Parliamentary Budget Office

PARLIAMENT
OF THE REPUBLIC OF SOUTH AFRICA

Quarterly Economic Brief

September 2015

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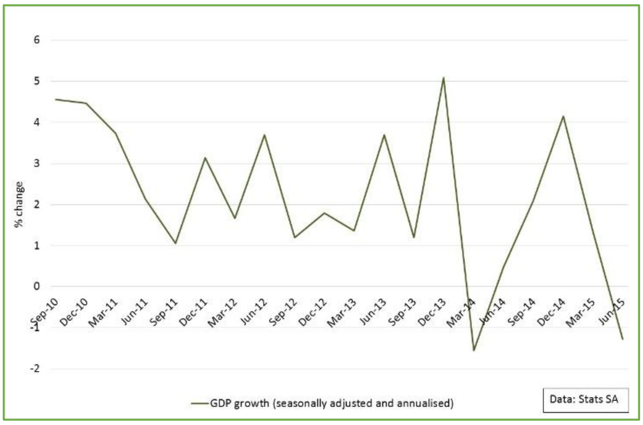
Growth

According to official data from Statistics South Africa (StatsSA), the South African economy shrunk by 1.3 per cent in the second quarter of 2015, compared to the previous quarter. This occurred against a backdrop of weak global growth, lower commodity prices, and a slowing Chinese economy. Output contracted in five of the ten economic sectors categorised by Stats SA.

The sectors reducing growth the most were:

- *Manufacturing*, which subtracted 0.8 of a percentage point from the quarter's growth by contracting 6.3 per cent
- *Mining,* after growing in three successive quarters, contracted 6.8 per cent, subtracting 0.5 of a percentage point from the quarter's growth
- *Agriculture*, which contracted 17.4 per cent due to severe droughts, subtracted 0.4 per cent from the quarter's growth.

Figure 1: Quarterly economic performance

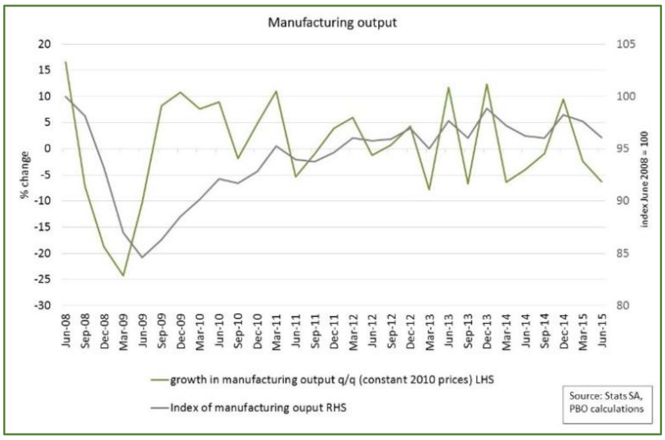


Although the economy shrank in the second quarter of 2015, it is still 1.6 per cent larger than at the same time in 2014 due to growth in the first quarter. Like other commodity exporting economies, South Africa has been affected by lower commodity prices (see commodities section pg. 3). The quarter's economic performance was also affected by frequent, managed load-shedding. Compared to the same quarter in 2014, the electricity, gas and water sector contracted by 2.9 per cent, with electricity production over the quarter decreasing by 2.1 per cent.

Manufacturing

The manufacturing sector's poor performance in the second quarter continues a trend of declining output. Manufacturing output has contracted in 10 of the 18 quarters since the beginning of 2011, and has not recovered to pre-financial crisis levels. This is despite a wide range of government policies and programmes to support the sector.

Figure 2: Manufacturing performance



Partly as a result of this poor performance, the sector's contribution to the economy has also been in decline. The direct contribution of manufacturing to GDP has fallen from a 15 per cent in 1994, to 7.8 per cent, slightly lower than the pre-crisis level of 8.5 per cent recorded in 2008.[1] Employment in manufacturing has also decreased from 1.3 million people in 2006 to 1.1 million. As a percentage of total formal non-agricultural employment, it has declined from 16 per cent to about 13 per cent today. Related to these changes, the capital-to-labour ratio – indicating the level of capital used relative to labour in the sector – increased from 68 in 1994 to 107 today. This trend of lowering reliance on labour relative to capital in production is consistent with international experience. In the South African case, this change has occurred at the same time as labour costs have increased. The average wage in the manufacturing sector has increased by over 65 per cent in real terms since 2004.

Mining

The contraction of the mining sector by 6.8 per cent in the second quarter is the third quarterly contraction in mining since the beginning of 2014. The mining sector has contracted by an average of 0.25 per cent a year between 2008 and 2014. The sector has been adversely affected by lower commodity prices (platinum, for which South Africa is the largest exporter, is at a 6 year low), prolonged work stoppages and irregular electricity supply.

Figure 3: Mining output (Index 2010=100)

The industry has undergone significant changes over the past two decades. In 1994 over half the Rand value of mining output was from gold, while commodities such as iron ore and coal accounted for less than 3 per cent and 12 per cent respectively. Today, gold's share has declined to 15 per cent of mining production, while iron ore (16%), coal (13%) and platinum group metals (21%) comprise about half. As is the case with manufacturing, mining's direct contribution to the economy has fallen from over 14 per cent in 1994, to about 8 per cent today.

Household consumption and growth

The retail sector contracted 0.35 per cent contraction in the second quarter of 2015. The sector's performance has been modest over the past two years, compared to the previous five years where it grew by an average of 2.5 per cent per year. Consumption expenditure by households plays an important role in the South African economy, comprising around 60 per cent of gross domestic expenditure. As consumer spending is financed through income or borrowing, employment and credit extension to households are important determinants of household consumption. Credit extension to households grew by a modest 3.4 per cent year-on-year in the second quarter. This may be partly attributable to low employment growth, high levels of household indebtedness and stricter lending criteria. Slowing credit extension has, however, possibly contributed to an improvement in the ratio of household assets to liabilities (from 4.3 in 2008, to 5.5 last year).

Employment

According to estimates from the Quarterly Labour Force Survey (QLFS) the official unemployment rate in the second quarter of 2015 was 25 per cent, lower than the first quarter's rate of 26.4 per cent. The broad unemployment rate, which includes discouraged job-seekers, is estimated at 36.7 per cent - 1.1 per cent lower than the previous quarter. The QLFS estimates indicate that over the past 12 months, the informal sector added more jobs (282 000) than the formal sector (80 000). While the second quarter results suggest an improvement in the labour market, like other survey statistics these estimates are subject to certain errors. Future estimates will reveal whether the estimated decline in unemployment accurately reflects labour market changes.

Table 1: Key labour statistics

	2Q 2014	1Q 2015	2Q 2015
Labour Force ('000s)	20 248	20 994	20 887
Employed	15 094	15 459	15 657
Unemployed - official	5 154	5 535	5 230
Unemployed - broad*			
Not economically active ('000s)	15 084	14 805	15 068
Discouraged work-seekers	2 419	2 397	2 434
Other	12 665	12 408	12 633
Unemployment rate - official (%)	25.5	26.4	25.0
Unemployment rate - broad* (%)	37.4	37.8	36.7

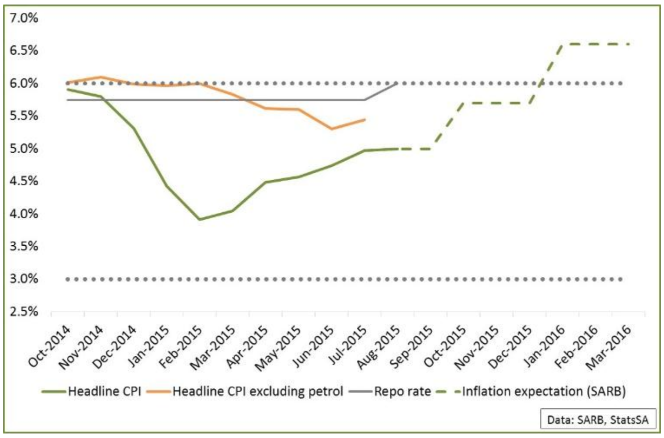
*The broad unemployment rate includes discouraged job-seekers

Data: Stats SA, Quarterly Labour Force Survey

Inflation

Headline inflation – as measured by the consumer price index (CPI) for urban areas – has continued its downward trend over the past 12 months. This decrease in the rate at which prices are growing is mainly attributable to the significant decline in oil prices since mid-2014. When petrol is excluded from the calculation, inflation is 1 - 2 per cent higher. While inflation is currently within the Reserve Bank's target range of 3 - 6 per cent, the Reserve Bank expects inflation to increase above 6 per cent in the first two quarters of 2016.

Figure 4: Inflation and monetary policy



At its July meeting, the Reserve Bank's Monetary Policy Committee (MPC) increased interest rates by 25 basis points to 6 per cent (the prime lending rate is 9.5%). It noted that domestic inflation was not to the result of excessive demand in the South African economy. Instead, one of the key reasons given by the MPC for its decision was the Rand's weakness and volatility. Between April and September, the Rand depreciated 12 per cent against the US dollar, with significant fluctuations. External factors affecting the Rand include declining commodity prices, volatility in Chinese stock markets, and the effects of the US Federal Reserve's monetary policy (see PBO June 2015 Quarterly Economic Brief).

Outlook

Following modest first quarter growth of 1.3 per cent, most analysts lowered their forecasts to below National Treasury's forecast of 2 per cent growth for 2015. Table 2 shows economic growth forecasts by different institutions. The Reuter's median forecast for 2015 – which summarises the forecasts of a wide range of economists – is only slightly below that of National Treasury. However, these forecasts do not reflect the recent contraction in the second quarter.

Compared to the first half of last year, the economy has grown by 1.62 per cent. For National Treasury's forecast to be realised, the economy would need to grow by 2.37 per cent for the second half of the year compared to the same half of 2014.

Table 2: Change in SA growth outlook

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

Growth in the remaining two quarters depends on a range of domestic and international factors, among which is the growth of South Africa's main trading partners. The Reserve Bank expects growth among these countries to be 3 per cent, slightly lower than in 2014. Continuing slow growth in domestic consumption expenditure and fixed capital investment, as well as electricity supply constraints, will put pressure on growth.

Feature: *Commodities*

South Africa's mineral resources have been a significant driver of economic growth since the first diamonds were discovered along the banks of the Orange River in the 1870's. Today, the country is the world's largest producer of chrome, manganese, platinum, vanadium and vermiculite. It is the second largest producer of ilmenite, palladium, rutile and zirconium and the third largest coal exporter. Once the largest gold producer in the world, South Africa now ranks 5th among its peers.

In 2014, the export value of all South Africa's mineral products amounted to approximately 30 per cent of total exports. Besides employing thousands of workers and generating revenue for the state, it is also heavily relied upon by the manufacturing and services sectors for business. The mining sector is, therefore, critical to the South African economy.

China is one of the largest consumers and producers of mineral resources. Towards the late 1990s, Chinese demand for minerals began to exceed its own output, creating a need for imports. Between 2002 and 2008, this surge in demand accounted for 61 per cent of the increase in iron ore trade, 45 per cent of lead ore, 31 per cent of nickel ore and 29 per cent of copper ore trade globally.[2] By 2008, China's per capita consumption of minerals amounted to one and a half times the world's average levels.[3]

Since the late 1990s, commodity prices – typically priced in US dollars – have been driven upward by an increase in demand for minerals.

Figure 5: Chinese economic growth and commodity prices, 1981 - 2014

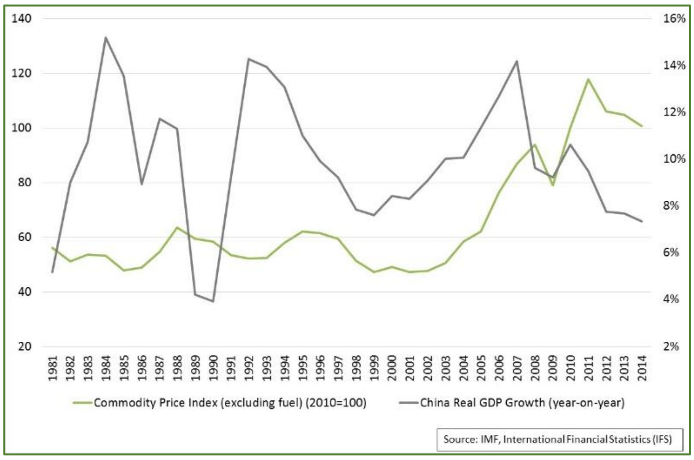
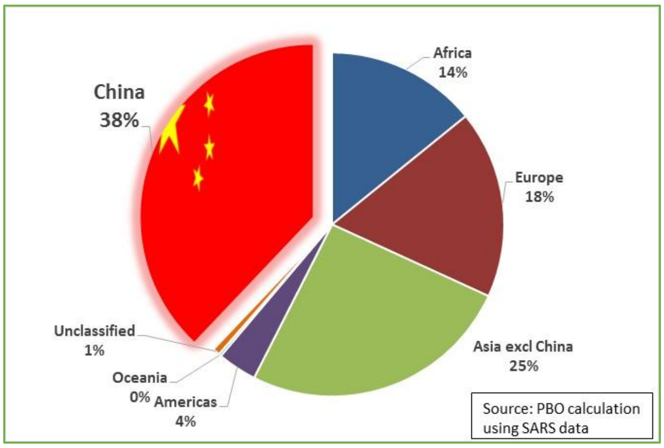


Figure 5 shows the trends in Chinese growth alongside commodity prices from 1996 onwards. Given the increased contribution of China to global demand for minerals, Chinese economic growth is believed to have a significant effect on commodity prices.

Commodity exporting countries have benefitted from the surge in Chinese mineral imports, through an increase in the volume of exports and the price of these. South Africa is no exception. Over the last 15 years, China has become South Africa's largest trading partner, with particular interests in iron ore, platinum and manganese products.

Figure 6: Cumulative value of South African mineral product exports, 2011



At the end of 2011, the value of South African mineral products exported to the rest of the world had grown to

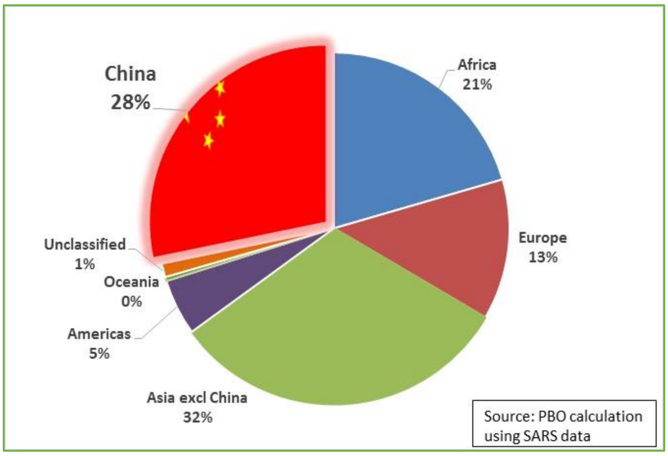
R188.3 billion for the year, with China accounting for about 38 per cent of trade.

In recent years, shifting Chinese economic policy has resulted in a changed outlook for commodities. In 2011, China announced its intention to restructure its economy. Since the 1990s, Chinese growth has been driven predominantly by state-led investment in infrastructure and manufacturing capacity. The plan is to move towards a more consumption-led economy. For commodities, less Chinese investment has meant that the demand for mineral products has declined.

South African commodity exports have been affected by the fall in demand on two fronts. Firstly, it has reduced the volume of South African mineral exports: growth in volumes was only 2.3 per cent in 2014, compared with 9.4 per cent growth in 2010. Secondly, the US dollar prices of commodities have fallen by approximately 26 per cent since the start of the year.[4] As a consequence, the total value of South African mineral exports to China has fallen by an average of 19 per cent over the last two years.[5]

For South Africa, this has reduced China's significance as a commodity trading partner. According to 2015 trade data, China's share of South Africa's mineral export trade has declined to 28 per cent.

Figure 7: Cumulative value of South African mineral products exports, 2015



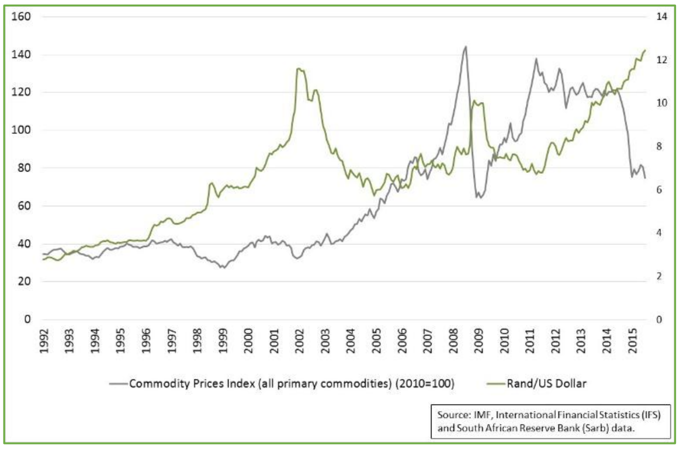
Falling commodity prices and export volumes have resulted in a weaker than anticipated financial performance by the South African mining sector. In an apparent response to this, several mining companies have recently announced plans to downsize and retrench workers to remain financially viable.[6]

An underperforming mining sector could mean that the state loses expected tax revenue.

Arguably, one of the most damaging effects of the slowdown in the demand for commodities, is the impact on the exchange rate. The decline in demand has meant that commodity exporting countries' exports have shrunk relative to their imports. For South Africa, this means less trade-based demand for the Rand, since fewer mineral products are being sold to the rest of the world and at lower prices. This can sometimes lead to currency depreciation, but the relationship is not always clear as there are various other factors influencing the value of the Rand at any particular moment.

This year, most emerging market currencies have devalued against the US dollar by between 10 and 20 per cent.[7] The US central bank's pending decision to raise interest rates is likely to be partly responsible for this decline. Figure 8 shows the trends in commodity prices and the South African Rand since 1992.

Figure 8: Commodity prices and the Rand, 1992 - 2015



While the US Central Bank's pending decision to raise interest rates may have been the main reason for Rand depreciation since 2011, the recent sharp fall in commodity prices has reinforced this trend. In the last two weeks the Rand has reached its lowest rates in the last decade, briefly trading at over R14 to the US dollar on the 24th August 2015. The exchange rate is likely to continue to be volatile and could be negatively affected by the raising of US interest rates, as well as the continued decline in Chinese demand for commodities.

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[1] The sector also contributes to growth and employment indirectly through linkages with other sectors (e.g. demand for commodities and services).

[2] European Commission research agency Polinares (2012).

[3] United Nations environment programme article (2013).

[4] FTSE 350 mining index (2015).

[5] PBO calculations using Sars trade data.

[6] http://www.iol.co.za/business/news/minister-alarmed-at-mining-sector-retrenchments-1.1858672

[7] Bloomberg data.