Parliamentary Budget Office

PARLIAMENT
OF THE REPUBLIC OF SOUTH AFRICA

Quarterly Economic Brief

June 2016

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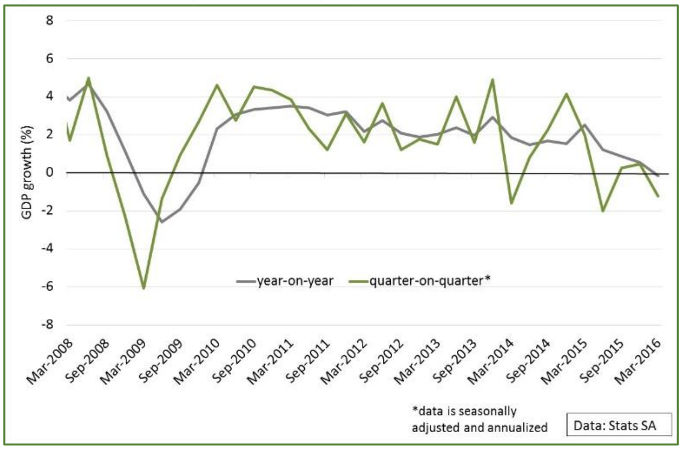
Gross Domestic Product

Stats SA's GDP data released in June showed that the South African economy contracted by a significant 1.2 per cent compared to the last quarter of 2015. Compared to the first quarter of 2015 the economy contracted by 0.16 per cent – the first year-on-year contraction since 2009.

Figure 1: Quarterly economic performance



The poor economic performance was primarily due to the effects of the country-wide drought since late 2015, a large reduction in mining output, as well as overall lower household consumption and investment in the economy.

Over the quarter, modest growth was recorded for the global economy (3.2%), while emerging market economies (4.7%) and advanced economies (1.6%) improved on their previous quarter's performance.

Mining

The mining sector contracted by a significant 18 per cent over the quarter, subtracting 1.3 per cent from the quarter's growth. This was due to a decline in iron ore and platinum production.

Agriculture and the drought

The drought affecting many parts of the country since late 2015 has severely affected the field-crop, horticulture and animal production of the agriculture sector. The Department of Agriculture, Forestry and Fisheries estimates domestic maize production to only be 7.7 million tons for 2015/16 compared to 9.9 million tons for the previous year. This contributed to the agriculture sector contracting by a 6.5 per cent over the quarter, subtracting 0.11 of a percentage point from the quarter's growth.

Table 1: international quarterly growth comparison

	2015					2016
	Q1	Q2	Q3	Q4	Year	Q1
China	6.4	7.2	6.9	6.5	6.9	6.3
India	7	10.4	7.9	4.8	7.5	9.6
Indonesia	4.1	4.8	5.2	5.8	4.8	3.9
Russia	-10.1	-4.1	0.4	-1.6	-3.7	1.1
Turkey	4.4	5.1	4.5	4.9	4	3.1
Brazil	-4.5	-7.7	-6.2	-5.2	-3.8	-1.1
Mexico	1.8	2.5	3.2	2.2	2.5	3.3
South Africa	*2.0*	*-2.0*	*0.3*	*0.4*	*1.3*	*-1.2*
Advanced economies	1.9	1.9	1.9	1.3	2	1.6
Emerging market economies	3.5	4.5	4.7	3.8	4	4.7

*quarterly growth is based on seasonally adjusted and annualised data

Data: Stats SA and SARB

Electricity

The utility sector – comprised of the electricity, gas and water industries – contracted by 2.8 per cent, subtracting 0.06 of a percentage point from the quarter's growth. The sector's contribution to growth has been in decline over the last five years, contracting by an average of 0.1 per cent per year since 2010. This is largely due to a reduction in the electricity produced in the country.

Figure 2: Quarterly economic sector performance

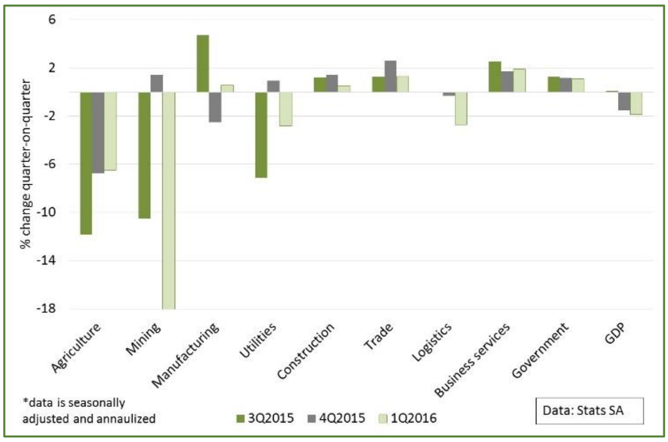
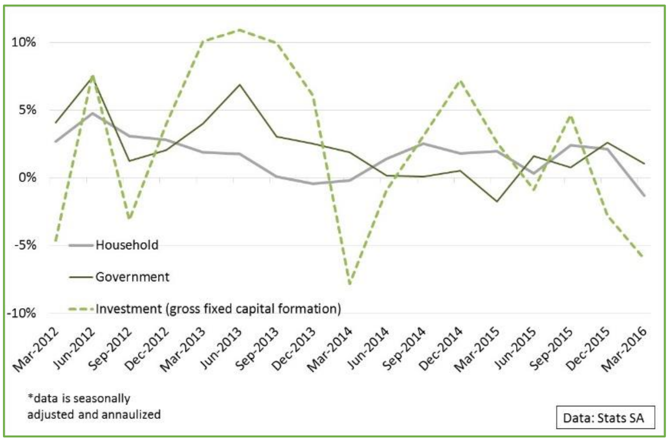
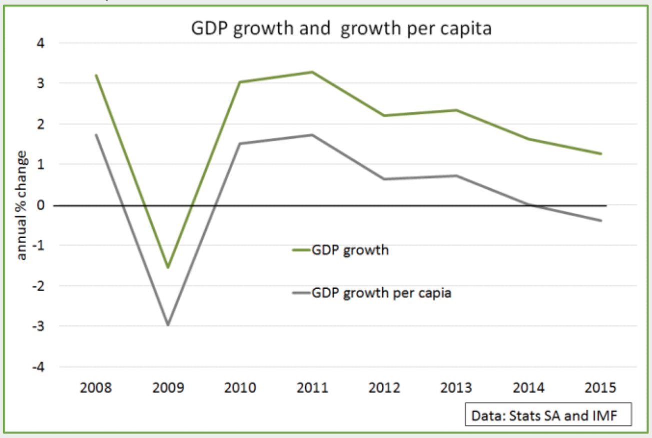


Figure 3: Components of gross domestic expenditure



Economic recession and per capita growth

An economic recession is technically defined as two or more consecutive quarters of contracting economic output. South Africa's last technical recession occurred between January and December 2009, where the country experienced four consecutive quarters of contracting economic output. This resulted in an annual contraction of 1.53 per cent. The effects of the global economic recession were primarily responsible for this contraction. Since then, the country has experienced two quarters of contracting growth – second quarter 2014 and first quarter 2016. If South Africa were to record a contraction in GDP in the second quarter of 2016, the country would be in a technical recession.



When economic growth is considered relative to the size of the population, the country's GDP per capita remained the same in 2014 and declined by 0.4 per cent in 2016. This indicates, that although the country is not in an economic recession, on a per capita basis the country is poorer today than it was in 2014.

Gross Domestic Expenditure

Real gross domestic expenditure contracted by 1.3 per cent in the first quarter of 2016 compared to the previous quarter. The contraction in total expenditure in the economy was due to a contraction in both household spending on goods and services (-1.3%), and total investment in the economy (-6%). The contraction in overall household spending, especially spending on durable goods, is in-part, due to higher inflation and interest rates.

General government spending on goods and services grew by 1 per cent in the first quarter compared to the previous quarter. This is consistent with government's attempt to moderate expenditure growth to meet fiscal consolidation objectives.

Domestic investment, represented by gross fixed capital formation, contracted by 6 per cent over the first quarter. This was due to significant contractions in private sector and government investment.

Employment

The Quarterly Labour Force Survey (QLFS) for the first quarter of 2016 indicated that unemployment in South Africa was at a 10-year high. The survey found the official rate of employment at 26.7 per cent – 0.3 per cent higher than recorded for the first quarter of 2015. The broad – or expanded – unemployment rate, which includes discouraged job-seekers, is estimated to be 36.3 per cent, marginally higher than recorded a year ago.

Table 2: Key labour statistics - QLFS

	1Q 2015	4Q 2015	1Q 2016
Labour force ('000s)	**20 994**	**21 211**	**21 377**
Employed	15 459	16 018	15 663
Unemployed - official	5 535	5 193	5 714
Unemployed - broad*	8 736	8 187	8 927
Not economically active ('000s)	**14 805**	**15 061**	**15 054**
Discouraged job-seekers	2 397	2 279	2 449
Other (not economically active)	12 408	12 782	12 605
Rates			
Official unemployment rate (narrow)	26.4%	24.5%	26.7%
Broad unemployment rate*	36.1%	33.8%	36.3%

*The broad unemployment rate includes discouraged job seekers
Data: Quarterly Labour Force Survey, Stats SA

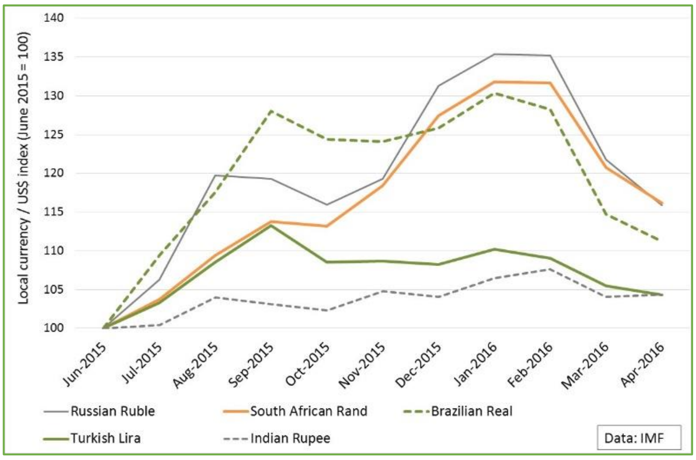
While the total number of people employed grew by 1.3 per cent over the last year, this growth was exceeded by the growth in the labour force (1.8%), resulting in an overall increase in the unemployment rate.

Exchange rate

The rand appreciated 18 per cent against the US dollar over the first four months of the year, from the December 2015 high of R16.80 to around R14.20 in April. Global factors, particularly the more gradual increase of US interest rates, US dollar weakness, and improved commodity prices contributed to currency appreciation across most emerging-market economies. Domestically, the country's commitment to reducing its debt levels, and the South African Reserve Bank increasing the repo rate also contributed to the strengthening of the rand.

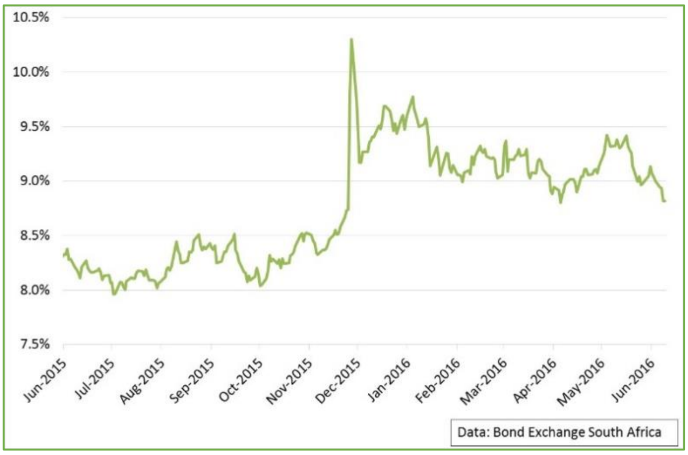
Figure 4: Rand vs US dollar

Figure 5: Rand and fellow emerging-market currencies



Sovereign risk

Figure 6: Yield on SA 10-year bond



The yield on South Africa's 10 year benchmark bond – an indicator of the riskiness of South African government bonds – decreased from the December 2015 high of 10.3 per cent to around 8.8 per cent in mid-April 2016. Part of this improvement was due to increased investor appetite for emerging market assets, especially due to the US Federal Reserve indicating a gradual increase to US interest rates. SA bond yields increased again during May, amidst concerns of a credit-rating downgrade. Following the affirmation of the country's investment-grade credit rating by all three agencies, SA bond yields improved.

South Africa's credit rating

During May and June credit ratings agencies Moody's, S&P, and Fitch affirmed the country's sovereign rating at an investment grade. The agencies noted risks that may result in a downgrade to non-investment status.

- Substantiating its decision, *Moody's* noted that the SA economy is likely to recover from 2017 onward, and that the country's debt is likely to stabilise this year due to the fiscal consolidation measures as per the 2016 Budget.
- *Standard & Poor's* noted that its negative outlook reflected the adverse consequences of lower growth. It warned that if policy measures do not improve economic performance, it may lower the country's rating (to sub-investment). S&P also warned that political tensions are also affecting the country's sovereign credit profile.
- *Fitch* noted that the risk posed by the country's low growth, high budget and trade deficits, and high debt levels are a cause for concern. However, Fitch added that these are balanced by strong institutions, well developed capital markets and a favourable debt-structure. It also views the country's fiscal consolidation measures as credible.

Responding to the three ratings agencies, National Treasury noted that its policy of fiscal consolidation was appropriate. It further noted that the next six months were critical to improve the performance of the economy, and that that government is taking steps aimed at:

- Restoring investor confidence and boosting investment
- Unblocking obstacles to faster employment growth
- Undertaking fiscal, State-owned companies, and regulatory reforms.

Comparing South Africa's debt outlook

Fitch	Moody's	S&P		Countries (selected)	
A+	A1	A+	Upper medium grade	Botswana	Malaysia
A	A2	A		Czech Rep.	Poland
A-	A3	A-		Japan	Slovakia
BBB+	Baa1	BBB+	Lower medium grade	India	Mexico
BBB	**Baa2**	BBB		Italy	Spain
BBB-	Baa3	**BBB-**		**South Africa**	Turkey
BB+	Ba1	BB+	Non-investment grade speculative	Bangladesh	Namibia
BB	Ba2	BB		Brazil	Portugal
BB-	Ba3	BB-		Indonesia	Russia

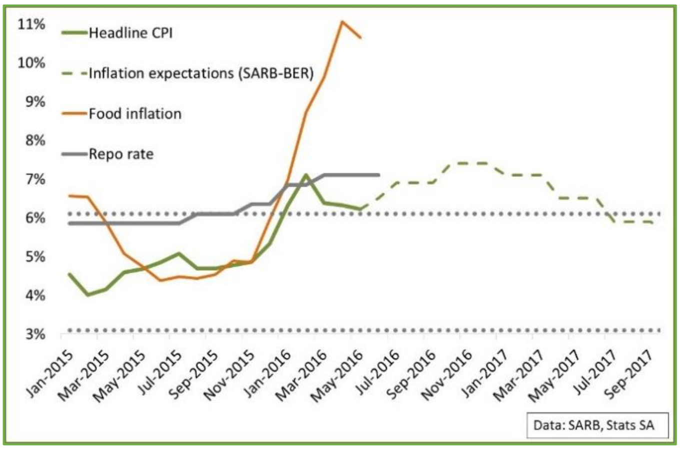
Inflation and monetary policy

Headline inflation – as measured by the consumer price index (CPI) for all urban areas – has exceeded the 6 per cent upper bound of the South African Reserve Bank's (SARB) target since the beginning of the year, averaging 6.37 per cent over the first five months of 2016. Inflation peaked in February (7%) and has since moderated.

The increase in inflation is due to both the effects of a weaker rand and higher overall food prices due to the drought. Food inflation has accelerated since the beginning of the year, averaging 9.3 per cent over the first five months of the year. Inflation is expected to remain above the SARB's target range for the next 12 months, averaging 6.7 per cent in 2016, and falling below 6 per cent in July 2017.

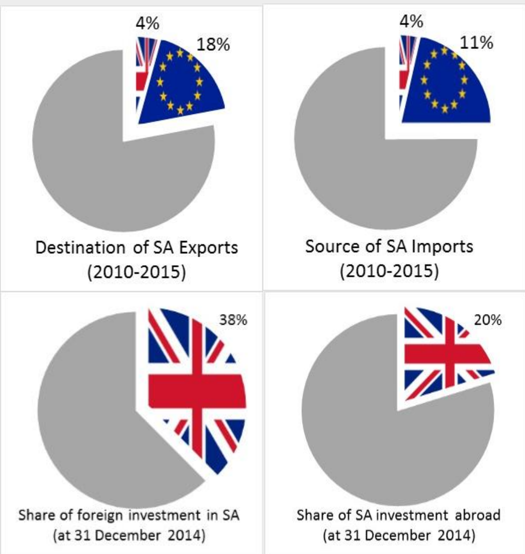
After increasing the repo rate at its January and March meetings, the Monetary Policy Committee kept the repo rate fixed at 7 per cent at its meeting in May. The Monetary Policy Committee noted that there are several up-side risks to inflation that may warrant further increases to the repo rate in the future. These include food prices, the oil price and the exchange rate.

Figure 10: Inflation and monetary policy



The Brexit and South Africa

The outcome of the 23rd June referendum for the UK to leave the European Union, commonly referred to as the "Brexit", has significant implications for the South African and the world economy. Although the British pound and the London Stock Exchange responded negatively to the announcement, the full extent and nature of the implications of Brexit are not known at present. The IMF estimates that the Brexit is likely to reduce UK growth over the medium-term by between 1.3 and 5.2 per cent, while the OECD estimates the Brexit will reduce UK growth by 3.3 per cent in the medium-term, and by between 2.7 and 7.7 per cent in the long-run. The UK will have to negotiate about 60 trade agreements with non-EU economies – previously covered by it being part of the EU. The nature of, and time it takes to reach the new agreements will affect the UK economy.



(data: SARS)

South Africa, as a small open economy with significant trade and investment ties to the UK and the EU, is exposed to these developments. The departure of the UK from the EU is likely to affect the South African economy, through the following channels:

Financial instability and uncertainty increases demand for assets perceived to be safe and decreases demand for assets perceived to be risky. South Africa, as an emerging-market economy, experiencing slow growth, credit ratings just above non-investment grade, and relatively high national debt, is perceived to be risky. To date, SA stocks and bonds have experienced a sell-off following the referendum, which has contributed to rand depreciation.

If the Brexit results in slower growth in the UK, the EU and world economy, demand for South African exports and the price of SA commodity exports will reduce. Leaving the EU leaves UK companies without duty-free access to European markets. The nature of the new UK – EU agreement will affect the UK and EU and ultimately the South African economy.

The EU-SADC Economic Partnership Agreement, recently signed, will no longer include the UK. South Africa and the SADC will have to enter new trade negotiations with the UK. In the absence of a new trade agreement, SA exports will not enjoy preferential access to UK markets and trade may be disrupted.

Depreciation of the British Pound and losses to London Stock Exchange will affect South Africa more than fellow African countries as there are more South African companies that are either listed or with operations in the UK. A weaker pound hurts profitability in rand terms, while SA companies with operations in the UK will not have duty-free access to EU markets until a new agreement is reached.

Outlook

National Treasury presented its lowest growth forecast for the current year (2016) in 17 years in the 2016 Budget. Its forecast was marginally higher than the forecasts of other agencies. The economy has since experienced one quarter of contraction. Updated forecasts suggest growth for the current year will be significantly lower than the 0.9 per cent forecast by the National Treasury. The Bureau for Economic Research expects growth for 2016 to be 0.1 per cent, while some respondents surveyed by Reuters forecast an annual contraction for 2016 (Nedbank: -0.1%). Significantly lower-than-expected growth will affect the country's ability to meet it fiscal consolidation objectives.

Table 3: Growth outlook

GDP growth outlook	2016	2017	2018
National Treasury - Budget 2016	0.9%	1.7%	2.4%
South African Reserve Bank - January 2016	0.9%	1.6%	-
South African Reserve Bank - May 2016	0.6%	1.4%	1.8%
Bureau of Economic Research - 1Q 2016	0.8%	1.5%	-
Bureau of Economic Research - 2Q 2016	0.1%	1.3%	2.2%
International Monetary Fund - January 2016	0.7%	1.8%	-
International Monetary Fund - April 2016	0.6%	1.2%	-
World Bank - January 2016	1.4%	1.6%	2.4%
World Bank - June 2016	0.6%	1.1%	2.0%
Reuters econometer (median) - February 2016	0.9%	1.5%	-
Reuters econometer (median) - June 2016	0.4%	1.2%	1.8%

Internationally, commodity prices, the developments surrounding Brexit, and the timing and extent of policy normalisation by the US Federal Reserve will affect the South African economy. International commodity prices have increased marginally since the beginning of the year, continued increase to commodity prices will support South African exports and the rand.

Domestically, the effects of the drought, higher interests rates, a weaker exchange rate, and declining investment and consumer spending are likely to negatively affect the country's growth this year. Multi-year wage negotiations in the mining sector also pose a risk to mining output.