Parliamentary Budget Office

PARLIAMENT OF THE REPUBLIC OF SOUTH AFRICA

Quarterly Economic Brief

October 2017

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This report incorporates data available up to and including the 12 October 2017, and was released on the 23 October 2017, ahead of the tabling of the 2017 Medium Term Budget Policy Statement.

Overview

South Africa emerged from a six-month technical recession in the second quarter of 2017 supported by growth in household consumption and exports. Despite these positive three-month developments, unemployment remains at a 13-year high, and investment continues to contract.

The revised outlook for the economy is poorer than was expected at the beginning of the year. Economic growth over the medium term is constrained by weak household spending, low investment and the effects of fiscal consolidation. A poorer growth outlook implies that fiscal projections presented in the Budget Review in February are unlikely to be realised.

Gross domestic product[1]

The South African economy grew by 2.5 per cent in the second quarter. Growth over the quarter was broad-based with eight of the ten sectors recording positive growth. Strong growth was recorded for the agriculture (33.6%), mining (3.9%) and utilities (8.7%) sectors. The construction and government sectors experienced contractions of 0.5 and 0.7 per cent respectively. Over the first half of 2017, the economy grew by 1.1 per cent compared to the corresponding period of 2016.

Figure 1: Economy emerges from a 6-month recession

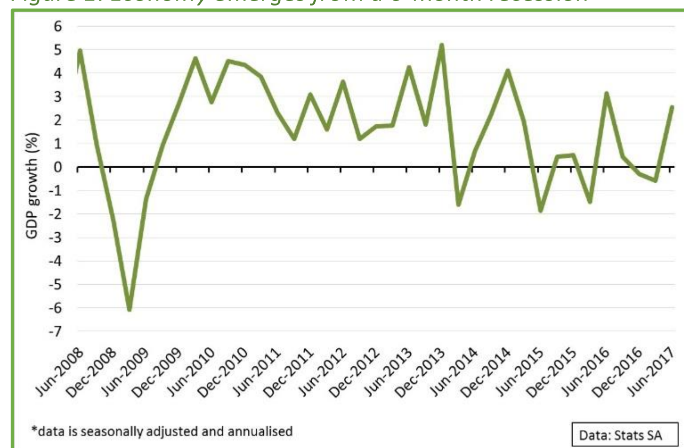


Table 1: Second quarter growth was broad based

% change q/q	Agriculture	Mining	Manufacturing	Utilities	Construction	Trade	Logistics	Business services	Government	Personal services	GDP
2Q2017	33.6	3.9	1.5	8.8	-0.5	0.6	2.2	2.5	-0.6	1.1	2.5
1Q2017	23.1	13.1	-3.7	-4.8	-0.8	-5.9	-1.6	-1.2	-0.7	-0.1	-0.6
4Q2016	-0.1	-11.5	-3.1	2.4	0.4	2.1	2.6	1.6	0.9	1.0	-0.3
3Q2016	-0.2	4.2	-3.3	-2.5	0.7	-2.0	1.7	1.3	2.0	1.4	0.4

Data: Stats SA

The agriculture sector recorded its second successive quarter of growth, following eight successive quarters of contracting output due to the effects of the countrywide drought. The sector grew by 33.6 per cent over the quarter, contributing 0.8 percentage points to the quarter's overall GDP growth of 2.5 per cent.

The strong performance resulted from favourable weather conditions since the beginning of the year, which have resulted in significantly improved field crop production.

[1] All expenditure/growth data is seasonally adjusted and annualised unless otherwise stated

The mining sector grew by 3.9 per cent, its second successive quarter of positive growth. The sector has been supported by improved commodity prices and higher output. Growth in the mining sector contributed 0.3 percentage points to the quarter's growth. Over the first half of the year, the mining sector grew by 5.3 per cent.

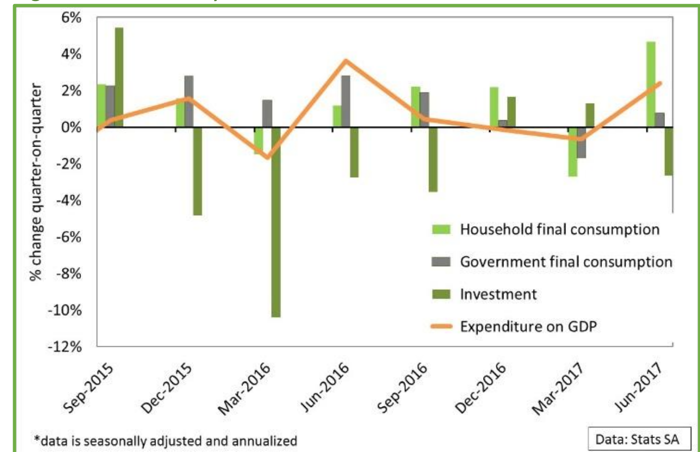
Expenditure on GDP

Measured from the expenditure side, the economy grew by 2.5 per cent in the second quarter of 2017 compared to the previous quarter. This follows two consecutive quarters of contracting growth. The improved performance over the quarter was due to increased household consumption, a modest increase in government consumption, and growth in exports.

Over the quarter household consumption grew by 4.7 per cent – its strongest quarterly growth in 5 years. This was in part due to base-effects following the large contraction in household consumption in the first quarter of 2017, and an increase in remuneration levels. The growth in household consumption contributed 2.8 percentage points to the quarter's growth. Over the first half of 2017 household consumption grew by only 1.1 per cent.

Government consumption expenditure grew modestly over the second quarter, by 0.8 per cent, contributing 0.2 percentage points to the quarter's growth. Government consumption expenditure over the first half of the year has contracted slightly compared to the corresponding period of 2016 despite this modest growth in the second quarter. This contraction, in part, reflects the government's efforts to reduce the primary deficit, and stabilise debt as a share of GDP over the medium term through reducing growth in the wage-bill and expenditure on goods and services.

Figure 2: Growth by sector



Over the quarter, total investment (gross fixed capital formation) in the economy contracted by 2.6 per cent. The contraction in investment subtracted 0.5 percentage points

Household consumption, debt and growth

The growth in household consumption expenditure of 4.7 per cent over the second quarter supported the quarter's overall performance, contributing 2.8 percentage points to the quarter's 2.5 per cent GDP growth. The growth in real disposable income of households, rebounded from a 2.1 percent contraction in the first quarter to 4.5 per cent in the second quarter. As disposable income increased faster than debt, household debt declined as a share of disposable income from 73 per cent in the first quarter to 72.6 per cent in the second quarter. However, the cost of servicing debt as a share of disposable income remained unchanged at 9.4 per cent. While the growth in both household consumption and GDP over the quarter is a positive development for the economy, the outlook for household consumption remains precarious.

Household consumption expenditure accounts for more than half of GDP in South Africa (approximately 60 per cent). Therefore, it is important to take account of the factors affecting household consumption. Household debt, in particular, significantly influences levels of household consumption and economic growth over the medium term.

South African households increased their level of leverage (debt stock level relative to assets) significantly during the period before the 2008 global financial crisis. That large increase in household debt could potentially affect the country's growth. Household consumption is affected by households' level of indebtedness, and the share of household income spent servicing debt. We expect that households paying off large debts accumulated before the 2008 global financial crisis would spend a greater portion of their income paying off debt, thereby reducing their consumption. This debt servicing may reduce the growth in household consumption and its contribution to GDP. Reduced household aggregate demand is usually associated with reduced output from business that may slow down investment and employment.

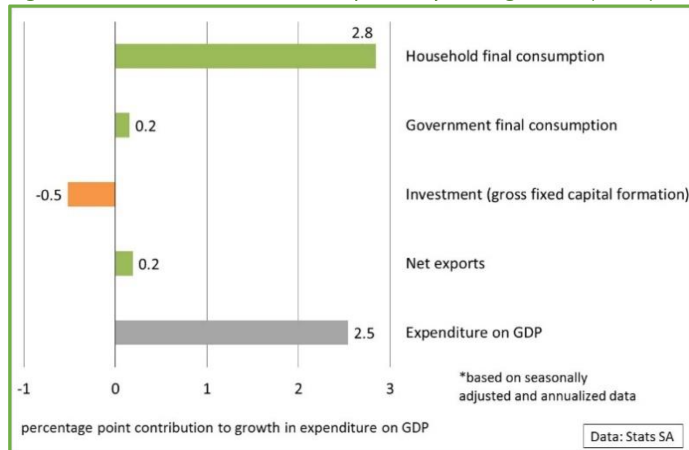
Prior to the 2008 global financial crisis and the subsequent slowdown in economic growth, South Africa recorded its fastest growth rates since the 1960s, with real GDP growth averaging 4.6 per cent a year between 2004 and 2008. Globally this period was characterised by bubbles in real estate and financial markets and booming commodities markets. Domestically debt to disposable income grew rapidly. This ratio grew from 0.54 in 2002 to 0.87 in 2008. Over the same period, consumption expenditure exceeded disposable income. Easy access to credit for households contributed to credit-fuelled consumption and large increases in household debt.

Increased debt-driven household consumption affected the allocation of finance and associated investment decisions in the South African economy. As a consequence, the bulk of capital stock growth (excluding general government services) from 2002 to 2008 occurred in the business services, transport and storage services, finance and insurance services and wholesale and retail trade services. These four services subsectors accounted for approximately 75 per cent of the change in capital stock for all economic subsectors from 2002 to 2008 when we exclude the change in capital stock of general government services. In other words, the bulk of capital stock formation by far occurred in services sectors associated with growth in consumption and financial activities not productive services and manufacturing.

Tightening credit conditions following the 2008 financial crisis contributed to the slowdown in economic growth and investment. Household consumption expenditure as a percentage of GDP was 61 per cent in 2007 and dropped 2 per cent of GDP to 59 per cent in 2010. South African households continue to slowly deleverage almost a decade after the initial impact of the global recession. The recent cost of deleveraging has been lower consumption expenditure and aggregate demand.

from the quarter's economic growth. Over the quarter, public corporation investment, which comprises about 20 per cent of total investment, contracted by 2.7 per cent - its third consecutive contraction. Investment by government grew by 4.4 per cent, and private corporations by 1.2 per cent – its first expansion in 15 months

Figure 3: Sector contribution to quarterly GDP growth (2.4%)



Exports and imports recorded positive growth over the quarter. Exports reached an 18-month high, growing by 14.4 per cent, whilst imports grew by 13.3 per cent. Net exports contributed 0.2 percentage points to the quarter's overall growth.

Employment

The official unemployment rate remained at a 13-year high in the second quarter. The Quarterly Labour Force Survey (QLFS), which measures both formal and informal employment, estimated the official unemployment rate for the first quarter at 27.7 per cent - an increase of 1.1 percentage points from the first quarter of 2016. The labour force grew by 5.2 per cent (1 097 573) over the year, exceeding the growth in the number of people employed (3.6 per cent – 543 313), resulting in an increase in the unemployment rate.

Table 2: Key labour statistics – Quarterly Labour Force Survey

	2Q 2016	1Q 2017	2Q 2017
Labour force ('000s)	**21 179**	**22 426**	**22 277**
Employed	15 545	16 212	16 100
Unemployed - official	5 634	6 214	6 177
Unemployed - broad*	8 880	9 291	9 304
Not economically active ('000s)	**15 412**	**14 634**	**14 941**
Discouraged job-seekers	2 526	2 277	2 361
Other (not economically active)	12 886	12 357	12 580
Rates			
Official unemployment rate (narrow)	26.6%	27.7%	27.7%
Broad unemployment rate*	36.4%	36.4%	36.6%
Youth unemployment** (narrow)	37.5%	38.6%	39.2%
Youth unemployment** (broad*)	48.8%	48.8%	49.5%

* The broad unemployment rate includes discouraged job seekers

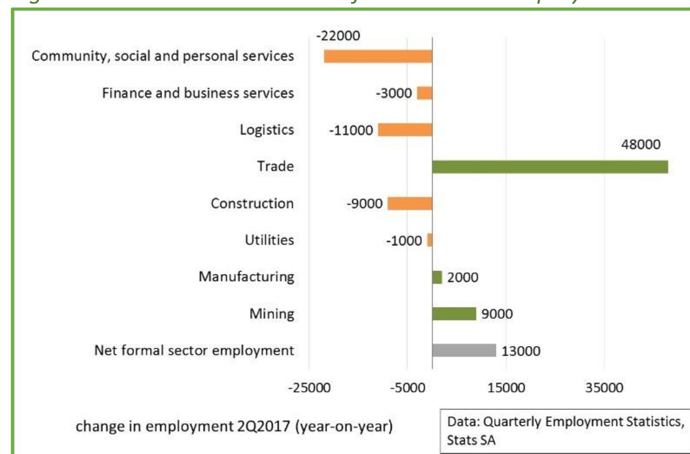
** Youth is defined as age 15 - 34

Data: Quarterly Labour Force Survey, Stats SA

The broad unemployment rate, which includes discouraged job-seekers, increased by 0.2 per cent over the last 12 months to 36.4 per cent. Broadly defined, the number of people employed increased by about 424 000

Youth unemployment reached an all-time high in the second quarter. Youth unemployment, officially defined, increased by 1.7 per cent over the year to 39.2 per cent. Broadly measured, the youth unemployment rate is 49.5 per cent.

Figure 4: Varied contribution to formal sector employment



According to the Quarterly Employment Survey – which surveys formal-sector firms and is therefore a more accurate reflection of formal sector employment than the QLFS – the economy added 13 000 net formal non-agricultural jobs over the year.

Five of the eight sectors experienced job losses over the 12-month period. These included community, social and personal service (22 000), logistics (11 000) and construction (9000). The significant reduction in employment in the community, social and personal services sector, which is primarily comprised of the public sector, is in part due to government's efforts to slow down growth in the public sector wage bill by freezing posts.

Current account

South Africa's current account deficit increased slightly during the second quarter of 2017 to 2.4 per cent of GDP (R110.5 bn on a seasonally adjusted and annualised basis) from the 2 per cent recorded in the first quarter of 2017.

Figure 5: Current account and trade balance

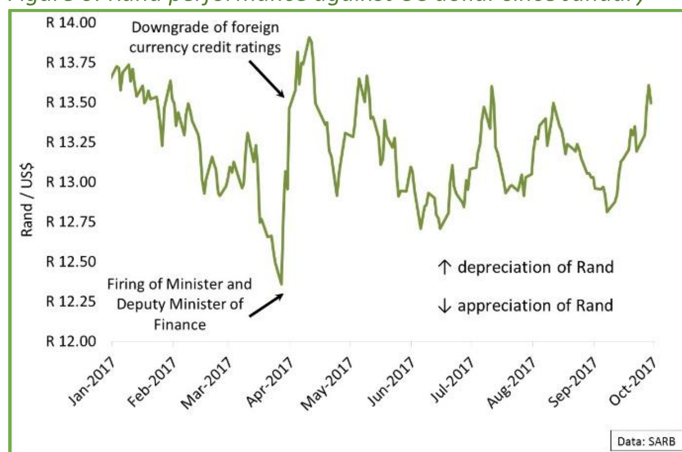
The increase in the current account deficit was due to a larger shortfall on the service, income and current transfer account, which increased from R149 bn to R175 bn. The trade balance remained in surplus for the third consecutive quarter (R65bn – 1.4 % of GDP), slightly larger than the previous quarter (1.3%), as the increase in exports (R52.1 bn) compensated for the increase in imports (R44.9 bn). In other words, the country had

a net trade surplus but outward financial transfers caused a current account deficit The larger current account deficit means that South Africa remains dependent on capital inflows from the rest of the world.

Exchange rate

The rand's performance has varied since the beginning of the year. After strengthening 10 per cent against the US dollar between January and March, the rand lost 13 per cent in two weeks following the cabinet reshuffle and the ensuing downgrade of the country's foreign-currency credit ratings. The rand subsequently recovered over the following three months, supported by stronger commodity prices, sustained demand for emerging market assets due to continued liquidity, stronger global growth, and an improvement in exports. Over the last three months the rand has been trading in a narrow band due to reduced global volatility and limited liquidity, amidst concerns over the winding down of the accommodative monetary policies of advanced economies.

Figure 6: Rand performance against US dollar since January



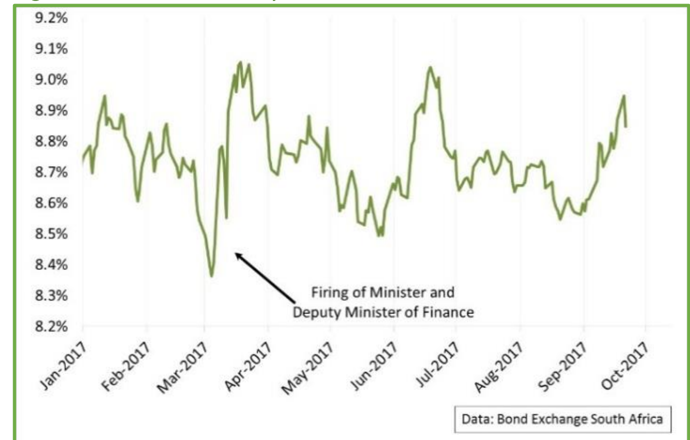
The rand, like the currencies of other emerging market economies, remains vulnerable to the monetary policies of advanced economy central banks. Both the European Central Bank and the US Federal Reserve have indicated their intention to commence "quantitative tightening" soon. "Quantitative tightening" entails central banks selling-off securities previously purchased under the "quantitative easing" program - enacted to support growth following the 2008 global financial crisis. "Quantitative tightening" reduces money supply in the economy and increases the domestic interest rates. An increase in US or European interest rates makes emerging market assets, particularly bonds, relatively less attractive compared to their advanced economy counterparts. This is likely to put pressure on emerging market currencies as funds flow towards advanced economy assets.

Sovereign risk and debt outlook

The yield on South Africa's 10-year benchmark bond – an indicator of market sentiment about the riskiness of South African government bonds – improved marginally over the first three months of the year, falling by 9 basis points to 8.9 per cent. The improvement was due to both the continued demand for emerging market assets, as well as expectations of lower domestic inflation. Bond yields, however, increased significantly following the cabinet reshuffle at the end of March, increasing by 90 basis points within a week of the event.

Bond yields recovered between April and June, and have traded in a narrow band since July. Yields have again increased over the last two weeks of September and early October amidst concerns over the impact of "quantitative easing" by the European and US central banks.

Figure 7: Yield on SA 10-year bond



The results from government bond auctions for the first nine months of the year, showed a lower average-clearing-yield compared to the first nine months of 2016, indicating both an overall improvement in the risk-perception of South African government bonds combined with a lower inflation outlook. This has resulted in lower government borrowing costs compared to the first nine months of 2016. Clearing yields on government's 20-year fixed rate bonds were on average 12 basis points lower than a year ago, and the average bid-to-cover ratio – and indicator of market appetite for a country's bonds – was higher than a year ago. There has however been a notable increase in borrowing costs since the first quarter of 2017. Average clearing yields on government's 20-year bonds increased by around 30 basis points, despite an improved inflation outlook, suggesting domestic factors have negatively affected borrowing costs.

Figure 8: Performance of government bond auctions

Government has taken steps to mitigate risk associated with increasing borrowing costs through issuing debt with longer maturity. Since 2008, the weighted average maturity of government debt has increased from 115 months to 185 months. This means that a smaller share of debt needs to be refinanced over the short term where borrowing costs are high and uncertain.

Figure 9: Increasing maturity profile of SA debt

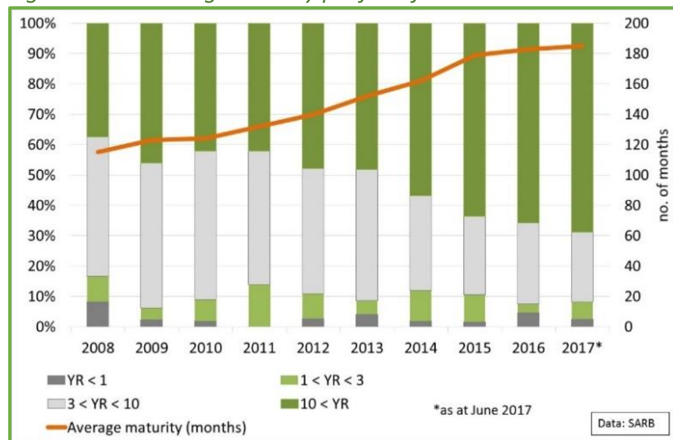
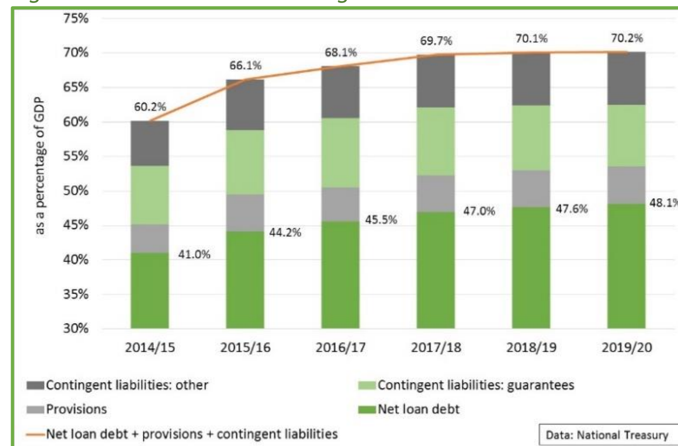


Figure 10: Net debt and contingent liabilities



South Africa's sovereign credit ratings – an assessment by the credit rating agencies of the likelihood that the country will default on its debt obligations – have been downwardly revised (indicating higher risk) since 2012 amidst concerns over the country's slowing economic growth and increasing debt. At present, the country's foreign-currency credit rating is rated sub-investment grade, whilst the country's local-currency credit rating is rated just above sub-investment grade. A downgrade by ratings agency S&P or Moody's to sub-investment grade will result in the country losing its investment-grade status on its local-currency debt as well.

Table 3: South Africa's sovereign credit ratings

	Foreign currency		Local currency	
	Rating	Outlook	Rating	Outlook
S&P	BB+	Negative	BBB-	Negative
Moody's	Baa3	Negative	Baa3	Negative
Fitch	BB+	Stable	BB+	Stable
indicates sub-investment grade			Data: S&P, Moody's, Fitch	

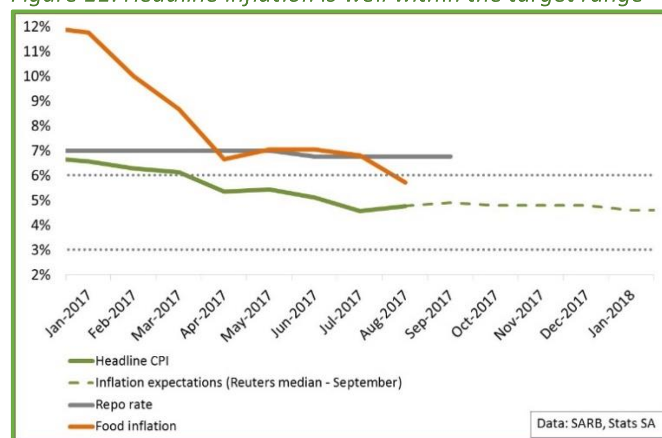
The loss of investment grade status on local-currency debt may have strong negative effects. A downgrade to sub-investment status on the country's local-currency debt would result in the exclusion of South African government bonds from influential global indices such as the Citi World Global Bond Index and the Barclays Global Aggregate Index. This exclusion could result in a significant share of foreign bond-holders selling-off South African local-currency bonds and significantly increase borrowing costs because approximately 40 per cent of local-currency debt is owned by foreigners The outcome of a local currency debt downgrade would in all likelihood make new debt more expensive than had been budgeted for in the 2017 Budget.

Contingent liabilities, particularly guarantees, pose a potential. risk to the health and sustainability of public finances. Over the past few years government guarantees have increased by over 190 per cent, with current exposure (share of guarantees utilised) above 65 per cent. The increased level of exposure, combined with the poor financial position of several state owned entities, and uncertainty around the Independent Power Program (21% of total guarantees) increases the chance of additional guarantees being called-upon

Inflation and monetary policy

Headline inflation – as measured by the consumer price index (CPI) for all urban areas – has remained below the upper bound of the South African Reserve Bank's (SARB) 3 to 6 per cent target range since April 2017, falling below 5 per cent in August for the first time since January 2016. The sustained decrease in inflation since April is due to lower food price inflation, a stronger rand and depressed demand pressures. Food price inflation, which fell as agriculture recovered from the drought, dropped below 6 per cent in August.

Figure 11: Headline inflation is well within the target range



After decreasing the repo rate by 25 basis points at its July meeting, the Monetary Policy Committee of the South African Reserve Bank kept the repo rate fixed at 6.75 per cent at its September meeting despite inflation outlook trending downwards towards the mid-point of the target range. The Monetary Policy Committee cited upside risks to inflation posed by the exchange rate, electricity price increases, and the pace of monetary policy normalization by the US Fed among the reasons for its decision to keep the repo rate fixed.

Outlook

The economy is expected to grow slower than government projected in February in the National Budget. Weak investment, slow household consumption, and the effects of fiscal consolidation are expected to continue to weigh-down domestic economic activity.

Table 4: Most analysts downwardly revised SA growth outlook

GDP growth outlook - calender year*	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%
South African Reserve Bank - September 2017	0.6%	1.2%	1.5%
Bureau for Economic Research - 1Q 2017	1.0%	1.8%	2.3%
Bureau for Economic Research - 3Q 2017	0.6%	0.9%	1.6%
World Bank - January 2017	1.1%	1.8%	1.8%
World Bank - October 2017	0.6%	1.1%	1.7%
International Monetary Fund - January 2017	0.8%	1.6%	-
International Monetary Fund - October 2017	0.7%	1.1%	1.2%
Reuters econometer (median) - March 2017	1.0%	1.7%	2.0%
Reuters econometer (median) - October 2017	0.7%	1.2%	1.5%
GDP growth outlook - fiscal year*	**2017/18**	**2018/19**	**2019/20**
National Treasury - Budget 2017	*1.3%*	*2.1%*	*2.3%*
International Monetary Fund - July 2017	1.0%	1.2%	1.9%
Bureau for Economic Research - 3Q 2017	0.6%	1.0%	-
RMB Global Market Research - October 2017	0.8%	1.1%	1.7%
Reuters econometer (median) - October 2017	0.8%	1.0%	-

*Growth projections correspond to publication date and not forecast date

A larger estimated budget deficit is expected, this combined with the revised lower nominal GDP growth projections mean that the estimates projected for the main budget deficit as a share of GDP are likely to be larger than estimates presented in the 2017 Budget Review. The downwardly revised growth projections will also translate into an estimate net debt as a share of GDP larger than the projection in the 2017 Budget Review.

It is important to note that this is contingent on government taking no remedial measures to increase revenue and/or decrease the expenditure ceiling to realise its fiscal objective of stabilising debt as a share of GDP over the medium term.