Parliamentary Budget Office

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Quarterly Economic Brief

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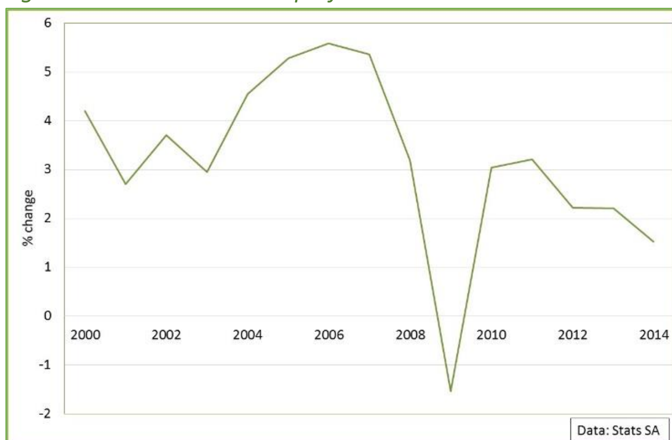
Growth

The year 2014 saw South Africa grow at its slowest rate since 2009, growing by a modest 1.52 per cent. Key domestic contributors to the poor performance included slowing domestic expenditure and industrial action in mining and manufacturing. The country's economic performance occurred against a backdrop of a hesitant global recovery. Advanced economies grew by 1.9 per cent, Sub-Saharan Africa by 4.9 per cent, and emerging and developing economies by 4.6 per cent.

Figure 1: Annual economic performance



Mining contracted by 1.6 per cent in 2014, subtracting 0.1 per cent from GDP growth for the year. This is largely a result of the five month strike in the platinum sector. Over the year, production in gold, diamonds, copper, coal and platinum decreased.

A key contributor to slow growth over the year was the electricity, gas and water sector. The sector contracted for the third year in a row, by 0.9 per cent. The actual volume of electricity available for consumption in South Africa contracted by 0.7 per cent compared to 2013. Total electricity available for consumption in South Africa (231 GWH) was 4 per cent lower in 2014 than it was in 2007, indicating the country's worsening availability of supply.

Gross domestic expenditure – total expenditure on final goods and services within the country – grew by a mere 0.4 per cent. Expenditure on capital stock (gross fixed capital formation) contracted by 0.4 per cent during the year, driven by a contraction in private sector investment (3.5%) and slower investment by general government.

For the year 2014, strong growth was experienced in the agricultural sector, which grew 5.6 per cent, its highest level since 2009. The main contributor to this was the record maize harvest, the highest yield since 1981 (14.3 million tonnes).

First quarter

During the first quarter of 2015 the economy grew by 1.3 per cent compared to the previous quarter.[1] This was poorer than the 4.1 per cent achieved in the previous quarter, and lower than expected (Reuters Econometer median: 1.6%). The lacklustre performance was driven by contractions in the agriculture and manufacturing sectors. Compared to the first quarter of 2014, the economy grew by 2.1 per cent.

Figure 2: Quarterly economic performance

The agriculture sector contracted significantly by 16.5 per cent in the first quarter of 2015 compared to the previous quarter. This was in-part due to base effects – 2014 record maize production. On a year-on-year basis, the sector grew by 6.21 per cent. Contracting output of 2.4 per cent was experienced in the manufacturing sector.

The mining sector grew by 10.2 per cent in the first quarter of 2015 compared to the last quarter of 2014, with higher coal and metal ores output (including platinum).

The construction sector grew by 0.8 per cent - its slowest rate in 18 months, reflecting slower capital investment on the part of the private sector and general government.

Government's contribution to the economy contracted by 0.8 per cent in the first quarter compared to the previous, the first contraction in 11 years. This reflects the effects of slowing government expenditure as government attempts to reduce the budget deficit. Many analysts have noted the potentially dampening effects on the economy of slowing public expenditure.

Employment

The Quarterly Labour Force Survey (QLFS) for the first quarter estimates the official employment rate at 26.4 per cent, the highest level since 2004. It increased from 24.3 per cent estimated for the previous quarter. The broad – or expanded – unemployment rate, which includes discouraged job-seekers, is estimated at 37.8 per cent, 1.6 per cent higher than the previous quarter.

Table 1: Key labour statistics[2]

	4Q 2014	1Q 2015*	Change
Labour force ('000s)	**20228**	**20994**	**3.8%**
Employed	15320	15459	0.9%
Unemployed - official	4909	5535	12.8%
Unemployed - broad**	7312	7932	8.5%
Not economically active ('000s)	**15415**	**14805**	**-4.0%**
Discouraged job-seekers	2403	2397	-0.2%
Other (not economically active)	13012	12408	-4.6%
Rates			
Official unemployment rate (narrow)	24.3%	26.4%	2.1%
Broad unemployment rate**	36.1%	37.8%	1.6%

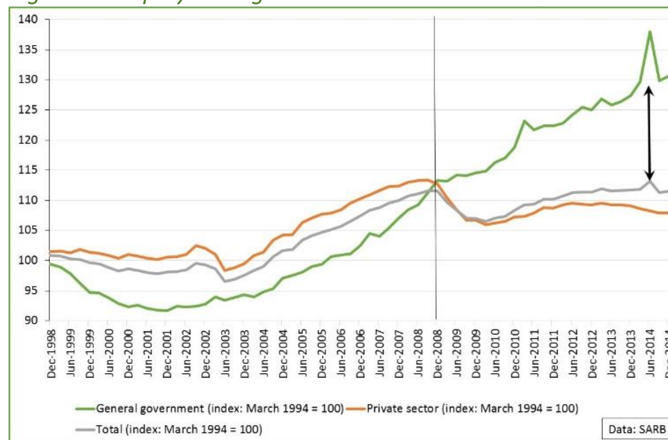
*From Stats SA new Master Sample based on Census 2011 data
**The broad unemployment rate includes discouraged job seekers
Data: Quarterly Labour Force Survey, Stats SA

The QLFS also shows faster growth in informal sector employment. Informal sector employment grew by 5.8 per cent in the first quarter, compared to formal sector employment which contracted by 1.1 per cent. Compared to the first quarter of 2014, informal sector employment grew by 9 per cent, while formal sector employment remained flat.

The QLFS category "Community, Social and Personal Services" is predominantly comprised of general government employment. This category is therefore a good indicator of general government employment. It decreased by 1.5 per cent compared to the last quarter, and by 2.3 per cent compared to the first quarter of 2014. The Quarterly Employment Survey – which provides a more accurate estimate of government employment also indicates slowing government employment. This may reflect the effect of government policy of freezing non-essential vacant posts.

Figure 3 shows the growth in general government employment compared to the private sector. After 2008, a counter-cyclical approach was adopted in response to weak economic growth. This led to a substantial increase in the size of the public service relative to shrinking private sector employment. The growth in government employment has had a significant impact on the unemployment rate, and is likely to have supported economic growth in the short-run by increasing household incomes and consumption. The current slowing government employment is therefore likely to place pressure on unemployment levels if the private sector isn't able to generate more employment.

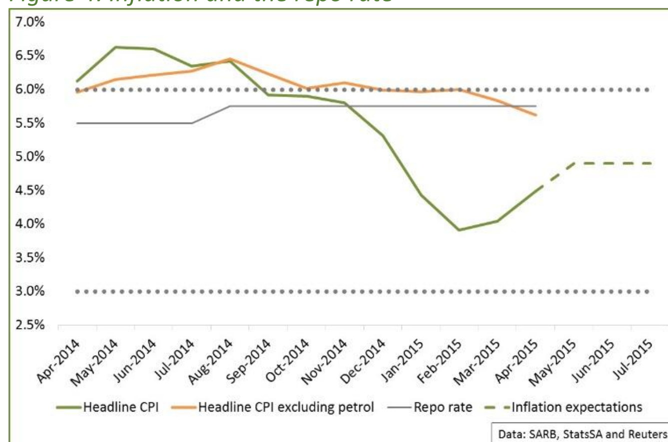
Figure 3: Employment growth



Inflation

After breaching the 6 per cent upper-end of the target range from March to August last year, headline inflation – as measured by the consumer price index (CPI) for all urban areas – slowed to a low of 3.9 per cent in February. This downward trend is mainly attributable to the significant decline in oil prices since mid-2014. As oil-prices increased, inflation began increasing from March this year to a rate of 4.5 per cent by April. Higher inflation in April was also due to the R1.62 increase in the petrol price, which included higher fuel and Road Accident Fund levies. When petrol is excluded from headline CPI, inflation remains close to the upper-end of the target range.

Figure 4: Inflation and the repo rate



In the context of lower headline inflation, the South African Reserve Bank's Monetary Policy Committee (MPC) kept the repo rate fixed at all three meetings this year at 5.75 per cent (the prime lending rate is 9.25%). However the SARB has noted several risks that could increase inflation in the future. These include the Rand's weakness and further depreciation when US rates increase, and possibly higher increases in food prices and

electricity tariffs. The SARB expects inflation to breach the upper-end of the target in the first quarter of 2016.

Outlook

Since the tabling of the 2015 Budget, where National Treasury forecasted growth of 2.0 per cent for 2015, most analysts have reduced their forecasts slightly to around 2.0 per cent. Following first quarter growth that fell short of expectations, the performance for the remaining three quarters depends on a range of domestic and international factors. The SARB's most recent leading indicator of economic activity suggests that growth will be weak over the next few months.

Table 2: Change in SA growth outlook

GDP Growth Outlook	2015	2016	2017
National Treasury Budget Review 2015	2.0%	2.4%	-
IMF World Economic Outlook - January 2015	2.1%	2.5%	-
IMF World Economic Outlook - April 2015	2.0%	2.1%	2.4%
South African Reserve Bank - January 2015	2.2%	2.4%	-
South African Reserve Bank - May 2015	2.1%	2.2%	2.7%
Reuters median forecast - February 2015	2.2%	2.5%	-
Reuters median forecast - May 2015	2.0%	2.4%	2.6%
Bureau of Economic Research - February 2015	1.9%	2.4%	-
Bureau of Economic Research - May 2015	1.7%	2.1%	2.6%

Domestically, slowing government expenditure will place pressure on the economy, both in terms of growth and employment. Electricity supply continues to present a constraint to growth. The effects of the recent increase in load-shedding on economic activity will become apparent in second quarter data (to be released in August). The recent public sector wage deal is likely to ease the concerns of credit ratings agencies over South Africa's ability to meet its budget deficit targets.

Internationally, increases in the oil price from its recent range of US$60-70 per barrel, will place upward pressure on the exchange rate. Similarly, the US economy's recovery will prompt its Federal Reserve to raise its target lending rate, resulting in lower demand for South African assets. As Europe and China are South Africa's key trading partners, slower growth in these regions will affect demand for South African exports and commodity prices.

Feature: *The Fed and the Rand*

In response to the global financial crisis in 2008, the US Federal Reserve (the Fed) attempted to stimulate the US economy by significantly reducing the rate at which financial institutions lend to each other – by lowering the fed funds rate. As the fed funds rate is affected by the rate at which the Fed lends to financial institutions – known as the discount rate – the Federal Open Market Committee (FOMC) lowered the discount rate. The Fed also injected funds into the economy through buying bonds from creditworthy institutions. The fed funds rate is currently between 0 - 0.25 per cent – its lowest level since the 1950s – down from 5.25 per cent in 2007.

Attempting to stimulate the economy by targeting a fed funds rate – the target policy rate – has limitations when the rates approach zero. This is known as a liquidity trap. This limitation, along with the nature and severity of the global financial crisis, meant that the Fed was forced to pursue unconventional stimulatory methods, such as quantitative easing (QE). QE entails the central bank buying a range of assets from various domestic markets over time to inject cash into the economy.

In the middle of 2013, the Fed announced that it would begin to reduce its QE – known as tapering. The tapering was conditional on an improvement in the US economy, signalled by positive economic data. It is for this reason that the focus of the FOMC, in recent years, has been on the level of economic growth and employment in the US economy. Under normal circumstances, an increase in economic activity leads to an expectation of higher inflation. This would prompt the Fed to raise its fed funds target rate to keep inflation near its 2 per cent target– as there is a lag from a change in the fed funds rate to its effect on prices. Concerns around future inflation, as well the desire to limit the problems associated with a near-zero fed funds rate, led to the expectation that an end to QE would be soon followed by an increase in the fed funds target rate. This has led to much speculation around the timing of the increase.

The FOMC began tapering as economic data improved. More recently, the FOMC has signalled that it intends to raise the fed funds target rate in the near future. The general idea appears to be to increase the rate to a "normal" level in what is described by commentators as a move towards the "normalisation" of monetary policy. What the "new normal" is after the global financial crisis is, however, a matter of much contestation.

The impact on emerging markets

Under normal circumstances, a change in the fed funds rate would affect global financial markets. However, after almost six years of QE the effect is even larger. Through QE the Fed added more than US$3.5 trillion worth of assets to its balance sheet resulting in vast amounts of cheap money flowing from US investors into foreign markets in search of higher returns.

An increase in the fed funds rate is widely expected to result in the substantial sell-off of relatively riskier emerging market assets in favour of less risky US assets. This would be likely to occur for two main reasons.

Firstly, an increase in the fed funds rate signals an expectation of stronger future growth in the US economy. This increases the expected future returns of income producing assets including stocks and property. The lower risk profile and higher anticipated returns of US assets relative to emerging market assets, is likely to result in funds flowing back to the US with asset prices rising.

Secondly, an increase in the fed funds rate affects the returns offered on short-term US government debt – debt repayable in less than a year. As was the case above, funds are likely to flow into these assets leading to an increase in prices.

In either case, the timing of the reallocation of funds to the US can be critical in maximising investor returns. An investor who invests too early would likely miss out on the higher returns offered in emerging markets while they wait for the fed to raise the target rate. An investor who invests too late could miss out on the increase in the prices of US assets. Correctly interpreting the signals from FOMC meetings is potentially lucrative for an investor. Hence the significant media attention devoted to

The US Federal Reserve Bank and stimulus

The US Federal Reserve (the Fed) requires highly creditworthy institutions to keep a fraction (+/- 10%) of their deposits with the Fed– known as the reserve requirement. The reserve requirement is necessary to ensure that at least some funds remain uninvested should a significant portion of depositors choose to withdraw their funds at the same time. In the case of commercial banks, they then typically invest the remaining funds in projects or assets.

The day-to-day operations of commercial banks often lead to cash shortfalls or surpluses – known as liquidity imbalances. Faced with a liquidity imbalance, banks can borrow or lend to either the Fed or other financial institutions. Commercial banks are able to borrow funds from the Fed in a temporary arrangement involving the exchange of some of the bank's assets for part of the Fed's cash reserves. The discount rate is the rate at which the Fed lends cash reserves to banks. Surplus funds accumulated by banks may be deposited with the Fed, however, they earn no interest which makes this an unfavourable option.

A more common method of resolving liquidity imbalances is to borrow and lend funds from other commercial banks. The fed funds rate is the rate at which highly creditworthy institutions borrow and lend money between each other. It can be viewed as the base rate that determines all other interest rates in the in US economy.

As the sole producer of US dollars, the Fed provides guidance to markets as to the cost of borrowing and lending the currency. The discount rate, therefore, informs the level of the fed funds rate. In the last 25 years, the fed funds rate has been about 0.5-1% higher than the discount rate.

The Federal Open Market Committee (FOMC) attempts to manage the level of employment and prices in the economy as well ensure moderate interest rates in the long-term. Traditionally, the FOMC attempts to achieve these objectives by targeting a specific fed funds rate through the setting of the discount rate and the injection or withdrawal of reserves from creditworthy institutions. For example, if the FOMC wanted to boost the US economy, it would target a lower fed funds rate. To achieve this, the committee could lower the discount rate and buy government bonds from creditworthy institutions – an injection of funds into the economy.

A lower fed funds rate is, however, problematic for a number of reasons, including: 1) it may disincentive saving as the returns earned are reduced 2) it may fuel asset bubbles – asset prices in select markets are inflated when cheap money is borrowed and invested in search of better returns 3) it could lessen the need for commercial banks to extend relatively riskier loans to job-creating businesses – since risk-free returns can be made by borrowing at low interest rates and investing in risk free assets like government bonds.

interpreting FOMC statements. However, for many emerging market currencies, the speculation leads to extreme volatility.

The implications for South Africa

The unconventional monetary policies pursued by developed economies since 2008 have generally been positive for emerging market asset prices and currencies. Many South African households have become wealthier as a result of the inflow of investment from abroad.

The reversal of those policies and the pending increase in the Fed's target rate could, however, reverse some of these gains.

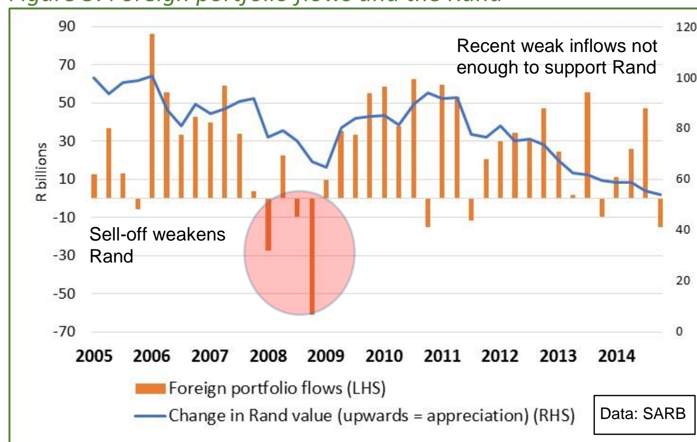
But, perhaps most harmful to South Africa in the short-term is the volatility in its financial markets leading up to the announcement of the rate increase by the FOMC. The value of the South African Rand is especially affected by investor speculation.

The Rand is one of the most highly traded currencies in the world as it is viewed by foreign investors as a good substitute for holding emerging market currencies. Moreover, South Africa's financial markets are well regulated, highly liquid and offer foreign investors a range of quality assets with exposure to other African markets. The latest estimate shows that about US$60 billion worth of Rands are traded daily in global foreign exchange markets.

The global appeal of the currency means that its value is largely determined by the buying and selling behaviour of foreigners of Rand based assets – such as South African shares and bonds – as well as any trading in the currency outside of South Africa's borders.[3]

Figure 5 shows how foreign buying and selling of domestic assets influences the value of the Rand.[4]

Figure 5: Foreign portfolio flows and the Rand



1 Quarter-on-quarter figures are seasonally adjusted and annualised.

2 Stats SA began using a new master sample since the first quarter survey. Based on the 2011 Census data, the new master sample is intended to provide a more accurate picture of the labour force.

3 The latest survey from The Bank for International Settlements (BIS) shows that about 55% of all the daily trade in the Rand takes place outside of South Africa's borders.

4 The value of the Rand relative to the US dollar is often used to represent the demand in the currency. This is because about 85% of all trade in the Rand is done in exchange for US dollars.