Parliamentary Budget Office

PARLIAMENT OF THE REPUBLIC OF SOUTH AFRICA

Quarterly Economic Brief

February 2018

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 developments for Members of Parliament following the release of quarterly economic data by Stats SA, the South African Reserve Bank and the National Treasury. This edition is released ahead of the 2018 Budget.

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This report incorporates data available up to and including the 16 February 2018, and was released on the 20 February 2018, ahead of the tabling of the 2018 Budget. Stats SA only releases GDP and the Quarterly Employment Survey for the fourth quarter in March the following year.

Overview

Following two consecutive quarters of contracting output, the economy grew over the second and third quarters of 2017, supported by a strong recovery in the agriculture sector, higher commodity prices, and a rebound in investment. Despite these positive six-month developments, unemployment remains close to its 13-year high, and the country remains susceptible to a downgrade of its domestic-currency credit ratings to non-investment grade.

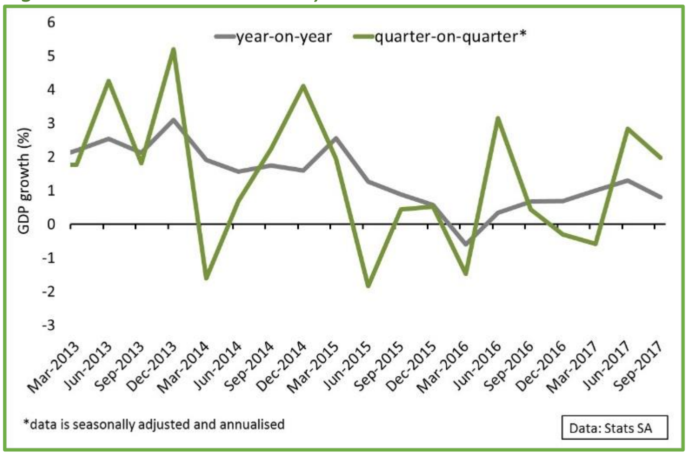
The revised medium-term economic outlook has improved compared with what was projected in the 2017 Medium Term Budget Policy Statement (MTBPS), in line with an improved global economic outlook. There however remain uncertainties around the global economic outlook arising from the potential effects of US tax policy changes and the unwinding of Quantitative Easing on emerging market economies.

The improved domestic growth outlook, however, implies only a marginal reduction in the revenue shortfall for 2017/18, with debt still projected to increase over the medium-term in the absence of additional remedial measures aimed at fiscal consolidation. The PBO estimates a R45.5 bn main budget revenue shortfall for 2017/18 when compared with the 2017 Budget estimate, resulting in a revised main budget deficit of 4.6 per cent of GDP.

Gross domestic product[1]

The South African economy grew by 2 per cent over the third quarter of 2017 – its second consecutive quarter of growth following two quarters of contraction. The primary sector of the economy experienced strong growth of 14.8 per cent, with both the agriculture (44.2%), and mining (6.6%) sectors growing. Contractions were recorded in the utilities (5.5%), construction (1.1%), trade (0.4%), and government (0.7%) sectors. Over the first three quarters of 2017, the economy grew by 1.1 per cent compared with the corresponding period of 2016.

Figure 1: A sustained recovery?

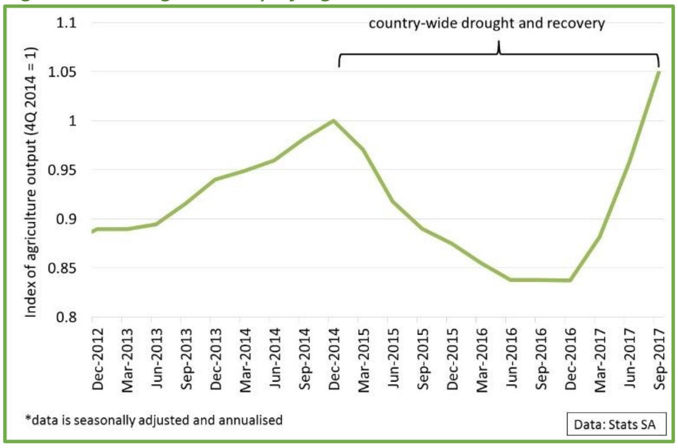


The agricultural sector grew by 44.2 per cent over the third quarter - its highest quarterly output in over 25 years. The sector recorded its third successive quarter of growth, following eight successive quarters of contracting output due to the effects of the countrywide drought. The strong growth contributed 0.9 percentage points to the quarter's overall GDP

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

growth of 2 per cent. Over the first three quarters of 2017, the sector grew by 22 per cent compared with the corresponding period of 2016. Whilst agricultural output has recently recovered, since the beginning of 2015 the sector has shed 10 per cent of its jobs (87 000 jobs) and investment in the sector has contracted. The sector also remains vulnerable to the current drought in the Western Cape, which contributes about 22 per cent to national agricultural output.

Figure 2: Strong recovery of agriculture



The mining sector grew by 6.6 per cent, its third successive quarter of positive growth. The sector has been supported by improved commodity prices and higher output. Growth in the mining sector contributed 0.5 percentage points to the quarter's growth. Over the first three quarters of 2017, the mining sector grew by 4.3 per cent.

Table 1: Tertiary sector slowing

% change q/q	Primary	Secondary	Tertiary	Agriculture	Mining	Manufacturing	Utilities	Construction	Trade	Logistics	Business services	Government	Personal services	GDP
3Q2017	14.9	2.1	0.3	44.2	6.6	4.3	-5.5	-1.1	-0.4	0.6	1.2	-0.7	0.9	2.0
2Q2017	14.8	1.9	1.1	38.7	8.2	1.5	8.8	-0.3	0.6	2.2	2.5	-1.1	1.3	2.8
1Q2017	15.3	-3.3	-2.1	23.1	13.1	-3.7	-4.8	-0.8	-5.9	-1.6	-1.2	-0.7	-0.1	-0.6
4Q2016	-9.0	-1.8	1.6	-0.1	-11.5	-3.1	2.4	0.4	2.1	2.6	1.6	0.9	1.0	-0.3

Data: Stats SA

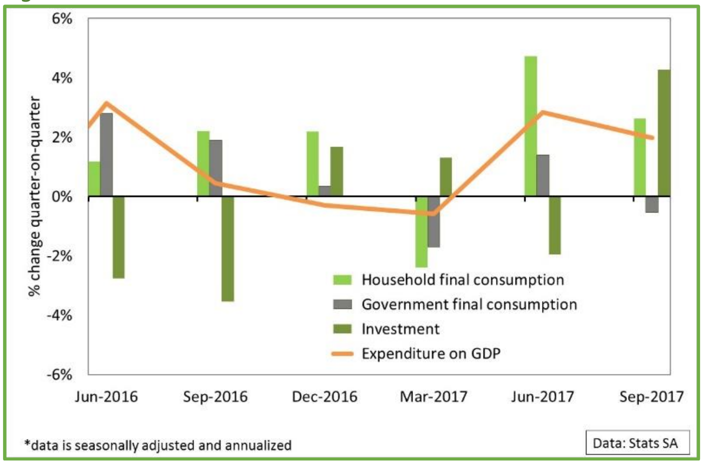
The utilities sector, comprised of the electricity, gas and water industries, contracted by 5.5 per cent over the quarter. This is in part due to a reduction in electricity produced over the quarter, which fell by 1.9 per cent on a seasonal basis compared with the last quarter. Over the first three quarters of 2017 the utilities sector contracted by 0.6 per cent.

Government's direct contribution to GDP contracted by 0.7 per cent – its third consecutive contraction. This reflects smaller increases to national budgets, including transfers to provincial and local government, as part of government's policy of fiscal consolidation. Over the first nine months of the year, government consumption spending grew by only 0.1 per cent, contributing 0 per cent to economic growth. Modest real increases to budgets over the medium-term will likely continue this trend.

Expenditure on GDP

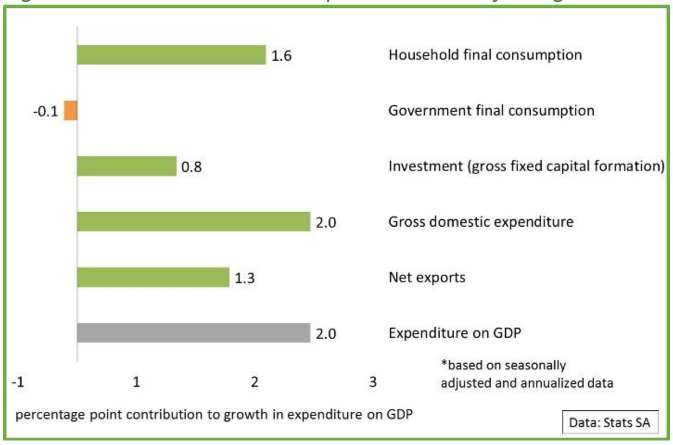
Measured from the expenditure side, the economy grew by 2 per cent in the third quarter of 2017, its second consecutive quarter of growth, following two consecutive quarters of contraction. The improved performance over the quarter was due to growth in investment, household consumption, and net exports.

Figure 3: Investment recovers



Over the quarter, household consumption grew by 2.6 per cent, its second successive quarter of growth. The growth in household consumption contributed 1.6 percentage points to the quarter's growth. Over the first three quarters of 2017, household consumption grew by 1.4 per cent, along with an increase in household disposable income.

Figure 4: Government consumption subtracts from growth



Government consumption expenditure contracted by 0.5 per cent, its second contraction in three quarters, subtracting 0.1 percentage points from the quarter's growth. Government consumption expenditure over the first nine months of the year has not grown compared to the corresponding three quarters of 2016, resulting in a zero contribution to GDP growth over the period. This contraction, in part, reflects 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. In nominal terms, the growth of total charges against the National Revenue Fund has decreased over the first 9 months of 2017/18 compared with the corresponding period of 2016/17. Similarly, total payments for operating expenditure for national, provincial and local government have grown slower compared than compared with the previous year.

Over the quarter, total investment (gross fixed capital formation) in the economy grew by 4.3 per cent, following a contraction recorded for the second quarter. The expansion in investment was broad based with government (4.4%), public corporations (4.8%) and the private sector (4.1%) recording increases in investment.

Contractions were recorded for both exports (10.3%) and imports (13.7%) over the quarter. Net exports contributed 0.2 percentage points to the quarter's overall growth.

Employment

According to the Quarterly Labour Force Survey, the official unemployment rate increased in the fourth quarter of 2017 to 26.7 per cent from 26.5 per cent recorded for the fourth quarter of 2016. The number of people officially unemployed increased by 99 248.

Table 2: Key labour statistics – Quarterly Labour Force Survey

	4Q 2016	3Q 2017	4Q 2017
Labour force ('000s)	**21 849**	**22 402**	**22 051**
Employed	16 069	16 192	16 171
Unemployed - official	5 781	6 210	5 880
Unemployed - broad*	8 900	9 422	9 216
Not economically active ('000s)	**15 055**	**14 971**	**15 474**
Discouraged job-seekers	2 292	2 436	2 538
Other (not economically active)	12 763	12 536	12 936
Rates			
Official unemployment rate (narrow)	26.5%	27.7%	26.7%
Broad unemployment rate*	35.6%	36.8%	36.3%
Youth unemployment** (narrow)	37.1%	38.6%	38.2%
Youth unemployment** (broad*)	47.7%	49.2%	49.1%

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

The labour force, officially defined, grew by 0.9 per cent (201 573) over the year, exceeding the growth in the number of people employed (0.6 per cent – 102 414), resulting in an increase in the unemployment rate. There was however a large increase in the number of discouraged job-seekers, which increased by 10.7 per cent over the year, its largest increase since 2011. The large increase in discouraged job-seekers underscores the importance of considering the broad definition of unemployment, as it counts discouraged job-seekers as part of the unemployed.

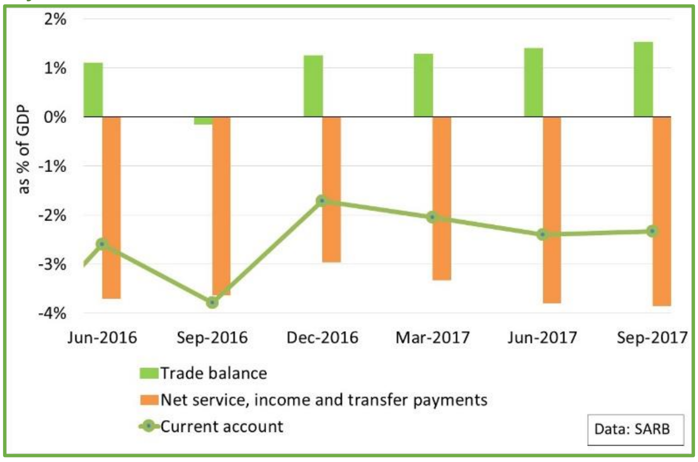
The broad unemployment rate increased by 0.7 per cent over the last 12 months to 36.3 per cent. Broadly defined, the number of people unemployed increased by about 316 574.

Youth unemployment remained close to its all-time high level in the fourth quarter . Youth unemployment, officially defined, increased by 1.1 per cent over the year to 38.2 per cent. Broadly measured, the youth unemployment rate is 49.1 per cent.

Current account

South Africa's current account deficit, held in deficit by the persistent net outflow of service, income and transfer payments, decreased slightly during the third quarter of 2017 to 2.3 per cent of GDP (R109 bn on a seasonally adjusted and annualised basis) from the 2.4 per cent recorded in the second quarter of 2017. The decrease in the current account deficit was due to an increase in the trade surplus, which increased from R64 bn to R71 bn – its fourth consecutive quarter in surplus.

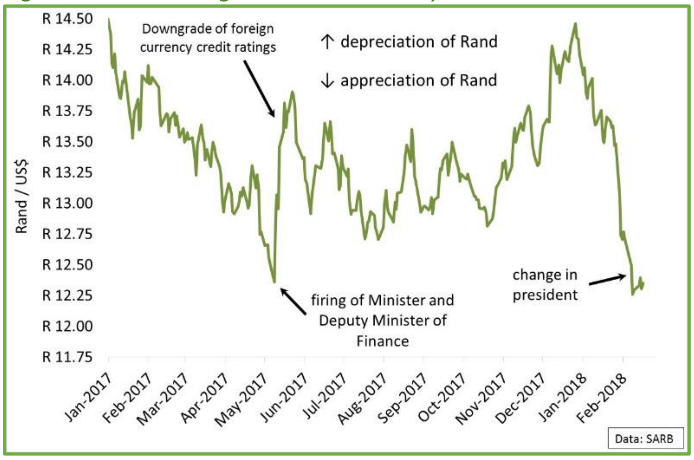
Figure 5: Improved trade balance reduces current account deficit



Exchange rate

After weakening against the US dollar in the second quarter of 2017 following the cabinet reshuffle and a credit ratings downgrade, the rand traded in a narrow band until the third quarter of 2017. The rand has strengthened significantly from the fourth quarter of 2017, along with other emerging market currencies as the dollar weakened against most major currencies. The rand strengthened by 18 per cent against the US dollar between November 2017 and January 2018, and reached its strongest level against the US dollar in February in ten months, following the change in the president.

Figure 6: Rand strengthens since January 2018



Externally, a stronger global growth outlook and higher commodity prices have supported the strengthening of the rand. Domestically, a narrower current account deficit, and recent domestic political developments, including the change in the president, have also contributed to a stronger rand.

The appreciation of the rand against the US dollar corrects for the deviation observed between the value of the rand and the currencies of other emerging market economies against the US dollar, from July 2017 to November 2017, when the rand weakened against the trend of strengthening emerging-market currencies. The rand is now trending in-line with the currencies of other emerging-market economies.

Stronger global growth, and sustained higher commodity prices is likely to support a stronger rand going forward. Government should save on budgeted foreign currency obligations from sustained rand strength compared with the level of the rand at the time of the MTBPS in October 2017. Any further downgrades to the country's domestic currency credit ratings may, however, contribute to a sell-off of South African bonds, resulting in a weaker currency.

Table 3: Foreign currency obligations from issuance of foreign currency debt March - September 2018

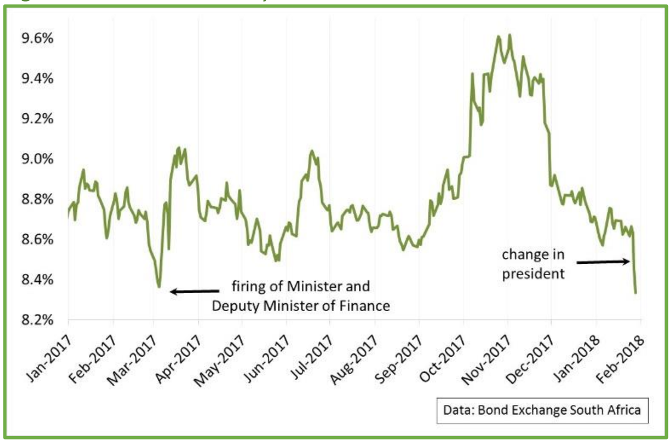
(currency - millions)	US$	¥	€	£	SEK	Total
Interest payment on foreign denominated debt	648.6	1714.1	19.7	0.3	35.7	
Redemption of foreign debt	19.3	47.0	10.4	3.6	347.2	
Total - in foreign currency	**667.9**	**1761.1**	**30.1**	**3.9**	**382.9**	
Total - in rands @ October '17 exchange rate	**9134.0**	**213.3**	**483.9**	**69.9**	**640.7**	**10541.8**
Total - in rands @ February '18 exchange rate	**7948.1**	**193.7**	**438.5**	**56.5**	**562.8**	**9199.6**
Decrease(increase) from change in exchange rate	**1185.9**	**19.5**	**45.4**	**13.4**	**77.9**	**1342.2**

Data: SARB, National Treasury & PBO own calculations

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 debt – has varied significantly since the beginning of 2017.

Figure 7: Yield on SA 10-year bond



After falling consistently over the first quarter of 2017, due to both the continued demand for emerging market assets, as well as expectations of lower domestic inflation, bond yields increased significantly at the end of March following the cabinet reshuffle. Yields then partially recovered between April and June, and traded in a narrow range between July and September. Yields again increased from late September amidst concerns over the impact of "quantitative easing" by the European and US central banks on emerging market assets, as well as the uncertainty over the creditworthiness of South African government debt following the tabling of the 2017 MTBPS in October. After reaching a high of 9.6 per cent in November, bond yields fell have fallen substantially – by more than 100 basis points. Bond yields improved again, falling by 30 basis points following the change in the president.

The results from government bond auctions since the beginning of 2017 reflect changing risk perception regarding South African debt, an improved domestic inflation outlook, and a change in global appetite for emerging market debt. Clearing yields on government's 20-year fixed rate bonds increased in March 2017 following the cabinet reshuffle, and remained around 9.5 per cent for the second and third quarter of 2017. The higher yields increased demand for South African debt, with the average bid-to-cover ratio – an indicator of market appetite for a country's bonds – increasing to above 4. Clearing yields again increased in November, amidst a global sell-off of emerging market bonds, as well as concerns about South Africa's credit rating. Yields have since recovered as a stronger global outlook has supported demand for emerging market assets, as well as the effect of local political developments.

A stronger global economic outlook, favouring emerging market assets, and the change in the president of the country continue to support the performance of South African bonds. South African bonds are currently trading in the same region as the investment-grade debt of other countries. Whilst an improvement in the domestic growth and inflation outlook will favour lower yields, a possible exclusion of South Africa's bonds from the World Government Bond Index, triggered by a further credit ratings downgrade, could result in an automatic sell-off of these bonds, an increase in bond yields, and a weaker rand.

Figure 8: Sustained demand for new bond issuance

Government has taken steps to mitigate risks associated with increasing borrowing costs through issuing debt with longer maturity. Since 2008, the weighted average maturity of government debt has increased from 9.6 years to 15.3 years. This means that a smaller share of debt needs to be re-financed over the short term, where borrowing costs are high and uncertain.

Figure 9: Debt maturity profile reduces short-term risk

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 rising debt. After the tabling of the 2017 MTBPS, which presented a slower trajectory for fiscal consolidation and a breach of the expenditure ceiling, ratings agency S&P lowered its ratings of the country's local and foreign currency debt, Moody's placed the country's debt on review for a downgrade, and Fitch affirmed its sub-investment grade rating of the country's local and foreign currency debt.

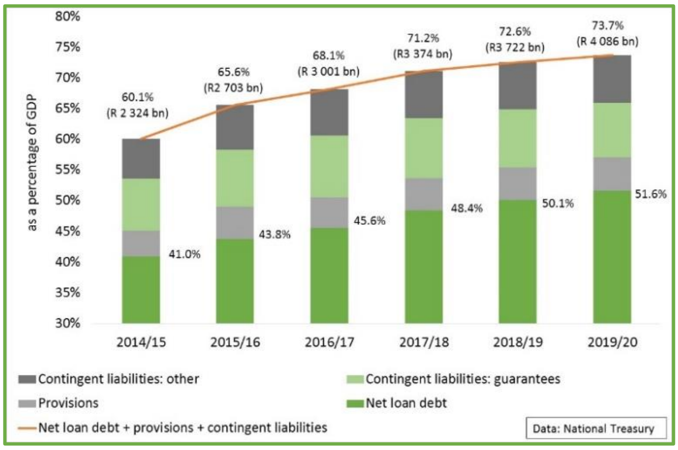
At present, S&P and Fitch both rate the country's foreign and local currency debt at sub-investment grade, whilst Moody's, scheduled to update its rating after the tabling of the 2018 Budget, currently rates both foreign and local currency debt at one-notch above sub-investment grade. A downgrade by ratings agency Moody's to sub-investment grade will result in the country losing its investment-grade status on its local-currency debt. A downgrade would result in the exclusion of South African government bonds from the World Government Bond Index. This exclusion would result in a significant share of foreign bond-holders selling-off South African local-currency bonds, which would significantly increase borrowing costs, as 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 MTBPS.

Table 4: Only Moody's rates SA debt at investment grade

	Foreign currency		Local currency	
	Rating	Outlook	Rating	Outlook
S&P	BB	stable	BB+	stable
Moody's	Baa3	under review	Baa3	under review
Fitch	BB+	stable	BB+	stable
sub-investment grade			Data: S&P, Moody's, Fitch	

Contingent liabilities, particularly guarantees, pose a potential risk to the health and sustainability of public finances. Over the past five 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 increases the chance of additional guarantees being called-upon.

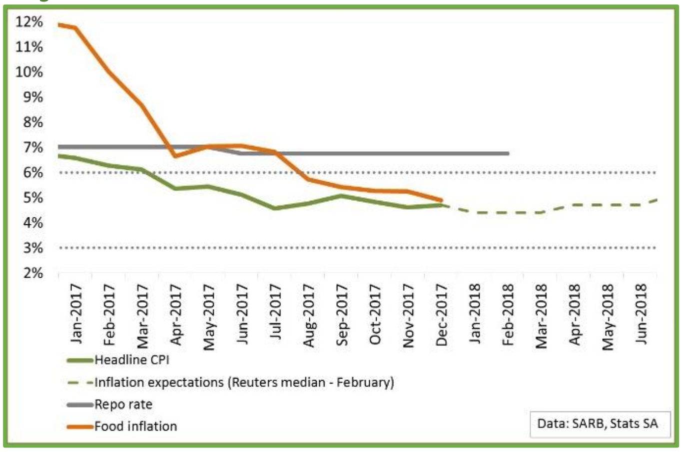
Figure 10: Net debt and contingent liabilities increase over the medium-term



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, reaching a two-year low in November 2017 (4.6%). The sustained decrease in inflation since April is due primarily to lower food price inflation, a stronger rand, and depressed demand pressures. Food price inflation, which fell as the agriculture sector recovered from the drought, has fallen to beneath the upper bound of the target range (4.9%). Inflation is expected to remain below 6 per cent over the next two years.

Figure 11: Headline inflation and expectations within the target range



After decreasing the repo rate by 25 basis points at its July 2017 meeting, the Monetary Policy Committee of the South African Reserve Bank kept the repo rate fixed at 6.75 per cent at its September 2017, November 2017, and January 2018 meetings. The Monetary Policy Committee noted that whilst the inflation outlook continues to improve and demand pressures remain muted, there are significant upside risks to inflation posed by the exchange rate from a credit ratings downgrade, the potential impact the path of fiscal consolidation may have on capital flows out of the country, and the oil price outlook.

Outlook

The 2017 MTBPS downwardly-revised the growth outlook for the medium term, from the 2017 Budget Review's projections. The MTBPS also estimated a significantly larger budget deficit for 2017/18, following poor revenue growth across almost all revenue instruments. The downward-revisions were in-line with the PBO's pre-MTBPS outlook, and that of other forecasters. The weaker growth and revenue outlook, translated into projections of larger budget deficits, and increasing debt relative to GDP over the medium term.

Following two quarters of moderate growth succeeding a two-quarter technical recession, the outlook for the economy has improved marginally. The strong recovery of the agricultural sector, higher commodity prices, a partial recovery in investment, and an improved outlook for global growth, suggest that the South African economy will grow faster over the medium-term, compared to the 2017 MTBPS outlook, but marginally slower compared with the 2017 Budget Review. Accordingly, since the MTBPS most forecasters have upwardly-adjusted their forecasts for the medium term.

Table 5: Growth projections- down, and then up

GDP growth outlook - calender year*	2017	2018	2019
National Treasury - Budget 2017	*1.3%*	*2.0%*	*2.2%*
National Treasury - MTBPS 2017	*0.7%*	*1.1%*	*1.5%*
South African Reserve Bank - March 2017	1.2%	1.7%	2.0%
South African Reserve Bank - September 2017	0.6%	1.2%	1.5%
South African Reserve Bank - January 2018	0.9%	1.4%	1.6%
World Bank - January 2017	1.1%	1.8%	1.8%
World Bank - October 2017	0.6%	1.1%	1.7%
World Bank - January 2018	1.1%	1.7%	1.7%
International Monetary Fund - January 2017	0.8%	1.6%	-
International Monetary Fund - October 2017	0.7%	1.1%	1.2%
International Monetary Fund - January 2018	0.9%	0.9%	0.9%
Reuters econometer (median) - March 2017	1.0%	1.7%	2.0%
Reuters econometer (median) - October 2017	0.7%	1.2%	1.5%
Reuters econometer (median) - February 2018	1.4%	1.7%	2.0%
GDP growth outlook - fiscal year*	**2017/18**	**2018/19**	**2019/20**
National Treasury - MTBPS 2017	*0.9%*	*1.1%*	*1.6%*
Bureau for Economic Research - 3Q 2017	0.6%	1.0%	-
Bureau for Economic Research - 1Q 2018	1.2%	1.8%	-
RMB Global Market Research - October 2017	0.8%	1.1%	1.7%
RMB Global Market Research - February 2018	1.2%	1.7%	-
Reuters econometer (median) - October 2017	0.8%	1.0%	-
Reuters econometer (median) - February 2018	1.2%	1.8%	-

*Growth projections correspond to publication date and not forecast date

Table 6: Marginal improvement in revenue outlook – 2017/18

R million	NT Budget Review 2017	PBO pre-MTBPS Oct 2017[1]	NT MTBPS 2017	PBO pre-Budget Feb 2018[1]
Personal income tax	482,086	462,755	461,262	459,997
Corporate income tax	218,692	209,864	213,905	216,729
Net value-added tax	312,750	305,295	301,320	299,913
Domestic Vat	344,823	339,929	340,354	338,159
Import Vat	162,304	151,159	151,967	152,653
Vat refunds	(194,377)	(185,793)	(191,000)	(190,899)
Customs and excise duties	96,118	83,853	88,135	85,751
Skills development levy	16,641	15,680	15,771	16,004
Fuel levy	70,902	70,819	70,088	70,892
Other[1]	68,299	58,780	64,219	63,886
Gross tax revenue	**1,265,488**	**1,207,046**	**1,214,700**	**1,213,173**
Non-tax revenue & NRF receipts	79,022	79,019	77,194	72,252
Less: SACU[3] payments	(55,951)	(55,951)	(55,951)	(55,951)
Main budget revenue	**1,242,417**	**1,183,978**	**1,193,457**	**1,196,871**
Main budget expenditure	**1,409,215**	**1,409,215**	**1,413,100**	**1,413,100**
Main budget balance	**(166,798)**	**(225,238)**	**(219,643)**	**(216,229)**
as share of GDP (%)	**-3.5%**	**-4.9%**	**-4.7%**	**-4.6%**
GDP in current prices	**4,741,206**	**4,617,802**	**4,672,180**	**4,689,815**
real GDP growth estimate	**1.3%**	**0.8%**	**0.9%**	**1.2%**
Tax buoyancy[4]	**1.39**	**1.14**	**1.02**	**0.93**

1. Revenue projections are from PBO's In-year revenue and expenditure model. PBO uses historical monthly profiles of revenue and expenditure and data available in section 32 reports to project full-year main budget outcomes. PBO's model is based on methodologies employed by other independent fiscal insitutions.

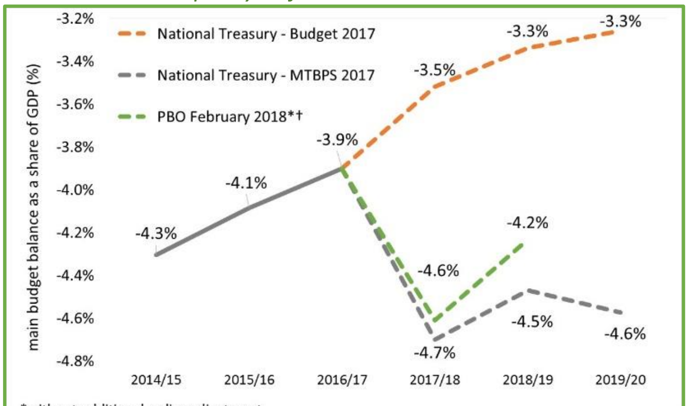
2. Other includes dividend withholding tax, ad valorem excise duties, interest on overdue income tax, taxes on property, stamp duties and fees, air departure tax, electricity levy, plastic bag levy and all other minor taxes

3. Southern African Customs Union. Amounts made up of payments and other adjustments. 2017/18 figures are preliminary

4. Percentage change in gross tax revenue divided by percentage change in nominal GDP. PBO estimate of tax buoyancy is based on actual nominal GDP for 2016/17 and updated nominal GDP projection for 2017/18

The marginal improvement in economic performance and outlook is reflected in a recent improvement in monthly revenue collection. Based on the actual outcomes for the first nine months of the current fiscal year, and historical monthly revenue profiles, the PBO's in-year revenue and expenditure model estimates a marginally smaller budget deficit for 2017/18 compared with the 2017 MTBPS projections. The main budget deficit is, however, still expected to be significantly larger than estimated in the 2017 Budget Review. It should be noted that the PBO's projections are not policy-adjusted, and thus do not reflect any steps that may be taken by government in the upcoming budget and over the MTEF to raise revenue and/or decrease expenditure to stabilise debt as a share of GDP.

Figure 12: Marginal improvement in budget deficit from 2017 MTBPS – without policy adjustment

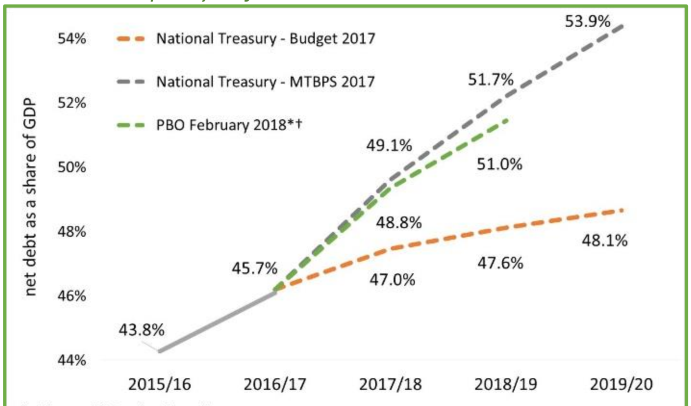


*without additional policy adjustment
†includes GDP estimate from Reuters February poll

Data: NT, Stats SA, Reuters, PBO own calculations

When compared with the 2017 MTBPS projections, the smaller estimated budget deficit, combined with the revised larger nominal GDP growth projection, results in a marginal improvement in the main budget deficit as a share of GDP for 2017/18 and 2018/19. The improved growth outlook, combined with a reduction in the borrowing requirement, also translates into a modest improvement in the outlook for debt as a share of GDP over the medium-term. The debt-to-gdp ratio does not, however, appear to stabilise over the medium-term, in contrast with government's stated fiscal objective.

Figure 13: Debt still expected to increase over the medium-term without policy adjustment



*without additional policy adjustment
†includes GDP estimate from Reuters February poll

Data: NT, Stats SA, Reuters, PBO own calculations

It is however quite likely that government may propose additional revenue and expenditure measures in the upcoming Budget to return the debt trajectory to a path of stabilisation. As such proposals may have negative consequences for economic growth, service delivery, and inequality, government and parliament should carefully consider future proposals to increase revenue and/or reduce growth in expenditure.