Parliamentary Budget Office

PARLIAMENT OF THE REPUBLIC OF SOUTH AFRICA

Quarterly Economic Brief

March 2017

Contents

The Parliamentary Budget Office (PBO) has been established in terms of the Money Bills Amendment Procedure and Related Matters Act (Act no. 9 of 2009). The PBO provides independent, objective and professional advice and analysis to Parliament on matters related to the budget and other money Bills. The PBO supports the implementation of the Act by undertaking research and analysis for the finance and appropriations committees. The PBO provides quarterly analysis of economic development for Members of Parliament following the release of quarterly economic data by Stats SA and the South African Reserve Bank.

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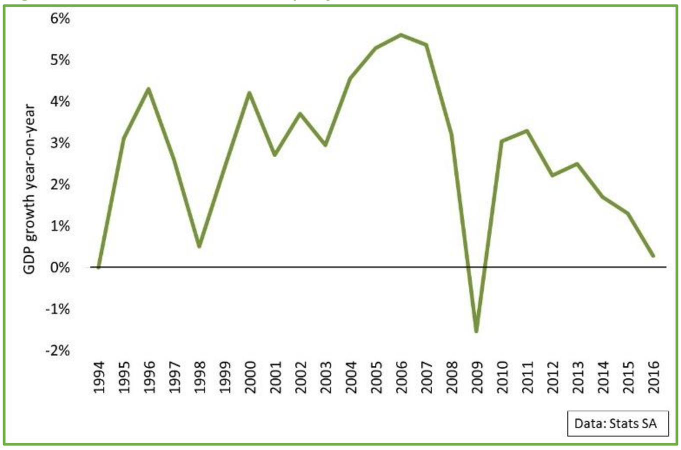
This report incorporates data available up to and including the 4th April 2016.

Gross domestic product

Statistics South Africa's GDP data released in March showed that the South African economy grew by a modest 0.3 per cent in 2016, its slowest growth rate since 2009 when the economy contracted due the effects of the global financial crisis. South Africa's poor growth mirrors that of the global economy, which also experienced its slowest growth (2.2%) since 2009. Poor domestic growth was driven by contractions in the agriculture, mining and utilities sectors, and modest growth in the manufacturing, logistics and construction sectors.

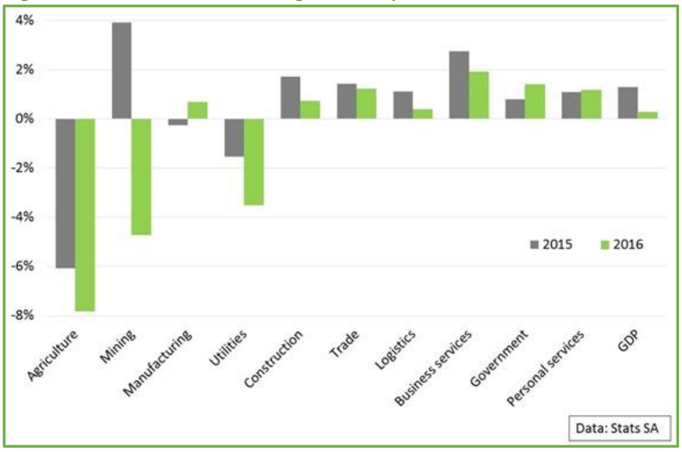
The agriculture sector, experiencing the effects of the country-wide drought, contracted by a significant 7.8 per cent over the year. This contraction subtracted 0.2 percentage points from the year's growth. This follows the 6.1 per cent contraction recorded for 2015. Summer rains have provided some relief, and initial estimates from the Crop Estimate Committee of the Department of Agriculture Forestry and Fisheries, indicate that maize production for 2017 will be strong, suggesting a recovery in the sector.

Figure 1: Annual economic performance



Despite higher overall commodity prices, the mining sector contracted by 4.7 per cent in 2016. This contraction subtracted 0.4 percentage points from annual growth. The poor performance was due to lower output across all mineral groups. The sector has contracted over seven of the last ten years. Its contribution to GDP has fallen from about 15 per cent in 1994 to less than 8 per cent today.

Figure 2: Annual economic growth by sector



The manufacturing sector recorded positive growth of 0.7 per cent for the year, reversing the losses from the 0.2 per cent contraction of 2015. The modest growth contributed 0.1 percentage points to annual GDP growth. The improved performance was in part due to the increase in motor vehicle production, as well as stronger export demand in the second quarter of the year.

Figure 3: Sector contribution to annual growth

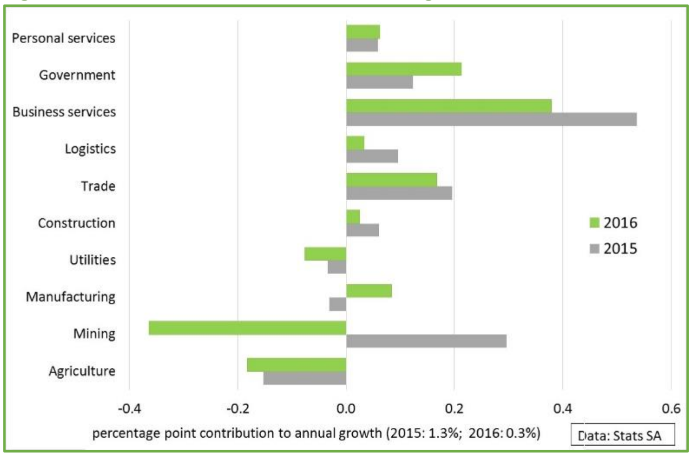
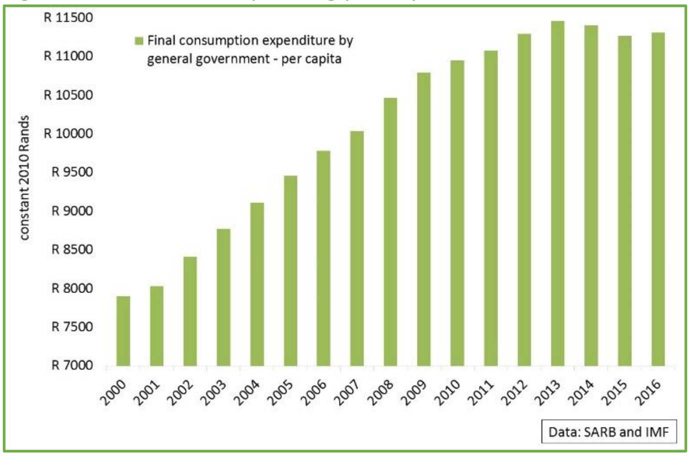


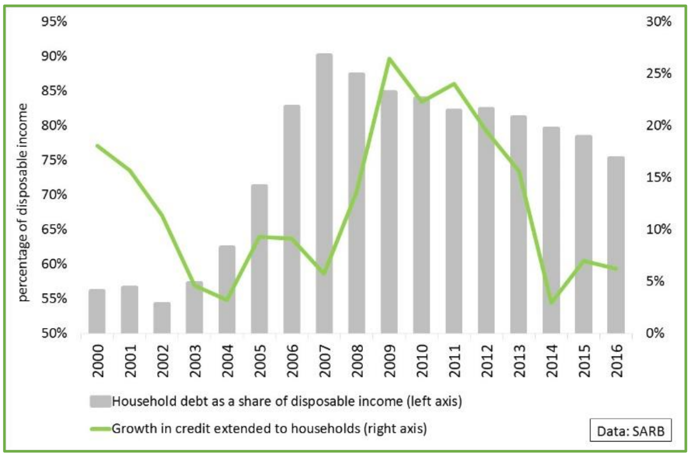
Figure 5: Government spending per capita



Gross domestic expenditure

Gross domestic expenditure contracted by 0.8 per cent in 2016, its first contraction since 2009. The contraction in domestic expenditure reflects depressed domestic demand and lower consumer confidence. Over the year, growth in household consumption slowed to 0.8 per cent from the 1.7 per cent recorded in 2015. Growth in household consumption, which comprises 60 per cent of GDP, contributed 0.5 percentage points to the 0.3 per cent GDP growth recorded for 2016. Reasons for slow household consumption growth include lower wage growth, slow employment growth, higher inflation, and the continued slowing of credit extended to households. While slowing credit extension to households has had a dampening effect on household consumption and therefore growth, it has however been a factor contributing to a decrease in overall household indebtedness.

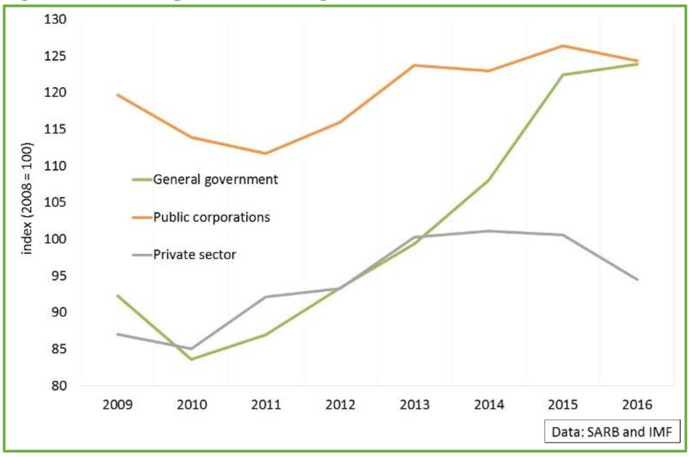
Figure 4: Decreasing household indebtedness



Growth in final government expenditure increased to 2 per cent from the 0.5 per cent recorded in 2015. Although government expenditure grew faster than the previous two years, it remains slower than it did between 2004 and 2014, where it grew by an average annual rate of 4.1 per cent. On a per capita basis, real final consumption expenditure by government increased in 2016 after decreasing over the previous two years. Additional decreases to government's spending ceiling, introduced to realise government's medium-term fiscal objectives, are likely to further reduce government's contribution to growth.

Over the year total investment in the economy (gross fixed capital formation) contracted by a significant 3.9 per cent, subtracting 0.8 per cent from annual GDP growth. While investment by general government grew by 1.4 per cent, investment by public corporations contracted by 2.1 per cent, and investment by the private sector contracted by a significant 6.1 per cent. Investment by the private sector has contracted for four consecutive years. Significant contractions in investment were recorded for mining (3.8%), manufacturing (8.4%) and logistics (5.6%). In addition to reducing the growth performance of the economy in 2016, the contraction in investment also adversely affects the country's growth potential.

Figure 6: Slowing investment growth



Over the fourth quarter of 2016 real gross domestic expenditure contracted by 1.9 per cent compared to the previous quarter. Household consumption maintained its momentum growing by 2.2 per cent over the quarter. Government consumption expenditure growth slowed to 0.4 per cent. Investment over the fourth quarter grew by 1.6 per cent, breaking the trend of four quarters of successive contractions.

Growth and revenue

Slow economic growth in 2016 contributed to slower growth in revenue for 2016/17. Preliminary outcomes of revenue collections for 2016/17, released by the South African Revenue Service, indicate a total tax revenue collection of R1 114bn. This is R8bn lower than forecast by National Treasury in the 2016

MTBPS, and R8bn higher than forecast by the Parliamentary Budget Office at the 2016 MTBPS. For a detailed assessment of the accuracy of National Treasury's revenue forecasts, see the Parliamentary Budget Office's study "Assessing the Performance of National Treasury's Tax Revenue Forecasts" (2017).

Table 1: Total tax revenue compared to forecast for 2016/17

	(R billion)	Forecast error* (R billion)	Forecast error* (percentage)
2016 MTBPS forecast			
National Treasury	1152	8	0.7%
Parliamentary Budget Office	1136	-8	-0.7%
Preliminary outcome	**1144**		

* a positive value indicates an over-estimation, a negative value indicates an under-estimation
Data: National Treasury, South African Revenue Service and Parliamentary Budget Office

Employment

The continued poor performance of the economy was reflected in rising unemployment and slow employment growth. The Quarterly Labour Force Survey (QLFS), for the fourth quarter of 2016, estimated the official rate of unemployment at 26.5 per cent - a 2 per cent increase compared to 2015. Over the four quarters, 588 000 individuals joined the ranks of the unemployed. The broad unemployment rate, which includes discouraged job-seekers, is estimated at 36.4 per cent, 1.5 per cent higher than recorded a year ago. Broadly defined, the number of people unemployed increased by about 713 000. Youth unemployment, officially defined, increased by 2.2 per cent over the year to 37.1 per cent. Broadly measured, the youth unemployment rate is 47.7 per cent.

Table 2: Key labour statistics - QLFS

	4Q 2015	3Q 2016	4Q 2016
Labour force ('000s)	**21211**	**21706**	**21849**
Employed	16018	15833	16069
Unemployed - official	5193	5873	5781
Unemployed - broad*	8187	9016	8900
Not economically active ('000s)	**15061**	**15044**	**15055**
Discouraged job-seekers	2279	2291	2292
Other (not economically active)	12782	12753	12763
Rates			
Official unemployment rate (narrow)	24.5%	27.1%	26.5%
Broad unemployment rate*	34.9%	36.3%	36.4%
Youth unemployment** (narrow)	34.9%	38.2%	37.1%
Youth unemployment** (broad*)	45.9%	48.6%	47.7%

* The broad unemployment rate includes discouraged job seekers
** Youth is defined as age 15 - 34
Data: Quarterly Labour Force Survey, Stats SA

Total employment only grew by 0.3 per cent, its slowest growth rate since 2010, based on the fourth quarter survey. Slow employment growth and job-losses, combined with lower wage settlements contributed to a shortfall in Personal Income Tax for 2016/17. Preliminary outcomes of revenue collections for 2016/17, released by the South African Revenue Service, indicate a Personal Income Tax shortfall of R16.2bn compared with the estimate provided in the 2016 Budget.

Current account

South Africa's current account deficit narrowed during the fourth quarter of 2016 to 1.7 per cent of GDP from the 3.8 per cent recorded in the third quarter. The improvement in the current account was due to higher exports, lower imports, and a lower deficit on the service, income and current-transfer account. Total exports over the quarter grew by 16 per cent on an annualised basis, corresponding to a R1.5bn increase in the rand value of exports compared to the previous quarter. The improvement was in part due to both higher export volumes, as well as higher export prices arising from stronger commodity prices. Imports decreased by 8 per cent over the quarter on an annualised basis (R8.3bn). While import volumes remain largely unchanged over the quarter reflecting low domestic growth, lower import prices – primarily due to rand strength – resulted in an overall decrease in imports.

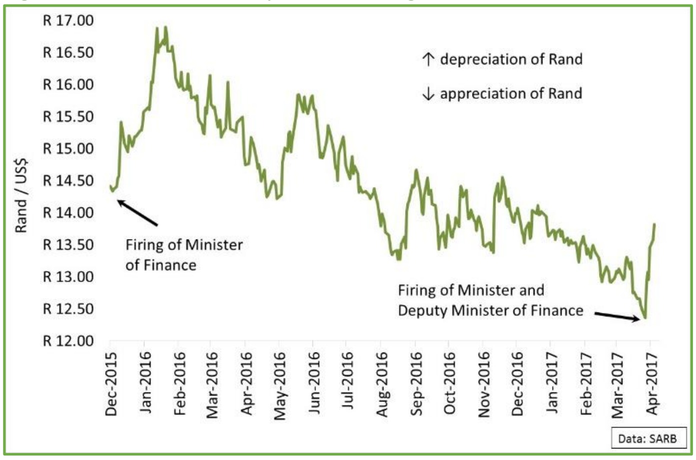
While a narrowing of the current account deficit decreases the country's dependence on foreign savings, it has direct implications for public finances. Lower import volumes combined with a relatively stronger rand (a lower rand price of imports) contributes to lower revenue collection from tariffs. Over the first nine months of the 2016/17 fiscal year, the rand value of imports grew by a mere 0.5 per cent. Preliminary outcomes of revenue collections from imports for 2016/17, released by the South African Revenue Service, indicate a shortfall of R8.3bn (15.4%) compared with the estimate provided in the 2016 Budget.

Figure 7: Current account and trade balance

Exchange rate

Exchange rate volatility remains an important concern for South Africa's economic performance. While the currencies of some emerging market economies, such as Mexico and Turkey, weakened – driven by geopolitical factors – the rand along with the currencies of other commodity exporting countries strengthened during 2016. The rand strengthened 12.9 per cent against the US dollar over 2016, from a January 2016 high of R16.90 to around R13.60 by the end of December 2016. This trend continued over the first three months of 2017, where the rand strengthened a further 10 per cent against the US dollar, reaching its strongest level since July 2015 (R/$ 12.35 – 27 March). Reasons for the strengthening of the rand include the effects of improved foreign earnings from higher commodity prices, and a marginal pickup in global demand. The gradual increase in the US Federal Reserve policy rate, and continued global liquidity from other major central banks – sustaining demand for emerging market assets – also contributed to a stronger rand.

Figure 8: Overall rand improvement against US dollar

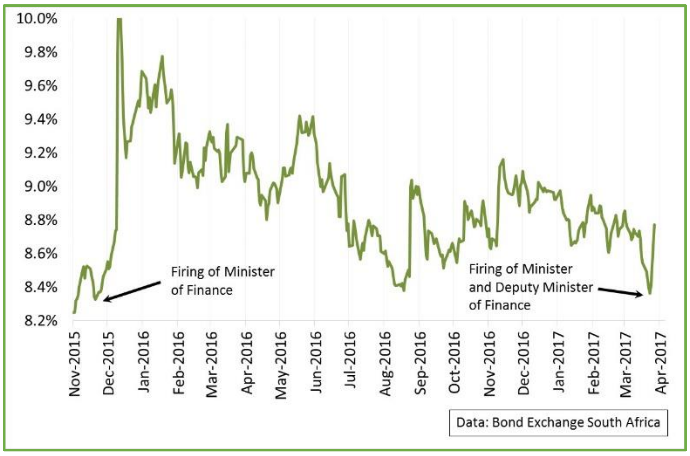


The recent gains in rand strength were reversed at the end of March 2017 when the Minster and Deputy Minister of Finance, along with several other cabinet ministers, were fired at the end of March. The Rand has since fallen over 10 per cent against the US dollar. When the Minister of Finance was fired in December 2015, the rand fell 16 per cent within a month and took a four months to recover to its previous level.

Sovereign risk

The yield on South Africa's 10 year benchmark bond – an indicator of the riskiness of South African government bonds – decreased from the January high of 9.5 per cent to a 2016 low of 8.6 by the end of December. Part of this improvement, especially over the first nine months of 2016, was due to continued investor appetite for emerging market assets supported by looser monetary policy in advanced economies. The improvement was also a result of a recovery in the country's risk outlook from investors following the loss of confidence that ensued when the Finance Minister was fired in December 2015. Bond yields, however, increased from September 2016 amidst uncertainty over the US Federal Reserve's rate hikes, uncertainty over the position of the Minister of Finance and the country's credit ratings.

Figure 9: Yield on SA 10-year bond



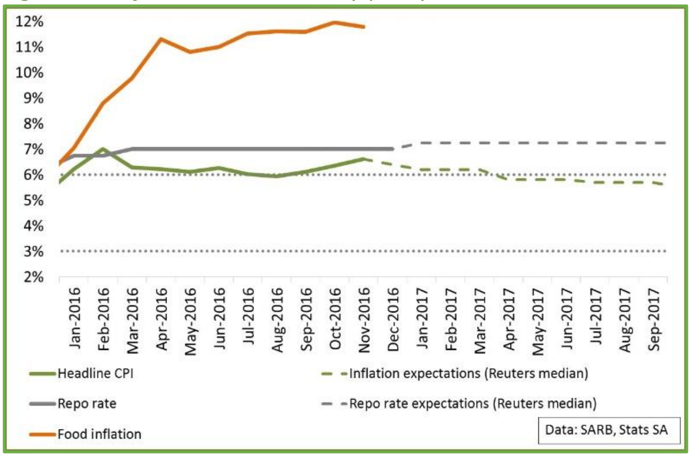
SA Bond yields responded positively to the US Federal Reserve increasing its policy rate by a modest 25 basis points in early March which suggested a less aggressive approach to policy normalisation. These gains were reversed at the end of March as bond yields increased again following the firing of the Minister and Deputy Minister of Finance. The yield on South Africa's 10 year benchmark bond reached its fell to 8.36 per cent in March - its lowest level in 16 months.. The yield on the 10-year benchmark bond increased by 41 basis points by the 4th of March. Government borrowing costs are likely to increase further amidst political instability and negative revisions to the country's credit ratings.

Further hikes by the US Federal Reserve, combined with hikes from other major central banks, such as the European Central Bank and the Bank of England, do not bode well for the Rand, decreasing liquidity and the differential between SA rates and theirs.

Inflation and monetary policy

Headline inflation – as measured by the consumer price index (CPI) for all urban areas – has remained above the South African Reserve Bank's (SARB) 3 to 6 per cent target range since December 2015, with the exception of August 2016, when it dipped to 5.9 per cent. After reaching 6.7 per cent in December 2016 (2016: 6.4%), inflation has moderated, decreasing to 6.3 per cent in February 2017. The higher inflation is in part due to high food price inflation and a higher oil price. Food price inflation, due to the effects of the drought, has averaged 11.1 per cent since the beginning of 2016. After reaching 12 per cent in December, food price inflation appears to be moderating. The Crop Estimates Committee of the Department of Agriculture, Forestry and Fisheries expects a marked increase in crop yields, which will put downward pressure on headline inflation. The SARB forecasted inflation to fall below 6 per cent in the fourth quarter of the year, slightly later than market expectations. Results from the March Reuters poll, indicated that CPI is expected to fall below 6 per cent in the second quarter of 2017.

Figure 10: Inflation and monetary policy



The Monetary Policy Committee (MPC) has kept the repo rate fixed at each of the six meetings since March 2016, when it last hiked the repo rate. Since the beginning of the current hiking cycle the Monetary Policy Committee has increased the repo rate by a cumulative 200 basis points. The MPC cited the relatively stronger rand, continued low exchange rate pass through, as well as an improved outlook for food prices in its decision not to increase the repo rate. The MPC noted that the current hiking cycle may have reached its end, however this would depend on a sustained lower-inflation environment.

Downgrade to sovereign credit rating

Following the firing of the Minister and Deputy Minister of Finance at the end of March, ratings agency Standard and Poor's (S&P) lowered its long-term foreign currency sovereign credit rating of South Africa to non-investment grade (BB+) and local currency to one-notch above sub-investment grade (BBB-). S&P noted that cabinet re-shuffle has put the country's fiscal and growth outlook at risk. S&P identified the rising risks emanating from contingent liabilities to the state, particularly in the energy sector, as part of their rationale.

Credit ratings agency Moody's announced that it had placed the country's credit ratings on review. Moody's is the only major credit ratings agency that currently rates South Africa's foreign-currency debt two notches above non-investment grade. This rating is likely to be downgraded.

Credit ratings agency Fitch noted that changes to the leadership of the Ministry of Finance, may negatively affect fiscal consolidation, transparency and management of state-owned enterprises. It also identified risks arising from contingent liabilities, particularly from the procurement of nuclear energy. Fitch noted that these developments could result in a review of the country's ratings.

Table 3: South Africa's foreign currency credit rating

Fitch	Moody's	S&P		Countries (selected)	
A+	A1	A+	Upper medium grade	Botswana	Slovakia
A	A2	A		Czech Rep.	Poland
A-	A3	A-		Japan	Malaysia
BBB+	Baa1	BBB+	Lower medium grade	Mexico	Peru
BBB	**Baa2**	BBB		Uruguay	India
BBB-	Baa3	BBB-		**South Africa**	Indonesia
BB+	Ba1	**BB+**	Non-investment grade speculative		Russia
BB	Ba2	BB		Brazil	Turkey
BB-	Ba3	BB-		Bangladesh	Ivory Coast
B+	B1	B+	Highly speculative	Angola	Kenya
B	B2	B		Cambodia	Rwanda
B-	B3	B-		Argentina	Egypt
CCC	Caa1	CCC+	Substantial risks	Mongolia	Belarus
	Caa2	CCC	Extremely speculative	Greece	Belize
	Caa3	CCC-	In default with little prospect for recovery	Venezuela	Mozambique

The precise effects of the downgrade on the economy and public finances are unknown. The rand has since weakened 7% against the US dollar, and borrowing costs have increased. GDP growth forecasts over the medium term have been revised downwards.

The effects of the downgrade on the exchange rate and government debt service costs are somewhat mitigated by government's strategy to maintain a low share of foreign-currency denominated debt in its portfolio. Less than 10 per cent of debt is foreign currency denominated. This limits the effect of a sell-off of the country's foreign-currency debt and its effect on the rand. However, as approximately 35 per cent of domestic currency debt is owned by foreigners, developments such as a downgrade to the country's local-currency rating, could trigger a sell-off of domestic-currency bonds resulting in further depreciation of the currency. Further rand weakness will be inflationary, and may cause the SARB to delay decreasing the repo rate, or even increase the repo rate should inflation increases be substantial and sustained.

Given the potential impact of the ratings downgrade on investment and consumption, through a sustained higher repo rate and reduced fiscal space due to higher debt service costs, the effects of the ratings downgrade are expected to be negative for GDP growth over the medium term. Debt that needs to be issued under the current conditions may be more expensive than budgeted for in the 2017 Budget. The rand is likely to continue depreciating against major currencies.

The majority of countries that have been downgraded to non-investment grade have not recovered. Of those that do recover, it takes an average of seven years to recover to investment grade. Of the country's that have had their credit-ratings downgraded to below investment-grade since 2000, less than a third have recovered to investment grade to date.

The MPC stressed that while the inflation outlook had improved, the heightened domestic political uncertainty presented a risk to both the exchange rate, which would affect inflation, as well as the country's growth outlook. The risk of political uncertainty materialised following the MPC statement with the firing of the Minister and Deputy Minister of Finance and the subsequent fall in the rand and increase in government borrowing costs. Decreases to the repo rate may now be delayed.

Outlook

Following the poor economic performance of the South African and global economy in 2016, growth is expected to improve over the medium term, especially in emerging market and developing economies. Higher commodity prices, a more gradual increase to the US Federal Reserve's Policy Rate, and low policy rates from other major central banks are likely to contribute to higher growth in 2017. The IMF forecasts the global economy to grow by 3.4 per cent in 2017, and by 3.6 per cent in 2018.

The 2017 Budget's central fiscal policy objective was to stabilise debt as a share of GDP over the medium term and to maintain the country's investment grade credit rating. This necessitated additional reductions to the country's expenditure ceilings, and new revenue raising measures. In the 2017 Budget, National Treasury forecast growth of 1.3 per cent for 2017 and 2 per cent for 2018, only marginally higher than the forecasts of other organisations. It was expected that the South African economy was approaching the trough of the business cycle, and would begin to recover. Factors contributing to a stronger growth outlook include higher commodity prices, the likely recovery of the agriculture sector, stronger global demand, and continued low policy rates from major central banks.

Table 4: Revised SA growth outlook

GDP growth outlook*	2017	2018	2019
National Treasury - Budget 2017	*1.3%*	*2.0%*	*2.2%*
South African Reserve Bank - March 2017	1.2%	1.7%	2.0%
Bureau of Economic Research - 1Q 2017	1.0%	1.8%	2.3%
International Monetary Fund - January 2017	0.8%	1.6%	-
World Bank - January 2017	1.1%	1.8%	1.8%
Reuters econometer (median) - March 2017	1.0%	1.7%	2.0%
RMB Global Markets Research - April 2017	0.5%	1.1%	-

*only the forecast from RMB Global Markets Research factors in the re-shuffle by the President in March, and the downgrade by S&P in April

The outlook will have to be revised following the cabinet re-shuffle at the end of March that caused a strong fall in the value of the rand, an increase in borrowing costs and a downgrade of the country's foreign currency credit ratings. When the Minister of Finance was fired in December 2015, the rand fell 16 per cent within a month and took four months to recover. Slower economic growth may result in weaker growth in revenue, which may necessitate further reductions to the country's expenditure-ceiling. Slower economic growth may also require additional revenue-raising measures for the country's fiscal objectives to be realised. This would limit the government's ability to fulfil its social and economic responsibilities.