%. In fact, the current level is only 1 percentage point below the all-time high of 80% reached in 2009 – see Figure 3. The only factor rated as a more serious constraint (of those surveyed) remains the general political climate. The surge in this indicator from 76% to 87% (matching a record high reached in 2016Q2) was not surprising given the controversial cabinet reshuffle and subsequent sovereign credit rating downgrades that took place just before this quarter's survey period. The general political climate constraint has a strong negative correlation with business confidence. In times where the political climate is rated as a serious constraint, business confidence tends to be low and vice versa.

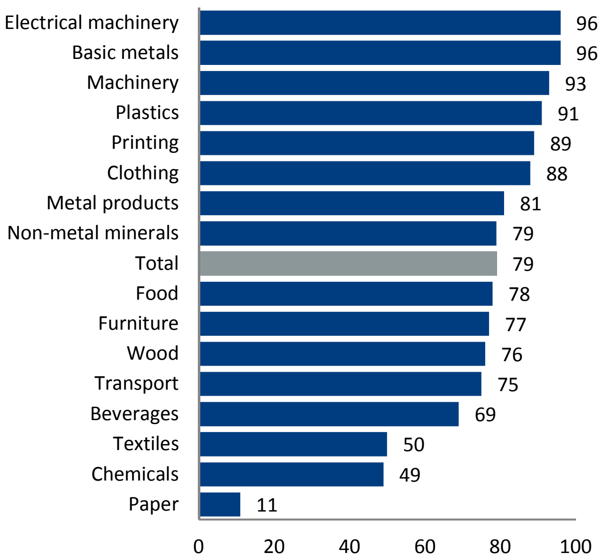
Figure 3: Constraints to business conditions



Source: BER

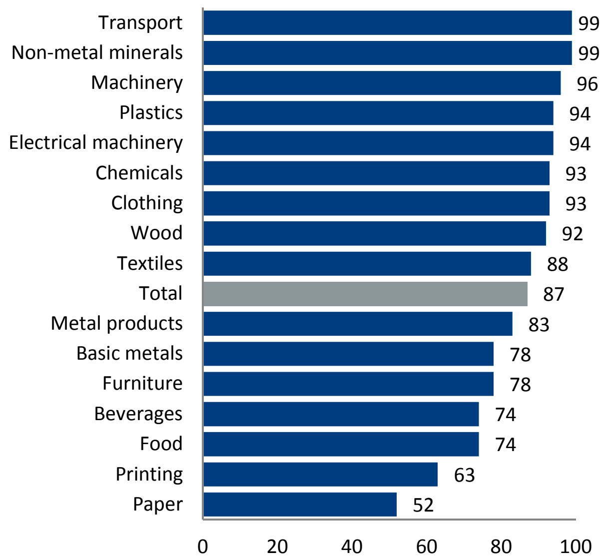
The insufficient demand and general political climate constraint indicators were reported as serious constraints in most subsectors (barring the paper subsector). In ten out of 16 subsectors, the weighted percentage reporting the general political climate as a serious constraint was above 80%. This was the case in seven subsectors for the insufficient demand constraint in Q2, while there was only one sector (basic metals) for which this was true in Q1. This points to a marked deterioration in demand across the manufacturing sector.

Figure 4: Insufficient demand constraint per subsector



Source: BER

Figure 5: General political climate constraint per subsector



Source: BER

Production volumes decline

Output slumps, contrary to expectations for an improvement

On the back of weaker demand, a net majority of 18% reported a decline in production volumes. Not only was this a deterioration compared to the net 3% that reported a decline in 2017Q1, it was also in sharp contrast to upbeat expectations expressed in Q1. A net majority of 12% had expected to report an increase in production volumes in Q2, this suggest that current expectations for an improvement in 2017Q3 may again prove too optimistic. The subsectors with the biggest net majorities reporting a decline in production volumes were plastic (with a net 81%), transport (78%), machinery (76%), furniture (67%) and basic metal (49%) producers. On the other hand, net majorities in the electrical machinery (82%), clothing (71%) and textiles (46%) subsectors reported an increase in production volumes. Unfortunately, these are of the smallest subsectors as measured by Statistics South Africa and are unlikely to lift growth significantly. In all, the current reading suggests that annual output growth is unlikely to recover meaningfully in 2017Q2. Indeed, the first official data available for Q2 shows that manufacturing output declined by 4.1% year-on-year in April. This was the biggest annual decline since mid-2014.

Employment indicators remain subdued

The (by manufacturers) anticipated improvement in employment did not occur. A net majority of 27% reported a decline in the number of factory workers in 2017Q2 compared to the same period last year, slightly better than the net 30% in Q1. In addition, a net majority of 26% (the biggest since 2014) reported a decline in the average hours worked per factory worker. This is often seen as a leading indicator of employment growth and the decline does not bode well for job creation going forward.

Rate of increase in purchasing prices continues to slow

Stronger rand, lower food prices contribute to slowdown in raw material costs

On the back of a stronger exchange rate (which lowers the cost of imports) as well as a lower Brent crude oil price, the rate of increase in the average purchasing price per unit of raw materials decelerated for a fourth consecutive quarter. At 41, the indicator is well below the long-term average reading of 58 points and at less than half of the 84 points reached in 2016Q2. Lower food price inflation on the back of expected bumper crops also contributed to the slowdown. In fact, in the food subsector, this indicator has come down from 98 in 2016Q2 to 24 in 2017Q2 (with a further slowdown to 19 expected in 2017Q3). However, despite the indicator measuring the rate of increase in the average labour costs per unit of production also ticking lower from 64 to 58 in Q2, total cost increases accelerated. Given that this indicator measures the rate of increase *per unit of production,* it could also be that the decline in production led to higher per-unit cost increases if fixed costs remained unchanged.

Continued pressure on profitability

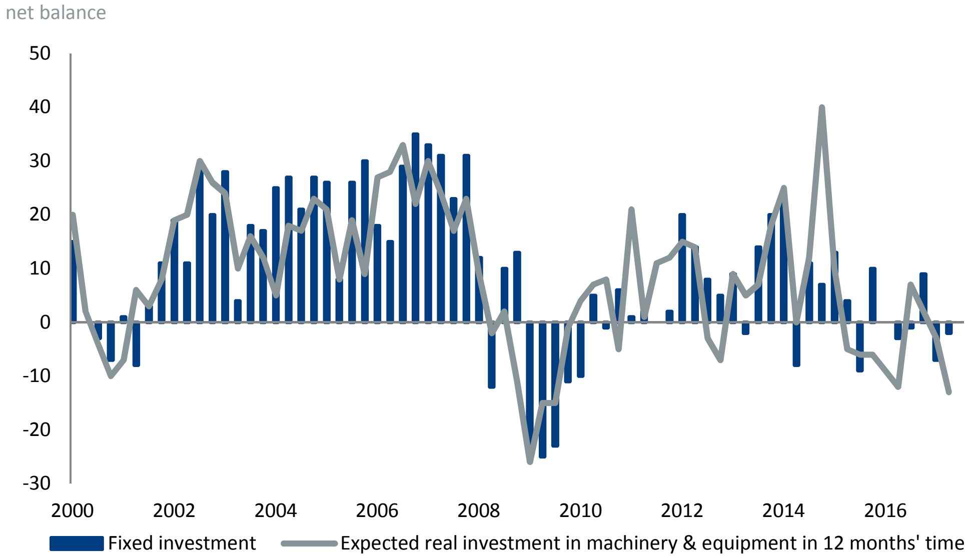
As mentioned earlier, the rate of increase in the average domestic selling price ticked up slightly in Q2. Export selling price inflation also moved higher in Q2, suggesting that the increase in costs may have been offset by higher selling prices. Nonetheless, amid significantly weaker volume growth (particularly on the domestic side), downward pressure on profitably (or at least turnover) likely remained a key factor weighing on overall business confidence.

Slack capacity weighs on investment

Another reason why confidence fell even further was the continued slack capacity within the sector. The percentage gross rating the present level of output below capacity edged up to 84% in 2017Q2, well above the long-term average reading of 71%. Again, the experience was widespread, with the percentage gross being above 90% in nine out of 16 subsectors. With slack capacity remaining high, a slight net majority of 2% reported a decline in the level of fixed investment compared to the same quarter last year. More concerning is the fact that a net majority of 13% (the biggest since 2009) expects a decline in real investment in machinery and equipment in 12 months' time. This suggests that the deterioration in the other long-term investment survey indicators observed last quarter likely persisted in Q2[4].

[4] Questions on long-term investment expectations are only surveyed in the first and third quarter of each year. In 2017Q1, the biggest net majority ever recorded (37%) reported that they expect a decline in the level of total fixed investment in 12 months' time and all of the questions on the subcomponents of investment fell deep into negative territory. These results are unpacked in detail in the 2017Q1 Absa Manufacturing Survey report, available on the BER's website.

Figure 6: Long-term fixed investment outlays scaled back further



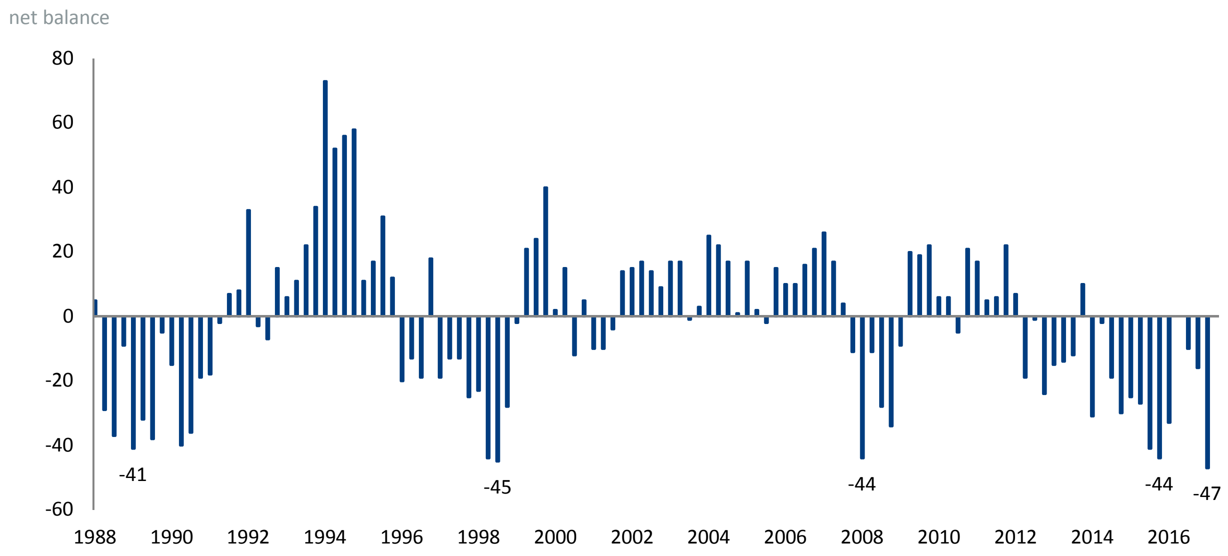
Source: BER

Outlook

The Absa Manufacturing Survey paints a subdued picture of conditions in the factory sector. Not only did business confidence slump, but activity measures also fell from the first quarter and some of the 'softer' indicators showed a marked deterioration. These include the constraint indicators, most notably the ones measuring the seriousness of the constraints posed by insufficient demand and the general political climate. Both these indicators rose to virtually record-high levels and, coupled with continued slack capacity in the sector, explain why planned fixed investment outlays remain in negative terrain.

The most concerning result of the survey, however, was that a net majority of manufacturers expects conditions to worsen further from already poor current conditions. A net majority of 47% (the biggest ever) expects a deterioration of business conditions in 12 months' time, this is not only sharply up from 16% in 2017Q1 but well above the long-term average reading of 1% - see Figure 7. While the sector may find some support from (European) export markets, and perhaps even see an uptick in domestic demand over the longer run, it is difficult to see how the sector will grow meaningfully without a sustained recovery in confidence. This would require an end to domestic political turmoil and a return of confidence-inspiring political leadership. While this is true for the overall economy, the manufacturing sector, at least over the short term, faces the additional threat of a massive strike in the steel and engineering sector with employers and the National Union of Metal Workers of South Africa (Numsa) so far not having reached an agreement on a new wage deal. The current arrangement ends at the end of June and was reached after a crippling month-long strike in 2014, which weighed heavily on the broader manufacturing sector.

Figure 7: Biggest net majority on record expects deterioration in business conditions in 12 months' time



Source: BER

Technical note

The aim of the business survey is to obtain information on economic movements before the numerical (official) data is available, by making direct contact with the entrepreneur. Short-term planning is hampered as numeric (official) data is released with a time lag. Business survey results not only reveal beforehand the direction of sales, production, employment, selling prices, etc. (for which official figures are published), but also provide **unique information**, such as business confidence, rating of business conditions and respondents' expectations for the next quarter for which no official data exist. *It is now widely recognised that these subjective individual expectations play a key role in economic developments*. Furthermore, the survey results of successive quarters provide a means of tracking cyclical movements, pinpointing trend changes and establishing forecasts. The survey technique, which the BER applies - the so-called *Konjunkturtest* - was developed during the 1950s in Germany, by the IFO Institute.

The survey results are obtained from questionnaires completed by senior executives in the trade, manufacturing and building sectors during the final month of every quarter. The business survey questionnaire contains a number of questions. These questions are of a qualitative nature, e.g. "Compared to the same quarter a year ago, are the volume of sales up the same or down?" No hard statistics are requested. The sample of executives remains the same from the one survey to the next. A panel is effectively established. The sample is divided according to main sectoral categories. Each firm receives a weighting in relation to turnover or size of workforce to provide for widely differing company sizes. Participants have to complete a "participant details form" every few years to ensure that they are correctly classified and to provide for changes in size. The list of participants is also reviewed regularly to ensure an appropriate representation of the universe.

The survey results reflect trends and not actual measured amounts. The respondents indicate "up", "same" or "down" when comparing a current activity with that of a corresponding quarter of a year ago. These responses are quantified by converting them into percentages and portraying them as **net balances**, *i.e. the difference between percentages "up" and percentages "down".* In this manner, the net balances vary from -100 to 100, where:

- -100 = the most negative response;
- 0 = a situation of no change; and
- 100 = the most positive response.

Thus, a net balance above 0 indicates that more respondents assessed an "up" than a "down", in other words an *improvement* from the situation during the corresponding quarter a year ago. A net balance below 0 registers a majority of "down" responses, in other words a *deterioration* from the situation during the corresponding quarter a year ago.

The net balance statistic is therefore a qualitative yardstick of the pace of business conditions and could be compared to year-on-year growth rates in actual volumes. A positive net balance implies positive year-on-year growth and *vice versa*. The higher the value of the net balance (positive/negative), the more dispersed the improvement/deterioration is in the aggregate sector.

All the indices, except those depicting *business confidence* and *constraints*, vary from -100 to 100. The **business confidence indices** vary between 0 and 100. These are measured in gross percentage terms. Respondents are asked to rate current business conditions as "satisfactory" or "unsatisfactory". The business confidence index is derived as the gross percentage of the respondents responding "satisfactory". The business confidence index should therefore be interpreted in the same manner as all the other indices, i.e. a value of 50 is indicative of neutrality, 100 indicates extreme confidence and 0 indicates extreme lack of confidence.

Constraint indices are calculated as: the answer of respondents rating a particular constraint as "serious" is weighted by 0,67%; those rating it as "slightly" by 0,33% and those rating it as "not a constraint at all" is discarded. The results are then multiplied by 100/67 = 1,49 to convert it to an index that can vary between 0 and 100.